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Statement of  
Alan Greenspan  
Chairman  
Board of Governors of the Federal Reserve System  
before the  
Committee on Banking and Financial Services  
U S House of Representatives  
May 22, 1997

I am pleased to be here today to present the views of the Board of Governors of the Federal Reserve System on the financial modernization legislation introduced by Chairman Leach, H.R. 10, the Financial Services Competitiveness Act of 1997. This bill would reform the Glass-Steagall prohibitions to permit the affiliation of banks and securities firms. It would also permit bank and insurance company affiliations and provide the flexibility for banking organizations to engage in other "financial" or "incidental" activities. The Competitiveness Act would facilitate the ownership of banks by other financial firms by creating a category of uninsured wholesale banks that may have some commercial affiliations. H.R. 10 would produce identical rules for banks and federally chartered thrifts and rationalize their regulation and supervision.

The Board strongly supports the approach to financial modernization embodied in H.R. 10. We believe it would improve the efficiency and competitiveness of the financial services industry and result in more choices and better service for consumers. However, as the Committee knows, the Board opposes one aspect of the bill, the authorization for so-called operating subsidiaries of banks to engage in some financial activities not permitted to their parent bank. Our concern is the transference of the safety net subsidy directly to those activities that the bill would authorize for subsidiaries of banks.

### **Better Services to the Public**

The Board believes that the Congress should widen the permissible range of affiliations for banking organizations in order to expand the choices for consumers and increase the efficiency of financial markets. Financial modernization should remove outdated restrictions that serve no useful purpose, that decrease economic efficiency, and that, as a

result, limit choices and options for the consumer of financial services. Such statutory prohibitions result in higher costs and lower quality services for the public. Their removal would permit banking organizations to compete more effectively in their natural markets. The result would be a more efficient financial system providing better services to the public.

Indeed, the Board urges that, as you consider the reforms before you, the focus not be on which set of financial institutions should be permitted to take on a new activity, or which would, as a result, get a new competitor. All are doing similar things now and are currently in competition with each other, offering similar products. Securities firms have for some time offered checking-like accounts linked to mutual funds, their affiliates routinely extend significant credit directly to businesses, and they are becoming increasingly important in the syndicated loan market. Banking organizations are already conducting a securities business. While indicative of the need for reform, which institution has hurdled some earlier restraint is not the issue. The Board believes that the focus should be: do H.R. 10 and the other proposed bills promote a financial system that makes the maximum contribution to the growth and stability of the U.S. economy? Is the removal of existing restraints in these bills consistent with a safe and sound banking system and containment of the federal safety net? Do the proposals increase the compatibility of our laws and regulations with the changing technological and global market realities in order to ensure that these goals are achieved? Are they consistent with increased alternatives and convenience for the public at a manageable risk to both the bank insurance fund and financial market stability? With the previously noted caveat, Mr. Chairman, the Board believes that these questions can be answered in the affirmative for your bill.

Banking organizations are in a particularly good position to provide securities underwriting, insurance, and other financial services to investors. They are knowledgeable about the institutional structure of the market, skilled at evaluating risk, knowledgeable about the financial needs of their customers, and operate from locations that are convenient for the public. Moreover, for centuries, the special expertise of banking organizations has been to accumulate borrower-specific information that they can use to make credit and related judgments that less well-informed savers and depositors cannot make. Using such information asymmetries has been the value added of banking on the credit side.

It would appear that many companies and individuals want to deal with a full-service provider that can handle their entire range of financing needs. This preference for "one-stop shopping" is easy to understand. Starting a new financial relationship is costly for companies and individuals and, by extension, for the economy as a whole. It takes considerable time and effort for a customer to convey to an outsider a deep understanding of its financial situation. This process, however, can be short-circuited by allowing the customer to rely on a single organization for deposit services, loans, strategic advice, the underwriting of debt and equity securities, and other financial services. As evidence that there are economies from this sharing of information, most of the Section 20 underwriting has been for companies that had a prior relationship with the banking organization.

The economic benefits of "one-stop shopping" can readily be seen for small and medium-sized firms. These firms, as a rule, do not attract the interest of major investment banks, and regional brokerage houses do not provide the full range of financial services these companies require. Rather, their primary financial relationship is with the commercial

banking organizations where they borrow and obtain their services. From the borrower's perspective, it makes sense to leverage this relationship when the time comes to access the capital markets for financing. It is thus reasonable to anticipate that if securities activities are authorized for bank affiliates, banking organizations, especially regional and smaller banking organizations, would use their information base to facilitate securities offerings for smaller, regional firms. The same efficiencies are likely to benefit local municipal revenue bond issues.

The Board's recent action to raise the Section 20 limits on ineligible revenues to 25 percent of the total will increase the number of banking organizations that can engage in securities underwriting. However, there are still a large number of banks that do not have the necessary volume of government, agency, and municipal bonds transactions to meet the other 75 percent of the total that would permit them to engage in an economically viable volume of corporate and/or municipal revenue bond underwriting, and hence to service their smaller customers. Investment banking services are now available for some of these smaller issuers, but at a relatively high cost. Moreover, the Board's recent decision does not address other important aspects of securities activities that are dealt with by H.R. 10, such as authorizing merchant banking and mutual fund sponsorship.

The convenience and cost savings for companies issuing securities will also accrue to individuals seeking other financial services. There are real potential benefits to consumers of "one-stop shopping" for loans, deposits, money market accounts, securities, and insurance. It is only artificial and outdated restrictions that stand in the way of lower cost and convenient delivery systems for our citizens.

### **The Need for Congress to Shape Developments**

Three major forces are rapidly changing our financial system and rendering old structures obsolete. These forces offer Congress the opportunity to restructure the financial services industry in a way that will serve the public interest by assuring minimum cost, maximum service, and prudent risk management.

The most profound force is, of course, technology—the rapid growth of computers and telecommunications. Their spread has lowered the cost and broadened the scope of financial services, making possible new product development that would have been inconceivable a short time ago, and, in the process, challenging the institutional and market boundaries that in an earlier day seemed so well defined.

Technological innovation has accelerated the second major trend, financial globalization, that has been in process for at least three decades. Both developments have expanded cross-border asset holdings, trading, and credit flows and, in response, both securities firms and U.S. and foreign banks have increased their cross-border locations. Under a congressional mandate, foreign offices of U.S. banking organizations have for some time been permitted, within limits, to meet the competitive pressures of the local markets in which they operate by conducting activities not permitted to them in the United States. In the evolving international environment, these off-shore activities have included global securities underwriting and dealing, through subsidiaries, an activity in which U.S. banking organizations have been among the world leaders, despite limitations on their authority to distribute securities in the United States.

Such a response to competition abroad is an example of the third major trend reshaping financial markets—market innovation—which has been as much a reaction to technological change and globalization as an independent factor. These developments make it virtually impossible to maintain some of the rules and regulations established for a different economic environment. As a result, the kinds of activities our banking organizations are conducting no longer fit the traditional paradigms of deposit taking and loan making.

Technological change, globalization, and regulatory erosion will eventually make it impossible to sustain outdated restrictions. That is what we are here today to discuss—the need to remove outdated restrictions and to rationalize our system for delivering financial services.

### **Risks in Modernization**

To be sure, with the benefits of financial modernization come some risks, but the Board believes the evidence indicates that the risks in securities underwriting and dealing are manageable. Underwriting primarily is a deals oriented, purchase and rapid resale, mark-to-market business in which losses, if any, are quickly cut as the firm moves to the next deal. Since the enactment of the Securities Acts—with their focus on investor protection—the broker/dealer regulator, the SEC, is quick to liquidate a firm with insufficient capital relative to the market value of its assets, constraining the size of any disturbance to the market or affiliates. The SEC now applies such supervision to Section 20 affiliates, and it would do so to securities affiliates under H.R. 10 and similar bills introduced in this Congress. Section 20 affiliates have operated during a period in which sharp swings have occurred in world financial markets, but they still were able to manage their risk exposures well with no

measurable risks to their parent or affiliated banks. Indeed, in order to limit the exposure of the safety net, the supervisors have insisted that securities affiliates have risk management and control systems that assure that risk can be managed and contained. As would be the case for securities affiliates with the Competitiveness Act, the Federal Reserve has required that such an infrastructure exist before individual Section 20 affiliates are authorized and that organizations engaging in these activities through nonbank affiliates have bank subsidiaries with strong capital positions.

The bill proposed by Chairman Leach attempts to accommodate the merchant banking business currently conducted by independent securities firms. Both bank holding companies with Section 20 subsidiaries and independent securities firms engage in securities underwriting and dealing activities. However, independent securities firms also directly provide equity capital to a wide variety of companies without any intention to manage or operate them. The Leach bill would permit securities firms that acquire commercial banks, as well as securities firms acquired or established by bank holding companies, to engage in all of these activities—underwriting and dealing in securities, as well as merchant and investment banking through equity investment in any business without becoming involved in the day-to-day operations of that business. These powers are crucial to permit securities firms to remain competitive domestically and internationally. Under the bill, the Board could establish rules to ensure that these activities do not pose significant risks to banks affiliated with securities firms, serve as a "back door" to the commingling of banking and commerce, or unduly spread the subsidy impact in the safety net.



As for insurance, the evidence is clear that, where risk is diversifiable and, hence, predictable, such as life and certain property insurance lines, the resultant business risks are manageable. The evidence is less clear for catastrophe-related property insurance. Other risks come from the same sorts of credit and interest rate risks about which banks are already knowledgeable. Life, automobile, and other insurance sales are virtually riskless and authorizing insurance brokerage sales by banks is likely to add additional convenience and service, as well as lower prices, for the public.

H.R. 10 would continue the holding company framework for nonbank activities, which the Board believes is important in order to limit the direct risk of new financial activities to banks and the safety net. The Board is of the view that the risks from securities and insurance underwriting are manageable using the holding company framework proposed in the Competitiveness Act. But there is another risk—the risk of transference to nonbank affiliates of the subsidy implicit in the federal safety net—deposit insurance, the discount window, and access to the payments system—with the attendant moral hazard. As the Committee knows, the Board believes that the subsidy is more readily transferred to a subsidiary of an insured depository institution than to its affiliates, and that the holding company structure creates the best framework for limiting this leakage. We have concluded accordingly that the further the separation from the bank, the better the insulation. We are concerned that conducting securities and similar activities as principal in subsidiaries of U.S. banks does not create sufficient distance from the bank.

Let me be clear that bank holding companies and their subsidiaries also benefit from the subsidy implicit in the safety net. Their capital costs are lower since a portion—currently

a large part of—the consolidated assets of the organization are in subsidiary depository institutions that have direct access to the safety net. This transfer, of course, is significantly smaller than the direct transfer to a bank subsidiary. But it is large enough to suggest that we should be cautious about extending permissible activities of bank or financial services holding companies to include nonfinancial commercial enterprises. Generally, public policy should give wide range to free market competition, including business decisions on affiliations. However, when such affiliations may imply subsidy transfers at best—and taxpayer support at worst—we should be very careful.

The world is changing rapidly and it may well become increasingly difficult to distinguish between banking and aspects of commerce. However, the free and open legal association of banking and commerce would be a profound and surely irreversible structural change in the American economy. We should, as a result, be careful to assure ourselves that whatever changes are made in our financial system do not distort our continued evolution to the most efficient financial system. In earlier testimony, I suggested that we would have to review carefully the kinds of combinations that could occur with a permissible basket for nonfinancial firms. As we have done so, the problems exposed have led us to a more cautious position. More generally, the subsidy transfer concerns and our uncertainty about the ultimate impact of free affiliation between banking and commerce on our financial system suggest to the Board that at least any wider authorization of banking and commerce should be postponed while we focus on financial modernization. Concerns about ensuring a two-way street should be addressed without attempting to make final decisions now about any future wider combinations of banking and commerce.

The legislation proposed by Chairman Leach also provides for oversight of the consolidated activities of a financial services holding company. The Board believes such oversight is essential to a sound financial system in which the public can have confidence. Some, however, have expressed concerns that such oversight is incompatible with an institution that owns a number of otherwise unregulated subsidiaries. That view is presumably directed at an expected level of significant supervisory intrusion and possibly from fear of new regulatory constraints by those acquiring a bank for the first time.

The Board also has concerns about excessive oversight, although for somewhat different reasons. In an environment of greater deregulation and financial reform, market discipline becomes ever more critical. Such discipline requires that market participants correctly perceive that nonbanking entities are not covered by the federal safety net. Providing bank-like supervision to nonbank affiliates of banks in the context of financial reform would send the wrong signal, creating difficult moral hazard issues. For these reasons, the agency charged with consolidated oversight should have a clearly defined -- -- role—one that permits it to protect affiliated banks and the safety net from abuse and excessive risk, while permitting operational synergies and imposing minimal interference with the growth or activities of the bank's affiliates.

### **Consolidated Oversight**

The Board believes that combination of the holding company vehicle and Federal Reserve supervision and regulation under the Bank Holding Company Act has limited the transfer of the safety net from the banks to the holding company parent and its nonbank subsidiaries. The historical experience in supervising bank holding companies also has shown

that knowledge of the financial strength and risks inherent in a consolidated holding company can be critical to protecting an insured subsidiary bank and resolving problems once they arise. Examples are easy to recall. BCCI, Continental Illinois, Barings PLC, thrifts, and Texas banks all exhibited problems that spread quickly among their affiliates, or required a consolidated approach to resolve the problems at least cost and disruption to the financial system. By approaching matters from the perspective of a consolidated organization, the Federal Reserve, the agency historically charged with conducting consolidated oversight, has also helped to *prevent* banking problems by addressing operational or capital deficiencies within a subsidiary bank, or elsewhere in the organization.

Moreover, continued gains in technology and in innovative risk management techniques permit organizations of all kinds to manage and control their activities on an increasingly centralized basis, with less attention paid to the individual legal entities that make up the organization. In that environment, it seems to the Board that oversight on a consolidated basis of an organization's broad-based activities becomes more crucial, not less. Bank supervisors throughout the world recognize this point, and have adopted consolidated oversight as a fundamental principle. The Congress also recognized the necessity of consolidated oversight for the U.S. banking system, by requiring, as a condition for a foreign bank's entry into this country, that the bank be subject to consolidated home country supervision. What is necessary for foreign banks entering the United States is surely just as necessary for U.S. banks and the U.S. banking system.

While important, consolidated oversight need not become unduly intrusive to financial services holding companies. The necessity to understand and review centralized risk

management and control mechanisms, and similarly to review intra-organizational fund transfers involving the insured depositories, does not require bank-like supervision of nonbank affiliates. H.R. 10 recognizes this. It would require the banking agencies to rely to the fullest extent possible on examination reports and other information collected by supervisors of other regulated entities. It would also provide for quite limited consolidated oversight for those organizations in which the bank subsidiaries represent a modest part of the overall organization and do not exceed a maximum size. In addition, the bill would require the banking agencies to defer to the SEC in interpretations and enforcement of the federal securities laws. It further eliminates the current legal requirements for applications for nonbanking activities by holding companies that own relatively small banks, an approach we believe could also be extended quite usefully to bank acquisition proposals. These are extremely important provisions both for existing bank holding companies and for securities firms and insurance companies that wish to affiliate with banks. Such provisions would greatly enhance the "two-way street" by eliminating unnecessary burden and red tape.

The Board not only supports these changes, but also recognizes that its own traditional approach to supervising and regulating bank holding companies must change as technology changes. Indeed, such changes are already well underway. They include a much streamlined application process, a more risk-focused/less transaction-testing approach to inspections, fewer firewalls between banking and securities affiliates of bank holding companies to accommodate operating synergies, and greater reliance on internal and external auditors. In anticipation of financial modernization legislation, the Board is considering alternative approaches to evaluating the capital adequacy of heterogeneous financial conglomerates, when banking is

not the dominant activity. Such flexibility would be required to ensure that bank-like standards are not indirectly imposed on insurance or securities firms and that the standards of their primary regulator prevail and allow them to compete effectively.

As the affiliates of banks increasingly conduct a nonbanking business, the desirability of avoiding the extension of bank-like regulation will require that the agency with oversight responsibility rely heavily on published financial reports, agency reviews of existing management information, examinations by other supervisors, and evaluations by market analysts when assessing the overall strength and potential riskiness of a bank's parent and affiliates. Such information can alert the oversight agency to look more closely at the organization and, if necessary, take steps to protect an affiliated bank. Indeed, that agency should be empowered and expected to prevent or curtail abusive practices and undue risks in an organization when they threaten affiliated banks and the safety net. Similarly, it should be just as responsible to assure that the transfer of the subsidy of the safety net from the bank to its affiliate, through intra-organizational funds transfers and other means, is kept to a minimum.

I believe the United States currently has a strong and effective supervisory process, and one that has also permitted its banking and financial system to fuel economic growth to a degree unmatched in the world today. While we have had our problems, most notably with thrifts, we must not forget our experience as we work toward a still-better approach. Our domestic banking system is also widely recognized as the most innovative and best capitalized system in the world, and its profits have reached new record levels in recent years. As I have pointed out previously, advancing technology will inevitably require increasing

reliance on private counterparty surveillance to contain credit and market risks. Nonetheless, we should recall that just six or seven years ago, events created pressures to expand and increase government banking supervision at all levels. In the present environment of prosperity and financial stability, it is easy to forget that experience and to believe that little or no oversight is now needed for consolidated entities.

We must move forward, but with proper balance, Mr. Chairman—with a balance that I believe your bill maintains, with the exception noted. The agency conducting consolidated oversight must be permitted to monitor both the financial condition of the organization and the potential transfer of risks to its insured depository affiliates. Moreover, we reiterate our concern that, regardless of how restructuring is addressed, the Congress not impair the ability of the Federal Reserve to monitor large banking organizations and respond effectively to systemic crises.

### **Conclusion**

Mr. Chairman, members of the Committee, the question is not whether we will have changes in financial markets. Technology, globalization, and market innovations are bringing rapid changes that cannot be reversed. The open questions are how banking organizations will participate, and will they do so in ways that appropriately balance the tradeoffs among risk, minimal use of the sovereign credit, and maximum competition, public benefit and convenience? If Congress does not act, the balancing will be done by market forces and, where possible, regulators forced to take positions by events. The Board believes that the Congress needs to act and that the Leach proposal—excluding authorization for new activities in bank subsidiaries—accomplishes a balancing of the risks and benefits of banks'.

participation in financial modernization The Board also urges that the Congress resist efforts to so limit consolidated oversight of banking organizations as to raise questions about our ability to limit risk exposures of insured depositories, to limit the transference of the safety net subsidy, or to prevent and manage financial market crises

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