S. HRG. 105–426

THE FEDERAL RESERVE'S PROPOSED CHANGES TO SECTION 20 FIREWALLS

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND REGULATORY RELIEF

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

ON

A REVIEW OF THE FEDERAL RESERVE'S PROPOSED MODIFICATIONS TO THE FIREWALLS THAT SEPARATE COMMERCIAL BANKS AND THEIR SECURITIES AFFILIATES TO DETERMINE IF SAFETY AND SOUNDNESS MEASURES ARE STILL IN PLACE, AND FOR OTHER PURPOSES

MARCH 20, 1997

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
47–726 CC WASHINGTON : 1997

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-056569-3

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THE FEDERAL RESERVE'S PROPOSED CHANGES TO SECTION 20 FIREWALLS

THURSDAY, MARCH 20, 1997

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
REGULATORY RELIEF,
Washington, DC.

The Subcommittee met at 10:05 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Lauch Faircloth (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. The Subcommittee will come to order.

I want to welcome all of the witnesses and the people that are here this morning because it is an important hearing and will have a lasting effect on the banking industry. So I thank everyone for coming.

This is the first hearing of the Financial Institutions Subcommittee in the 105th Congress. I want to welcome Senator Sarbanes and thank him for being here this morning. I look forward to working together. Also, Senator Bryan has now joined us.

Very simply, we called this morning's hearing because the Federal Reserve's proposal is an important one. In fact, much of what has transformed the banking industry over the last decade has been in the regulatory area, not in the legislative area. The legislative area should have taken a more aggressive lead position than it has. This is why we're having this hearing. It is the job of Congress to conduct prudent oversight of the banking agencies. With respect to this issue at hand, Section 20, firewalls.

No one is more supportive of doing away with unnecessary rules and regulations in the Federal bureaucracy than I am. But many of these laws are drafted by people who have never been involved in the private sector, banking or otherwise.

But having said that, we need laws to protect against financial fraud. Some people might say, and I hear this, that times have changed. It can't happen again. We have more capital in the industry and we have tougher regulators. This is true. But there can and there will be financial fraud, it is just a question of the scale to which it happens. It will happen.

That is why this Subcommittee is taking a close look at what the Federal Reserve is doing. Certainly, there's some duplication in the laws affecting banks and security firms that should be done away with. And I am fully supportive of raising the threshold to 25 percent for noneligible securities. But there are some important things that should be kept. In fact, the Federal Reserve has proposed keeping some of the key firewalls that we are going to be talking about today.

So the real purpose of the hearing is to explore these areas. Let's look at them and keep the Congress informed. That's what we plan to do with the witnesses today.

Before we begin, let me recognize Senator Bryan for an opening statement, and then Senator Sarbanes.

Senator BRYAN. Mr. Chairman, if you have no objection, I would be pleased to yield to the Ranking Member of the Full Committee, and then make a statement after that.

Senator FAIRCLOTH. Certainly.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Senator Bryan.

I am going to have to leave to go to another hearing. In fact, Chairman Greenspan is testifying this morning and I am supposed to be at that hearing. It's a busy day for the Fed on the Hill.

Mr. Chairman, I want to commend you for convening this important hearing. The growth of securities underwriting subsidiaries of bank holding companies, the so-called Section 20 subsidiaries, is one of the most significant developments in the structure of financial services over the past decade.

These securities affiliates have been approved by the Fed pursuant to its interpretation of Section 20 of the Glass-Steagall Act. To date, the Federal Reserve has conditioned approval for these securities affiliates on compliance with a set of numerous and rigorous firewalls.

Now, the Fed has proposed to modify these firewalls—actually, in fact, to eliminate most of them, or a great number of them. It is highly appropriate, therefore, that the Subcommittee review the firewalls and the Fed's recent proposal.

As I understand it, the firewalls imposed by the Fed on Section 20 subsidiaries serve three purposes.

First, and most importantly, they protect FDIC-insured banks and the taxpayers who stand behind that insurance fund. They are intended to prevent the risks associated with underwriting and with dealing in securities from spilling over into insured depository institutions. Specific provisions intended to prevent this include prohibitions on banks extending credit to or purchasing assets from Section 20 affiliates, and prohibitions on banks extending credit to enhance the marketability of or to repay securities underwritten by a Section 20 affiliate.

Second, certain firewalls are designed to prevent a Section 20 affiliate from competing unfairly with securities firms not affiliated with banks. For example, the Fed has prohibited banks from extending credit for the purpose of purchasing securities underwritten by a Section 20 affiliate.

Finally, some of the firewalls are designed to protect customers from potential conflicts of interest. As an example, the Fed has prohibited banks from purchasing securities underwritten by Section 20 affiliates for their trust and fiduciary accounts.

Now in January of this year, the Federal Reserve proposed the most sweeping revisions to these firewalls since the Fed began approving securities underwriting by Section 20 affiliates in 1987. In the Fed's own words, it is "proposing to eliminate most of them."

The gist of the Federal Reserve's position is that experience with Section 20 affiliates has shown that specific regulatory propositions for such affiliates are not needed. Instead, the Fed takes the view that the statutory provisions that apply to all bank affiliates are sufficient to govern the relations between a bank and an underwriting affiliate.

As I understand it, the Fed proposes to rely chiefly on Sections 23A and 23B of the Federal Reserve Act, which limit the volume of transactions between a bank and its affiliates and require such transactions to be on terms at least as favorable to the bank as those prevailing for comparable transactions.

The firewalls have protected banks and their customers and have not hindered the growth of Section 20 affiliates in number or in size. The Fed has recently taken action to allow these affiliates to grow larger.

The current proposal represents a significant change in the structure governing securities affiliates of banks. It deserves to be reviewed, both for its own importance, and for the light it may shed on any financial legislation the Committee may consider this Congress. Therefore, I think, Chairman Faircloth, this is a very important hearing.

Now, since I cannot stay, I am going to leave a couple of questions for the record for Governor Phillips.

Governor Phillips, the questions I want to ask you are about the adequacy of the statutory firewalls on which the Federal Reserve now proposes to rely. Currently, the regulatory firewalls adopted by the Fed prohibit certain types of transactions. For example, a bank is forbidden to lend money in order to make payments on or to increase the marketability of securities underwritten by a securities affiliate. A bank is also forbidden to purchase securities underwritten by an affiliate.

As I understand it, the statutory provisions discussed in your testimony limit the aggregate volume of transactions of affiliates, but do not prohibit some types of transactions. The question is don't some types of transactions pose such clear conflicts of interest that they should not be permitted at all? Aren't these precisely the types of transactions about which we need to be on guard, in fact, the very types of transactions that were found to be commonplace before the enactment of Glass-Steagall?

So, as you can see, my concern runs to the fact that some of these types of transactions you now are precluding from rigorously controlling through regulation. If you drop your regulations and rely only on the statutory provisions that run to the volume of transactions rather than the type of transaction, you are going to be permitting practices to take place which I think would cause any reasonable observer to be concerned about the safety and prudence, and competitive workings of our economic system.

Thank you very much.

Senator FAIRCLOTH. Thank you, Senator Sarbanes.

We have been joined by the Chairman of the Senate Banking Committee, Senator D'Amato. We would be delighted to hear his statement or anything he has to say.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

The CHAIRMAN. Senator Faircloth, I want to join with Senator Sarbanes in commending you for calling this hearing on this very important issue.

Let me say this. What I have a sense of is that we are having a very unwholesome competition, very unwholesome, and that competition is between the regulators.

We have the Comptroller of the Currency issuing regulations, and some of them are absolutely imprudent. And the Federal Reserve Board responding with equally imprudent proposals—to eliminate "firewalls."

I also join with Senator Sarbanes in expressing very real concern about almost a total abdication of separation between the Section 20 affiliate and the insured bank and assuring that we prevent self-dealing, and that we keep the resources of the American taxpayer from being placed at risk in situations that it was never intended to be used for.

Now, I have to tell you, as far as I am concerned, if this competition between the regulators continues, then I am prepared to start to offer piecemeal, single-shot legislation dealing with what I perceive to be overreaching, dangerous kinds of opening up taxpayers to the kinds of situations that we've experienced in years gone by.

We have seen failures where people never dreamed they would take place, just recently as it relates to the thrifts, taxpayers being exposed to losses of billions and tens of billions of dollars.

I know why the Fed is coming up with the proposal we examine today. They don't want to "lose the action." They are the prime regulator and they have done a good job. Suddenly the Comptroller's action makes the Section 20 affiliate and the holding company structure unnecessary because a bank can now create a subsidiary. I think the actions of both regulators imperil the system.

If we don't have taxpayers' dollars backing these business enterprises, through the FDIC, and that's what they are, I don't care. Run a casino, if you want. But, by gosh, let's make sure that we don't have taxpayers' dollars that are going to be placed at risk. It is just wrong.

I think that we, the Congress, also bear responsibility for having acted in a way which has encouraged and almost given license to the Office of the Comptroller to go their merry way by not acting on broad financial reform.

I would suggest one other thing, Mr. Chairman. I think that we should get Mr. Ludwig in here and go over some of these rules that he's promulgating. This mad dash, and that's what it is, this dash into an area that I think can jeopardize the taxpayers of this country by creating operating subsidiaries of a bank for the purpose of engaging in "nonbanking" activities—securities, insurance, etc.—that the bank itself is not permitted to engage in. It is probably not legal; it is certainly unwise.

I don't want to see a situation where we begin to get into the kinds of conflicts that Senator Sarbanes has touched on. Let's not kid ourselves, that is what we are doing, and we should not be allowing that.

So while I understand and I have great respect for the Fed and its work, and I have been a constant supporter, I will tell you, what we have now is an unhealthy competition between regulators.

Those are my concerns. I think it's wrong. I am going to ask that my full statement, which expresses what I have just said in very judicious terms be placed——

[Laughter.]

—in the record, and please strike all of my other remarks.

No.

[Laughter.]

Thank you, Senator Faircloth.

Senator FAIRCLOTH. Thank you, Senator D'Amato.

I voiced exactly what you just said previously, and I want our audience to know that there had been no——

The CHAIRMAN. No collaboration.

Senator FAIRCLOTH. —previous conversation or cooperation. Just simply, when the legislature failed to lead, then the regulators jumped in front, and that is exactly what happened.

Now, I would like to recognize the Ranking Member on this Subcommittee, Senator Bryan.

OPENING STATEMENT OF SENATOR RICHARD H. BRYAN

Senator BRYAN. Thank you very much, Mr. Chairman.

I want to join with my colleagues in commending you for holding this very important hearing.

Currently, there are some 28 firewalls which the Federal Reserve has in place which were designed to protect a bank and its customers from the potential hazards of combining commercial and investment banking. In January of this year, the Federal Reserve proposed sweeping revisions to those firewalls. Now, there are some who claim that the proposal doesn't go far enough, and others who complain that it goes too far.

My own personal inclination is to be very cautious in this area. And I say so, Mr. Chairman, because my baptism on this Committee as a new Member in 1989 was the occasion in which the savings and loan collapse burst forth upon the land. In retrospect, I believe that crisis could have been fully anticipated as a consequence of the enactment of Garn-St Germain in the early 1980's.

Then, as now, it is contended that it is a new world, that there are different types of competition, different kinds of products that are on the market. The S&L's asserted that they could no longer compete effectively in the marketplace. And so we changed dramatically, I say, we, the Congress, changed very dramatically the operating rules for S&L's. In 1989, we reaped the harvest of those changes and the American taxpayer suffered the consequence as the result of our action in enacting FIRREA, necessary to protect many, many depositors.

I remember all too well the fiasco of customers in the lobbies of Lincoln Savings and Loan branches being encouraged to swap their Federally-insured CD's for worthless junk bonds.

Soon thereafter, we faced a crisis in the banking industry. We provided a line of credit, which we did not have to draw down upon, and the industry today is healthy and enjoys record profits. We are all very pleased to see that that has come about.

But I guess the bottom line is that I am not crazy about expanding powers and reducing safeguards that may undermine the insurance fund and may lead to some regulatory abuses.

I am going to abbreviate my comments because Senator D'Amato has raised a concern that I have, and that is the competition among regulators to reach the lowest common denominator of regulation so that their particular regulatory institution will be more attractive than other rival regulators, reducing burdens upon those who are regulated.

I must say, I do not oppose the changes that we have made in the past to lighten the regulatory burden. I was a cosponsor of the legislation that was enacted in the last session of the Congress, The Economic Growth and Regulatory Paperwork Reduction Act of 1995, and before that worked with Members on both sides of the political aisle as we reduced the burdens on the banking industry with respect to the currency transaction reports.

I think those were solid and well thought out, and I believe that the burdens that existed prior to the enactment of these two pieces of legislation were appropriate for us to take action.

But having said that, it is my view that the overarching concern is to protect the public. And although financial institutions change and market conditions change and new financial products are offered almost monthly, it is my view that the basic quality of human nature has not changed, and that the underlying rationale—I say that with all respect to my colleagues—is that human nature has not changed, and human nature will not change. There are those who are obviously motivated by greed who cannot resist the temptation of taking advantage of others, and so I think we have to be realistic in terms of approaching the format that we are going to use as a regulatory model. And that is a concern that I have.

Let me just express one other concern and I will abbreviate my remarks, Mr. Chairman, because I do want to hear the witnesses, as I know my other colleagues do. That is that I am troubled to some extent by the fact that, rather than approaching this in a comprehensive sense, we have allowed the regulators to do it piecemeal. I have some real concerns about that.

I would hope that we can address a comprehensive regulatory update, recognizing that the old framework does not reflect the modern realities. But I must say I am going to approach this with a great deal of caution because I am concerned about the nature of some of the proposals that have been advanced and this competition among the regulators that our Chairman has so forcefully addressed himself to.

Thank you, Mr. Chairman.

Senator FAIRCLOTH. Thank you, Senator Bryan.

We recognize Senator Enzi of Wyoming.

OPENING COMMENTS OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman.

This hearing is an important part of the process of the regulatory changes that have been proposed by the Federal Reserve Board and they will have an enormous impact on the financial services industry.

The proposed regulatory changes not only have an impact on the select few that deal directly with the banks and securities, but also on the average American. This hearing is all about taking the necessary precautions against the possibility of repeating the errors that devastated the financial markets during the 1920's and the 1930's. It is our duty to carefully examine all attempts to remove the regulatory firewalls that have disciplined financial services in this country.

Granted, many changes other than the Glass-Steagall have taken place since the Great Depression that have provided additional safeguards and firewalls. Some of these firewalls are archaic and unnecessary. The financial services industry is changing and is growing at such a rapid pace that it has outgrown many of the restrictions.

I am not opposed to modernization. In fact, I am a champion of it. However, we should still proceed cautiously when dealing with such a far-reaching issue as this.

I look forward to further examining the regulatory changes.

Thank you, Mr. Chairman.

Senator FAIRCLOTH. Thank you, Senator Enzi.

I must say that I am delighted to see the interest shown by the other Senators on the Banking Committee this morning. It demonstrates to all of us the interest and the weight that it carries on this issue.

Now let me welcome our first witness. Dr. Susan Phillips, a Governor of the Federal Reserve Board, has been an outstanding member of the Board since 1991. She was former Chairperson of the Commodity Futures Trading Commission from 1983 to 1987.

Let me also add, Dr. Phillips, that your entire statement will be made part of the record. So we hope that you'll be able to keep the spoken part of your statement to 10 minutes or thereabouts.

We appreciate you being here today and we look forward to seeing you again because we are probably going to be having some more hearings.

OPENING STATEMENT OF SUSAN M. PHILLIPS MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Dr. PHILLIPS. Thank you very much, Mr. Chairman.

I am very pleased to be here today to discuss the Board's Section 20 firewalls. I will try to abbreviate my comments and would appreciate my full statement being included in the record.

Section 20 firewalls are the restrictions the Board has imposed on bank holding companies engaged in underwriting and dealing in securities. The purpose of the firewalls is to insulate a bank and its customers from the potential hazards of combining commercial and investment banking.

Since last year the Board has been engaged in a comprehensive review of the 28 firewalls it erected in the late 1980's, and the Board has recently proposed to eliminate a majority of those restrictions. This oversight hearing, I think, provides a constructive opportunity for comment and analysis of the Board's proposal.

To start, it might be useful to place the firewalls in their historical and regulatory context. Although the firewalls have served an important role, they are not the only protection against the hazards of affiliation of commercial and investment banks. It is these other protections on which the Board is proposing to rely in removing many of the firewalls.

One important protection is the placement of securities activities in a separate subsidiary of the bank holding company, rather than in the bank itself or a subsidiary of the bank. Affiliates of a bank are not under the bank's control, do not have their profits or losses consolidated with the bank's, and are less liable to have their creditors recover against the bank. A bank, therefore, has less incentive to risk its own reputation or expose itself or its customers to loss in order to assist a troubled Section 20 affiliate or a failed underwriting by that affiliate.

Also, because securities activities are conducted in an affiliate, banks are limited in their ability to fund those activities by Sections 23A and 23B of the Federal Reserve Act. These restrictions are vitally important. Section 23A limits the total value of transactions with any one affiliate to 10 percent of the bank's capital and limits transactions with all affiliates to 20 percent of capital. It also requires that substantial collateral be pledged to the bank for any extension of credit. Section 23B requires that inter-affiliate transactions be at arm's length and on market terms, and imposes other restrictions designed to limit conflicts of interest.

Thus, affiliate status prevents the bank from passing along the Federal subsidy inherent in the Federal safety net to its Section 20 affiliate by extending credit. Regulators could conceivably limit a bank's ability to use credit to subsidize a direct security subsidiary of the bank by applying Sections 23A and 23B. But the equity investment in the subsidiary would still be funded from subsidized resources backed by the Federal safety net. Even if the investment were deducted from the capital of the bank, the subsidy inherent in the transfer would remain.

A second protection is examination of the bank holding company, including the effect of securities activities on insured depository institution subsidiaries. The Federal Reserve monitors compliance with Sections 23A and 23B and other aspects of the relationship between a bank and its Section 20 affiliate. In its supervision of bank holding companies, the Board increasingly pays attention to risk-management systems and policies that are centralized at the holding company level governing both the bank and its Section 20 affiliate.

A final series of protections is the regulatory regime that applies to all broker-dealers, including Section 20 subsidiaries. The Securities Act of 1933 and the Securities Exchange Act of 1934 impose registration, capital and disclosure requirements, anti-fraud protections, and other investor-protection measures. These laws, and their enforcement by the Securities and Exchange Commission, address many of the safety and soundness and conflict-of-interest concerns about affiliation of commercial and investment banks.

Many of these protections were not present in 1987 when the Board first erected its firewalls. Section 23B of the Federal Reserve Act had not been adopted. Risk-based capital standards now require a bank to hold capital against many of the on- and off-balance-sheet exposures it maintains in conjunction with a Section 20 affiliate. Finally, the Interagency Statement on Retail Sales of Nondeposit Investment Products was not adopted until 1994. The Interagency Statement includes disclosure and other requirements that are now the primary means by which the Federal banking agencies seek to ensure that retail customers are not misled about the nature of nondeposit products they are purchasing on bank premises.

When the Board last year decided to re-examine the firewalls, we felt it important to do so with a fresh eye, benefiting from 10 years of experience supervising the Section 20 affiliates, acknowledging both regulatory and legal developments since 1987, and focusing on the relevance of the firewalls in today's financial markets. As we began to look at the concerns that the firewalls were designed to address, we asked two questions.

First, does the affiliation of a commercial bank and an investment bank cause safety and soundness or other concerns not present with any other commercial bank affiliation, concerns not addressed by general bank holding company regulation?

Second, does operation of a broker-dealer within a bank holding company cause concerns that independent operation does not—concerns not addressed by broker-dealer regulation?

In some areas, most notably, consumer protection, we believed that the answer was "yes." In most other areas, however, the Board believed, at least pending public comment, that the answer was "no."

The answers to these questions are important because the firewalls are far from costless. They impose operational inefficiencies on bank holding companies that increase their costs and reduce their competitiveness, and they limit a bank holding company's ability to market its products in a way that is both most profitable and desired by its customers. As such, the firewalls have served as a significant barrier to entry for small- and mid-sized bank holding companies because those companies cannot realize sufficient synergies or achieve adequate operating revenues to justify establishing a Section 20 subsidiary. The loss is not just to these companies, but also to their customers and market competition.

Let me now briefly mention the most important of the firewalls to which the Board has proposed changes. I will not discuss all 28 of the firewalls but have attached a summary list to my full statement and their proposed disposition.

The comment period on this proposal closed last week.

The Board proposed to eliminate a series of the firewalls that constitute a blanket prohibition on a bank's funding its Section 20 affiliate, and instead rely on the protections of Sections 23A and 23B of the Federal Reserve Act. The firewalls in question prohibit a bank from extending credit to a Section 20 affiliate or purchasing corporate and other nongovernmental securities being underwritten by the Section 20 affiliate, or in which the affiliate makes a market. These firewalls were intended to prevent a bank from assisting a troubled affiliate by lending to it on preferential terms or by bailing out a failed underwriting by purchasing securities that cannot otherwise be sold.

If the Board were to eliminate the funding restrictions, Sections 23A and 23B of the Federal Reserve Act would continue to impose quantitative and qualitative restrictions on inter-affiliate transactions. They would limit the amount of such funding, require that it be collateralized, require that such funding be on arm's-length terms and at market rates, and require that any purchase by the bank be approved by its outside directors. We believe these are substantial protections, and have proposed to rely on them in place of a firewall.

Indeed, 14 of the Section 20 subsidiaries which operate under the Board's 1987 securities order have for 10 years operated without a funding firewall, but subject to Sections 23A and 23B. The Board has not encountered funding abuses at those companies.

Three of the Board's firewalls restrict the ability of a bank to assist a Section 20 affiliate indirectly by enhancing the marketability of its products or lending to its customers. These firewalls prohibit a bank from extending credit or offering credit enhancements in support of corporate and other nongovernmental securities being underwritten by its Section 20 affiliate, or in which the Section 20 affiliate makes a market; extending credit to issuers of securities to repay principal or interest on securities previously underwritten by a Section 20 affiliate; or extending credit to customers to purchase securities currently being underwritten by a Section 20 affiliate. The firewalls share a common purpose—to prevent a bank from imprudently exposing itself to loss in order to benefit the underwriting or dealing activities of its affiliates.

However, as financial intermediation has evolved, corporate customers frequently seek to obtain a variety of funding mechanisms from one source. By prohibiting banks from providing routine credit or credit enhancements in tandem with a Section 20 affiliate, these firewalls hamper the ability of bank holding companies to serve as full-service financial services providers, reducing options for their customers. For example, existing corporate customers of a bank may wish to issue commercial paper or issue debt in some other form. Although the bank may refer the customer to its Section 20 affiliate, the bank is prohibited from providing credit enhancements even though it is the institution best suited to perform a credit analysis—and, with smaller customers, it is perhaps the only institution willing to do so.

As another example, the restriction on lending for repayment of securities causes a bank compliance problems when renewing a company's revolving line of credit if a Section 20 affiliate has underwritten an offering by that company since the credit was first extended. The bank must either recruit other lenders to participate in the renewal or amend the line of credit in order to specify that its purpose does not include repayment of interest or principal on the newly underwritten securities.

Even if these firewalls were lifted, a bank would still be required to hold capital against all credit enhancements and credit extended to customers of its Section 20 affiliate. Section 23B would require that such credit and credit enhancements be on an arm's-length basis. Similarly, the Federal anti-tying statute would prohibit a bank from offering discounted credit enhancements on the condition that an issuer obtain investment banking services from a Section 20 affiliate. Thus, for example, a bank could not offer such credit enhancements at below market prices, or to customers who were poor credit risks, in order to generate underwriting business for Section 20 affiliates.

The next pair of firewalls I will discuss requires a bank holding company to deduct from its capital any investment in or extensions of credit to a Section 20 subsidiary.

The original purpose of the deduction was to ensure that the holding company maintained sufficient resources to support its Federally-insured depository institutions. The Board proposed to eliminate this deduction.

The capital deduction is not required for any other nonbank subsidiary of a bank holding company and is inconsistent with Generally Accepted Accounting Practices which require consolidation of subsidiaries for accounting purposes. The deduction, therefore, has created confusion and imposed costs by requiring bank holding companies to prepare statements on two bases. The deduction does not strengthen the capital of either the bank or its Section 20 affiliate, and elimination of the deduction would not create or expose any incentive for a bank holding company to divert necessary capital from a depository institution to a Section 20 subsidiary.

The Board has already finalized important changes to the cross-marketing and interlocks firewalls which previously prohibited a bank and a Section 20 affiliate from sharing personnel or marketing efforts. The Board acted on these firewalls before the others because it had previously sought comment on them some years ago and because they were identified by commentors as the most truly burdensome.

After reviewing its experience administering these firewalls, the Board decided that they caused inefficiencies that could not be justified by any benefit to safety and soundness. In fact, to the extent that senior bank managers may now oversee related operations at a Section 20 affiliate, risk management and safety and soundness may actually be improved.

Moreover, existing disclosure requirements adequately address concerns about customer confusion arising from increased cross-marketing and employee interlocks. Specifically, the Interagency Statement on Retail Sales of Nondeposit Products states that, prior to the initial sale of a nondeposit product by a bank employee or on bank premises, the customer must receive and acknowledge a written statement that the product being sold is not Federally-insured, is not a deposit or other obligation of the bank, is not guaranteed by the bank, and is subject to investment risks including loss of principal.

I'm pleased to report that early indications of the effects of these changes and the change in the revenue limit have been favorable. The Board currently has pending three applications to establish a Section 20 subsidiary. As we had anticipated, two of these are small- to mid-size bank holding companies which may previously have found it either too expensive to fund the dual-staffing required by the interlocks restrictions or too difficult to generate sufficient eligible revenue to maintain compliance with a 10 percent revenue limit. Furthermore, existing Section 20 subsidiaries have indicated that they have been able to rationalize their organization and expand their activities given the added flexibility with respect to both staffing and revenue.

Before concluding, I should also like to note which restrictions the Board proposed to retain.

The Board proposed to retain as operating standards existing firewalls requiring adequate internal controls and documentation, including a requirement that a bank exercise an independent and thorough credit judgment in any transaction involving an affiliate. Such standards are especially important in the Section 20 context because of the likelihood that a bank and its Section 20 affiliate may be selling similar products to the same customer.

Because of the potential for customer confusion as to which products are Federally-insured, the Board proposed to require a Section 20 affiliate to make disclosures to customers similar to those that the Interagency Statement requires of banks selling nondeposit products on bank premises.

The proposal would also continue to prohibit an affiliated bank from knowingly advising a customer to purchase securities underwritten or dealt in by a Section 20 affiliate unless it notifies the customer of the affiliate's role. The proposal also continues to prohibit a bank and its Section 20 affiliate from sharing any nonpublic customer information without the customer's consent.

Thank you very much, Mr. Chairman. That concludes my formal statement.

Senator FAIRCLOTH. Thank you, Dr. Phillips.

Before we start the questioning of Dr. Phillips, I want to recognize Senator Grams from Minnesota for an opening statement.

OPENING COMMENTS OF SENATOR ROD GRAMS

Senator GRAMS. Thank you very much, Mr. Chairman. I'll try to be brief. I know we want to get to the questions.

This Subcommittee today will be reviewing the Federal Reserve's proposal of January 17 to significantly modify 28 regulatory firewalls that restrict transactions between a bank and its Section 20 securities affiliate.

Firewalls have been implemented by the Federal Reserve for two primary reasons. First, they maintain the safety and soundness of the deposit insurance system by buffering a bank from the risks of the activities of its nonbank affiliates. Second, for those who believe that a bank receives a net deposit insurance subsidy, they prevent the bank from artificially subsidizing the activities of its nonbank affiliates.

Historically, firewalls have been an effective mechanism for controlling transactions between banks and their affiliates. Such regulations, however, can be cumbersome and can increase consumers' costs for financial services. And it is because of these costs that I commend the Federal Reserve for looking into ways to judiciously amend their firewalls while still maintaining the safety and soundness of the deposit insurance system.

I think our review of firewalls is also important in the context of the current debate over financial modernization.

As you know, I strongly support financial modernization. I believe that the affiliation and cross-marketing restrictions of the Glass-Steagall Act and the Bank Holding Company Act artificially segregate the three types of financial services—banking, securities, and insurance. These laws create artificial barriers to competition that hurt consumers by making financial services more costly and less convenient.

It is my view that the application of statutory and regulatory firewalls between the bank and all of its nonbank affiliates and operating subsidiaries will permit us to terminate all affiliation and cross-marketing restrictions in a safe and sound manner.

Mr. Chairman, again, I want to commend you for holding this important oversight hearing and I look forward to hearing from our distinguished witness this morning.

Senator BRYAN. Thank you very much, Senator Grams.

Senator GRAMS. Thank you.

Senator BRYAN. The Chairman has asked me to recognize our colleague, Senator Reed, for any comments that he would care to make at this point.

OPENING COMMENTS OF SENATOR JACK REED

Senator REED. Mr. Chairman, like all of our colleagues, we are interested in the testimony of the witness.

Suffice it to say that the Section 20 subsidiaries have provided a great service to consumers and lower costs in delivery of securities. I am interested in hearing the rationale for some of these changes. But, by and large, the Federal Reserve's policy toward Section 20 subsidiaries have been very effective in delivery services to consumers throughout the Nation.

Thank you, Mr. Chairman.

Senator FAIRCLOTH. Thank you, Senator Reed.

I have some questions, and I am sure all of the other Senators do. But one fundamental question that is disturbing a lot of Senators, as you can gather by the number we have at this Subcommittee hearing this morning, is the rivalry between regulators in the banking industry.

I don't think it reflects well upon either of the regulators. Did the Fed decide to re-examine the firewalls because of what was going on by the Comptroller of the Currency? Did that influence your getting into the re-examining? What prompted the Fed to re-examine the firewalls? We have a lot of people here today, including a lot of Senators, so if you would, answer as briefly and to the point as possible.

Dr. PHILLIPS. Yes, sir, Mr. Chairman.

First of all, I don't think this question of rivalry with respect to other regulators played a factor at all in this particular case. In fact, really, the Federal Reserve is the only regulator that sets the firewalls. So in that sense, this was something that we were doing on our own.

Senator FAIRCLOTH. Well, may I interrupt you?

Dr. PHILLIPS. Surely.

Senator FAIRCLOTH. Does Mr. Ludwig know that?

[Laughter.]

Dr. PHILLIPS. I'm sure he does. Yes, I'm sure he does.

But I wanted to indicate that when these firewalls were first erected, the Fed indicated at that time an interest in continuing to monitor the effectiveness of the firewalls. I think at the time there was concern that maybe additional ones should be added. There was a sense that we needed to gain some experience because this was new for the banking industry. We actually first proposed to amend some of the firewalls in 1990.

So this has been a longstanding effort. And then as part of the Riegle-Neal Regulatory Reduction Review, Section 303, the effort to review the firewalls was folded into that review.

But predominantly, there have been a number of things that have changed which I tried to outline in my testimony. So we tried to look at the firewalls with a fresh eye.

Senator FAIRCLOTH. Well, it might not be so, but the feeling of many Members of this Banking Committee is that the fresh eye came after Comptroller of the Currency Ludwig started coming out with some rules of his own.

And while we are talking about the Comptroller of the Currency, I noted on page 1 of your statement at the bottom, you mentioned that one of the important protections in place is that the securities activities are an affiliate of the bank, not in the bank itself. What do you think of the Comptroller of the Currency's Part 5 proposals? Are the firewalls adequate in that proposal?

Dr. PHILLIPS. Well, I must say that we had felt that it was much more appropriate to have these kinds of activities in an affiliate of a holding company. And we have believed that the holding company is a better mechanism to contain the kinds of moral hazard concerns that are attendant to the leakage of the safety net to nonbanking activities.

It is for that reason that we believe that the holding company format is better than an operating subsidiary format for the expansion of these nonbanking activities, so that the safety net and the benefits of access to a depository institution aren't spread unduly.

Senator FAIRCLOTH. Thank you.

Now have the SEC and the National Association of Securities Dealers been consulted on the proposals you have come forth with?

Dr. PHILLIPS. I must admit I am not sure whether or not they have commented. But I will be glad to check on whether they have submitted a comment. I don't believe they did.

Senator FAIRCLOTH. I mean did you consult with them?

Dr. PHILLIPS. When we were proposing the regulations?

Senator FAIRCLOTH. Yes.

Dr. PHILLIPS. I don't believe we did.

Senator FAIRCLOTH. You did not?

Dr. PHILLIPS. But I'll check. Let me check to make sure on that because the staff do routinely talk with staffs of other agencies, so they may have done so. I didn't, however.

Senator FAIRCLOTH. In your statement you mentioned the cost of complying with the firewalls, this is a most important issue.

Just as a general rule, the Federal Government has gotten out of control on the cost-benefits of regulations we issue. It's an area in which we have just gone way overboard without any sensitivity to the private sector and the realities of making money. We issue rules and regulations and don't worry about what the cost and the effect will be. How costly is it going to be to a bank? And maybe give us a good example of the extra cost to the banks to keep these firewalls in place.

Again, if I may ask, we only have 5 minutes per Senator, so we need to move succinctly with the questions.

Dr. PHILLIPS. I think one of the best evidences of the costs of these firewalls is the fact that we really haven't had that many firms set up Section 20 subsidiaries—only about 40.

Many of the smaller firms, mid-sized firms, have not found it economic to be able to set up a Section 20 sub. It's the revenue limit that we have had in the past that constrain, but in addition, the firewalls.

So we're very hopeful that reducing the firewalls and the change in the limit will, in fact, allow some of the small- and mid-sized companies to be able to set up a Section 20 sub. And that should improve competition and provide services to smaller firms in the capital formation process.

Senator FAIRCLOTH. Thank you.

Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman.

Let me follow up on the last question that our Chairman asked. I gather that the rationale in part for the changes that are being proposed by the Fed is that they are very costly. The Chairman just asked you about the cost as it relates to some of these changes that are being made. And you have indicated that part of the cost, in your view, is that a lot of financial institutions of mid-size have not chosen to establish these subsidiaries. Therefore, you conclude that it must be too costly for them to do so, that by making the change, that they will be more encouraged to do so, if I understood the thrust of your testimony?

Dr. PHILLIPS. Yes, sir.

Senator BRYAN. Is that based upon surveys? Anecdotal evidence? What do you base that conclusion on?

Dr. PHILLIPS. Well, certainly it has been comments from bankers over the period of years that we have had these firewalls in place. In some instances, it has been the comment process. And of course, the earlier firewall changes that we put out for comment in 1990. So we have had an extended period of formal conversation with the banking community on these issues.

Senator BRYAN. I would appreciate it if you would have your staff make available to us those comments that you have previously received so that we might have a chance to look at them in a different context.

Dr. PHILLIPS. Surely.

Senator BRYAN. Let me ask you. One of the changes that you make is to change the capital requirements for investing in these subsidiaries. You indicate that, in your view, it is no longer necessary to have this capital deducted from the capital requirements of the holding company. I gather that you reached the conclusion that there is no greater risk, so you say in your testimony, than in other types of holding company subsidiaries. Is that right?

Dr. PHILLIPS. That is correct. Now a holding company must still be adequately capitalized.

Senator BRYAN. No, I understand that. But it seems to me that your premise is that a securities affiliate or subsidiary is no riskier than any other kind of subsidiary. What do you base that on?

Dr. PHILLIPS. Well, I think that is part of the case. But in addition, the SEC, of course, has capital requirements. And so these Section 20 affiliates are subject to the same kinds of regulations, including SEC capital requirements.

Senator BRYAN. It just seems to me that common sense would suggest to us that certain subsidiaries may be riskier than others. It may be legitimate to impose greater requirements with respect to those kinds of subsidiaries in which there would be a higher risk. I gather your conclusion is that there's not a higher risk in terms of a securities subsidiary.

Dr. PHILLIPS. I think what we are focusing most of our supervisory power on at this point is at the holding company level and trying to assure that the holding company is adequately capitalized. To that extent, that is going to include, of course, all of the affiliates. And if you have a broad diversification, that may well augur for what level of capital would be appropriate at the holding company level.

Senator BRYAN. I gather from your testimony that you have provided and what you have testified here orally this morning, that the relationship between the securities subsidiary and the holding company must be, "an arm's-length transaction or relationship."

Many of the firewalls that were previously proposed in 1987 and 1989, I believe you have testified, had specific categorical prohibitions—you can't do this, you can't do that. You have now kind of changed that whole basis, it seems to me, in the new regulations. I guess my question is how do you make a determination as to whether these transactions are arm's length until a problem has surfaced and then you go back and retrospectively review that relationship and you may very well conclude that, look, it was not an arm's-length transaction?

Dr. PHILLIPS. Well, I think those kinds of considerations can always come up, and hopefully, would be caught in the examination process.

So to that extent, if you name specific kinds of transactions that are prohibited, as soon as you do that, folks are going to find ways of creating some other slightly different kind of transaction to sort of "game" the system.

We felt that it's appropriate to have more general standards, to have transactions adequately collateralized and, as we indicated, at arm's-length distance, and then go back in the supervision process to try to assure that conduct is being appropriately conducted.

Senator BRYAN. It seems to me these changes do enhance the risks that are involved. Now maybe it's as you say, that those risks are offset by other considerations that you've suggested to justify the proposed changes.

My last question, Mr. Chairman, and I know my time is about to expire, is two-fold. One, how frequently are these institutions today audited or subjected to an examination? Two, do you propose as a result of reducing the firewalls, giving them much greater latitude, having much less in the way of restrictions—what are you proposing, if anything, with respect to an increased regime for regulatory review, either in terms of an examination, an audit, or some type of an intermediate evaluation of the institution?

Dr. PHILLIPS. We have been actually in recent years overhauling the examination process to make it more risk-focused and to——

Senator BRYAN. How often does that occur?

Excuse me, Dr. Phillips.

Dr. PHILLIPS. Actually, we do them on an annual basis.

Senator BRYAN. So you do it on an annual basis, then.

Dr. PHILLIPS. Yes, sir. The other thing I wanted to mention is that, if you look at various kinds of activities that are undertaken by banks and securities affiliates and so on, you can make a good argument that securities activities are no more risky than other activities that are undertaken in the bank; for example, loan activities. That is still predominantly where banks lose money.

It's not as much the risk as it is the question of not spreading the subsidy from banking activities to other kinds of activities.

Senator BRYAN. So I take it that the answer to my question is that you would not increase the frequency of the evaluation?

Dr. PHILLIPS. No, sir. At least we're not anticipating at this time.

Senator BRYAN. Would you change the focus of it? Would you conduct a different type of an examination or inspection? And I'm not using words of art, so help me out here, Dr. Phillips. But what I'm saying is you are changing the rules dramatically, and what they are allowed to do is greatly expanded as a result of these proposals. Would the type of examination or inspection that you do annually, would that change or would it continue to be the same kind that it's been in the past?

Dr. PHILLIPS. I believe we will have to make some adjustments to the examination process with more emphasis on 23A and 23B, in particular. And also on the disclosure requirements. That's another major protection.

Senator BRYAN. Thank you very much.

Senator FAIRCLOTH. Thank you, Senator Bryan.

Senator Rod Grams.

Senator GRAMS. Thank you very much, Mr. Chairman.

Dr. Phillips, we know firewalls are invaluable and a tool for buffering banks from any risk taken by its nonbank affiliates. But to go back to the question of talking about cost, and you said it has probably limited a number of these banks. But how costly are they? Do firewalls impose costs on the consumers of banks, the customers, and their security affiliates? And if so, can you give us examples?

It is costly, so we are really passing that cost on, and these firewalls, if duplicative, add additional cost and less convenience for the consumers. Is that right?

Dr. PHILLIPS. Yes, we believe that to be the case. And part of it, I think, is a change in the market practices of customers wanting one-stop financial services.

Senator GRAMS. Right.

Dr. PHILLIPS. And so, to the extent that we prohibit Section 20 affiliates from doing certain kinds of things, then the customer has to break up their request over several institutions and that is costly. In some cases, it makes them unable to obtain certain kinds of services.

Senator GRAMS. So it does take away from the convenience and it does add, in most cases, to the cost to the consumer?

Dr. PHILLIPS. Yes, sir, we believe that to be the case.

Senator GRAMS. It is also my understanding that the regulatory firewalls that you are proposing to modify are those that do not apply to the foreign security subsidiaries of U.S. banks. If that's the case, what has been the experience of banks and their foreign subsidiaries over the past decades? In other words, has the lack of firewalls caused any problem?

Dr. PHILLIPS. No. And in fact——

Senator GRAMS. Drawing from experience.

Dr. PHILLIPS. That actually is part of the experience that we've drawn on in the examination of these firewalls.

When the Board erected the firewalls in 1987, I don't think many people were quite sure how things were going to develop. And so, the Board was very conservative with firewalls. But over a period of time, I think it's been that experience, and not seeing problems, as you cited, or in these original 1987 companies, 14 companies, that we have not had significant problems. And that gave us assurance that it was appropriate to make this proposal.

Senator GRAMS. So this is just good oversight, going back and finding where some of the problems or unintended consequences have evolved, and to try to change them?

Dr. PHILLIPS. Yes, sir.

Senator GRAMS. I would like to take away from the focus of the regulatory firewalls for just a minute to take a look at the firewall of Section 23A of the Federal Reserve Act.

Now Section 23A states that a Federally-insured depository institution may not extend credit to a nonbank affiliate greater than 10 percent of capital and surplus. It is my understanding that daylight overdrafts are exempted from this limitation. If that's the case, have a lack of restrictions on the aggregate amount of daylight overdrafts ever impaired bank safety and soundness and is this a risk that we need to be concerned about at all?

Dr. PHILLIPS. That is something we constantly do have under review. And maybe at some point we will get to a point where we can address that specifically. That is part of the safety net. And so, part of what we are trying to do is make sure that we are not having the safety net leaked to some of this nonbanking activity. But that surely is part of the safety net.

Senator GRAMS. Do you know if it has ever impaired a bank's safety and soundness?

Dr. PHILLIPS. No, it has not, and that is watched very carefully during the day. It has not yet been a specific problem, but it is something that we constantly monitor.

Senator GRAMS. Thank you very much, Mr. Chairman.

Senator FAIRCLOTH. Thank you, Senator Grams.

Next, we'll hear from Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Most of the firewalls or the changes you are proposing have to do with underwriting activities of the subsidiaries. Is that a fair assessment?

Dr. PHILLIPS. Generally, that is the largest part of their activity, yes, Senator Reed.

Senator REED. Originally, the Board imposed limitations on the amount of revenue they can derive from underwriting activities. Is that correct?

Dr. PHILLIPS. We still actually have a revenue limit in place.

Senator REED. And that's about 25 percent?

Dr. PHILLIPS. Twenty-five percent, yes, sir.

Senator REED. But despite that revenue limit, does this constitute most of their activities, the underwriting?

Dr. PHILLIPS. Yes. That's the predominant reason for setting up a Section 20 subsidiary.

Senator REED. With respect to Senator Bryan's question about the capital accounting, you're proposing that now the bank holding company can include within its capital its investment in the Section 20 subsidiary?

Dr. PHILLIPS. Yes.

Senator REED. Is that the book investment or is there some periodic evaluation of the actual value of the investment?

Dr. PHILLIPS. I believe it is the book investment. But if you don't mind, let me check that one for you.

Senator REED. OK. Some other proposed changes. The Board proposes to eliminate the firewall with respect to extending credit to anyone who is viewed with the purpose of enhancing the marketability of securities underwritten by the subsidiary. Why would you consider eliminating that firewall? If a bank is extending credit, the bank of the holding company is extending credit to someone who is trying to enhance the marketability of the securities, isn't that something that we should be concerned about?

Dr. PHILLIPS. Well, this I think goes back partially to some developments that have occurred in financial markets. It's now become a lot more routine to provide credit enhancements, and I don't think that that was as common early on. Part of the concern, though, is that those credit enhancements be adequately collateralized and the banks must hold capital against those enhancements. And that was not the case earlier. So we believe that there are existing newer restrictions in place to address that.

Senator REED. So your view is that the rules pertaining to the bank subsidiary with respect to the collateralization and the capital of the bank is sufficient to preclude the necessity for this particular rule.

Dr. PHILLIPS. Yes, to protect the bank.

Senator REED. There is another proposal you are making that would eliminate the current prohibition of advertising that would suggest that the bank is in any way responsible for the securities operations. Could you justify that proposal?

Dr. PHILLIPS. Well, there has been concern about customers believing that if this is related to a bank, that it might be guaranteed by the bank, that it might then, in fact, ultimately be guaranteed by the Federal Government. We felt that it's appropriate to make those kinds of disclosures quite clear. And this has also been the case, for example, with the sale of mutual funds, to make sure that customers do not believe that those are insured products.

Senator REED. I may have misunderstood it, but it appears that in the proposal you are eliminating that requirement.

Dr. PHILLIPS. We were eliminating it, but actually, it's because we separately have an Interagency Statement that has been developed. It was actually done just in 1994. And so, this Interagency Statement that now is broader we believe will cover this concern. It is also in Section 23B, my staff have just informed me. But the Interagency Statement specifically does address some of these disclosure factors.

Senator REED. So, in effect, this disclosure is covered in some other provision of the law.

Dr. PHILLIPS. Yes, which is why we're proposing to eliminate it.

Senator REED. Most of this whole approach to the firewalls is simply taking away requirements in your specific regulation which are contained in other provisions of the law or other practices.

Dr. PHILLIPS. That is largely the case. Sections 23A and 23B, we believe, adequately cover a lot of the factors, but in addition, this disclosure statement.

Senator REED. Rather than just going through each one of these little items and quizzing you, could you indicate from your position and the Federal Reserve's position, what are the remaining firewalls that provide the kind of safety and soundness that we all assume is provided by Federal Reserve's regulation with respect to the sections—what would you point to, say, when we finish this regulatory process? Here are the three or four things that still make this supremely sound and sure.

Dr. PHILLIPS. Well, I would stress 23A and 23B, the funding requirements that are contained there. Section 23B requiring arm's-length transactions, the risk-based capital requirements, and the requirement that the holding company be adequately capitalized.

The other thing that actually has not been mentioned so far is prompt corrective action at the bank level. Some of those things have been implemented since the firewalls were erected. And then in addition, of course, the disclosure statement and the increased emphasis on making sure that customers understand that these are not insured products.

So I think that it is the combination of those things that have given us reason to believe that it is appropriate to re-examine these firewalls.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Senator FAIRCLOTH. Thank you, Senator Reed.

Next we'll call on Senator Enzi for any questions he may have.

Senator ENZI. Thank you, Mr. Chairman.

I think that probably in this particular hearing, we are talking more complex than I am able to listen. So I will have to try some questions maybe that have been asked to some degree already.

I want to turn to some of the specifics of the firewalls, particularly the issue of capital.

Why shouldn't bank holding companies deduct from their capital the amount of money that's been put in the securities subsidiary? Aren't we trying to insulate the bank holding company from any losses in the securities subsidiary? And wouldn't it make sense to keep them separately capitalized?

Dr. PHILLIPS. Actually, the holding company must consolidate capital. So, in that sense, the capital at the Section 20 subsidiary is already counted. And it is required to maintain adequate capital and at the same time the bank is required to be well capitalized. If the bank becomes less than well capitalized, we must take prompt corrective action, which means the holding company may have to inject capital at that point to the bank.

The focus is really on assuring the safety and soundness of the depository institution. If you were to subtract the capital, it doesn't really add or detract, in a sense, to the safety and soundness of the bank because of these additional requirements.

Senator ENZI. So you are saying that there's a double capitalization that we don't need any more?

Dr. PHILLIPS. Well, because it's consolidated in any case, I think that's where the protection is.

Senator ENZI. OK. The Board has said it will review the firewall about lending to a customer to buy securities from the securities subsidiary that it has underwritten.

My question is this—isn't it an important firewall that we keep? Even the Fed has noted that this is the one that gives rise to the greatest potential conflict. Could the firewall be abused if there were a steep decline in the stock market, and there seems to be some indication that that could happen?

Dr. PHILLIPS. Again, I think I would point to these other kinds of protections. The arm's-length requirement, for example, if it were a trust customer of a bank, there has to be full disclosure with regard to the marketing activities of a Section 20 affiliate.

So I think it is the disclosure and the collateralization that is required and, again, the capital requirements.

Senator ENZI. How often are the arm's-length reviews of the transactions looked at and reported?

Dr. PHILLIPS. Those would be reviewed as part of the supervision process, as part of the examination process. We do such examinations annually.

Senator ENZI. And you think that will be adequate to take care of any potential conflicts?

Dr. PHILLIPS. Well, we believe that to be the case. And as I say, there have been some companies that operated under the earlier order that were not subject to the firewalls, and we have not seen, for example, funding problems or capital problems.

But clearly, to the extent one changes rules or firewalls, we are going to have to make appropriate changes in the examination process to make sure that we pick up and we try to observe what kind of behavioral changes we're seeing by the banks.

Senator ENZI. Based on that answer, I suspect I know the answer to the next question, then, and that's some concerns about the bank trust accounts. The Fed has proposed allowing the bank to purchase securities from the securities affiliate. It could then be placed in bank trust accounts. This seems to me to have some great potential for abuse. What's the reason that the Board thinks that this can be repealed safely?

Dr. PHILLIPS. Again, I think it really has to do with the kinds of disclosure requirements. A customer will have to acknowledge and approve these kinds of inter-affiliate transactions. So there would have to be full disclosure of those kinds of activities.

Senator ENZI. We are talking about just bank trust accounts, not individual trust accounts?

Dr. PHILLIPS. No, I think it would be both.

Senator ENZI. And so the bank who handles the trusts and has the right to handle that trust without complete disclosure to the individual in some cases is going to make notification to whom?

Dr. PHILLIPS. First of all, you would have to have disclosure as to the nature of the transaction. In addition, the bank would have to have set up appropriate separation of activities so that it's truly at an arm's-length transaction.

I am not quite sure where you are heading with this, but we will be glad to take a further look at that one if this is an area that you have a particular concern.

Senator ENZI. I'm just trying to watch out for the consumer here and see if the notification is something really that the consumer is going to get or, again, if we're relying on an annual audit to pick up these sorts of things which may or may not be found.

Dr. PHILLIPS. We are requiring that the consumer actually sign a consent.

Senator ENZI. A blanket consent once, or each transaction?

Dr. PHILLIPS. I believe it would have to be with respect to each transaction.

Senator ENZI. OK. My time is up.

Senator FAIRCLOTH. Dr. Phillips, one thing that bothers me some is that you were not sure whether the SEC and Arthur Levitt had been contacted—maybe some staff did, maybe some staff didn't. This has gone on for some time and you do not know whether it has even been discussed with the SEC or the National Association of Securities Dealers. You think it might have. But it would just seem to me, and I'll just make the statement, that if it hasn't been done, it needs to be done and quickly.

Dr. PHILLIPS. We'll be glad to do so.

Senator FAIRCLOTH. Following up on Senator Enzi's question, I know what you said, that the bank would be required to—the trust department, before it moves into an account.

But we are thinking in terms of a relatively smaller bank situation, a small bank. The securities subsidiary has some securities that maybe they have underwritten, or whatever. They aren't doing well at all.

What is to stop them from moving in to improve the bank's statement, from moving a good bit of those into senile Ms. Jones' trust account?

Dr. PHILLIPS. Well, first of all, in coming back to this Interagency Statement and the required disclosures——

Senator FAIRCLOTH. Just quick and simple, what is the required disclosure?

Dr. PHILLIPS. In other words, that this was a security that had been underwritten by the Section 20 affiliate.

Senator FAIRCLOTH. They disclose that to the Federal Reserve.

Dr. PHILLIPS. They disclose it to the customer and the customer would have to acknowledge that as part of the statement. Also, they are supposed to separately——

Senator FAIRCLOTH. Wait a minute. Now, they disclose that to the customer. The customer has great confidence in the bank or they wouldn't be a customer. So what's to stop the bank from glossing this over to the customer, the value? We've underwritten this. We know it's wonderful. We wouldn't have taken it unless it was a really great opportunity. What's to stop the bank from saying that when they have a problem on their hands?

Dr. PHILLIPS. Section 23B is still going to prohibit a bank from purchasing, either as principal or as fiduciary, any security which the Section 20 affiliate is the principal underwriter. So we believe that that protection is——

Senator FAIRCLOTH. Now, we're cutting out all the sections. Tell me that again. Eliminate all the sections. Just tell me what you just said flat out.

Dr. PHILLIPS. OK. Section 23B of the Federal Reserve Act—this is separate. This is not a firewall. This is part of the Federal Reserve Act. It prohibits a bank from purchasing as principal or as fiduciary any security for which a Section 20 affiliate is a principal underwriter during the existence of the underwriting or selling syndicate, unless such a purchase has been approved by a majority of the bank's board of directors who are not officers of any bank or any affiliate. If the purchase is as fiduciary, the purchase must be permitted by the instrument creating the fiduciary relationship, court order, or State law.

Senator FAIRCLOTH. Well, that is certainly a lot of impressive language.

[Laughter.]

I'm still not sure it's as waterproofed as the language sounds.

On the issue of lending to help out the security affiliate, the Board is proposing to repeal the firewall that prevents lending to an issuing company for the purpose of repaying the security affiliate. If we repeal this, would it not give the securities firm associated with a Federally-insured bank an upper hand in the securities business?

Dr. PHILLIPS. Here I think 23A, which, again, limits the amount of credit which can be extended to an affiliate to 10 percent of capital helps. In addition, those transactions must be collateralized.

Senator FAIRCLOTH. Well, Dr. Phillips, certainly a lot has been said about 23A and 23B. The Federal Reserve Act is in place to protect abuses. Section 23B prevents lending on more favorable terms to an affiliate as a securities affiliate. How vigorously do bank examiners look at the lending transactions between affiliates? Realistically, how close do the examiners, when they go in, look at these transactions between affiliates of the bank?

Dr. PHILLIPS. So far as I know, they do look at them very carefully, and there have been violations that have been discovered.

If it would be helpful to the Subcommittee, I would be glad to have the staff write a more detailed report on our supervision experience under 23A and 23B.

Senator FAIRCLOTH. I would like that.

Senator Enzi, do you have any further questions?

Senator ENZI. It seems to me it would be pretty handy if we had a little better summary of these firewalls and the consumer protection that's left when the firewall is gone on each of them.

Senator FAIRCLOTH. I think that is probably very good. Would you like to ask Dr. Phillips to give you maybe a written summary of how that would exist?

Senator ENZI. Yes. I really would appreciate that. Also, Senator Reed asked for the list of what's left after these firewalls are gone. I think that's an extremely important one, too.

Dr. PHILLIPS. We'll be glad to supply that.

Senator FAIRCLOTH. Thank you, Dr. Phillips, and thank you for being with us today.

Now, I would like to welcome the second panel.

Mr. Victor Warnement from NationsBanc Capital Markets, Inc. Mr. Warnement is the General Counsel for their Section 20 subsidiary in Charlotte.

Mr. Rick Roberts is here on behalf of the ABA Securities Association and the American Bankers Association. Mr. Roberts is the Executive Vice President and Treasurer of Wachovia Corporation in Winston-Salem, North Carolina and Atlanta, Georgia. He is accompanied by Ms. Rachel Robbins, General Counsel and Managing Director for J.P. Morgan & Co., Inc. in New York.

Finally, I would like to welcome Professor Charles Calomiris, from the Columbia University, Graduate School of Business in New York. He's now affiliated with the American Enterprise Institute.

Mr. Calomiris, is that the correct pronunciation of your name?

Mr. CALOMIRIS. Callo-miris.

Senator FAIRCLOTH. Calomiris.

Let me add that each of your statements will be entered into the record in their entirety. And we do ask, in view of the time, if you could limit your opening statement to 10 minutes.

Mr. Warnement, we will begin with you, if we may.

OPENING STATEMENT OF VICTOR A. WARNEMENT GENERAL COUNSEL, NATIONSBANC CAPITAL MARKETS, INC. SUBSIDIARY OF NATIONSBANK CORPORATION

Mr. WARNEMENT. Thank you, Mr. Chairman.

Mr. Chairman and Members of the Subcommittee, I welcome this opportunity to offer my views on the Federal Reserve Board's proposed modifications to the firewalls applicable to Section 20 subsidiaries of bank holding companies. I commend the Subcommittee for holding this oversight hearing and its interest in understanding more about the Fed's proposals to generally reduce the regulatory burdens currently imposed on Section 20 companies.

As General Counsel to NationsBanc Capital Markets, Inc., one of the largest and most active Section 20's in the country, and given my prior experience in representing numerous issuers and investment banks in securities transactions as an outside lawyer, I believe I can provide some insights with respect to these proposed modifications from both a regulatory and business perspective.

I would like to first provide some background perspective from NationBank's viewpoint and then respond to the areas of concern raised in Senator Faircloth's letter requesting our testimony.

As the financial services industry has grown and changed at an accelerating pace over the past several decades, and extremely rapidly over the past 10 years, our Nation's bank holding companies have become more and more constrained by what in many respects has become an outdated regulatory framework. The American economy, our industries, consumers, and communities will gain from the kinds of reforms and modifications initiated by the Federal Reserve Board over the past several months to permit bank holding companies to deliver more competitive products and services to their customers.

The Fed's recent and proposed changes will allow Section 20's to operate and compete more efficiently and effectively. This in turn will ultimately work to the benefit of both retail and institutional customers of all types to increase competition, lower costs, increase access to financial products and services, and improve service and continuing innovation.

The Fed has acknowledged that existing firewalls, when adopted, were a conservative set of rules. While accomplishing their original purpose of isolating Section 20's from most of its affiliates, the firewalls have created significant compliance costs for bank holding companies and have impeded dramatically the synergies and efficiencies that they should gain from operating permissible investment banking and capital markets' businesses.

The absence of abuse and record of performance by bank holding companies in utilizing their underwriting powers has been fostered by prudent risk management, by senior management of our respective institutions, and by continuing developments and innovation in risk-management systems and techniques that permit relevant risks to be assessed and controlled in a more precise manner.

As the Subcommittee knows, the Fed is proposing to replace its 28 firewalls with eight operating conditions. We believe it is appropriate to repeal all firewalls, except those where the Fed's concerns are not addressed by other statutes and regulations. In large part, the Fed's action may be seen as an acknowledgement that securities underwriting and dealing activities are not inherently riskier than certain other banking and nonbanking activities currently undertaken by bank holding companies and, therefore, should not be subject to more burdensome limitations.

I would like to now respond to the issues raised by Senator Faircloth in his letter requesting our testimony.

First, NationsBank does support the Fed's proposed modifications. We, along with numerous others, believe the Fed could reasonably go further in reducing the regulatory burdens we face. We, and other institutions and various industry groups, have submitted comment letters to the Fed expressing this general view because adequate other protections do exist. We hope the Fed considers those views carefully in its considerations.

Let us be clear—we fully support the Fed's current initiative as a prudent and reasonable approach in reducing both unnecessary and burdensome regulations.

The Chairman has also asked that we address concerns involving safety and soundness.

The Fed's proposed changes can clearly be implemented while preserving the safety and soundness of our Nation's banking system and the integrity of its insured depository institutions. In fact, reducing these regulatory burdens and permitting them to be more actively and efficiently engaged in the securities business should have the effect of ultimately enhancing the safety and soundness of our banking system. The experience of the past 10 years has demonstrated that bank holding companies can operate profitable and sound investment banking business.

Even if the firewalls were totally eliminated, numerous layers of regulation and supervision would still apply to Section 20 activities. It is also very important to note that the Fed has gained tremendous experience in understanding and supervising Section 20 activities and the foreign bank subsidiaries of our bank holding companies.

The bank and securities regulators are also moving in the direction of a more functional and consistent regulatory approach, and the Fed now places great emphasis on evaluating, understanding, and making recommendations concerning the soundness of our risk-management systems and our philosophies.

Finally, as the Fed's annual examinations have focused more heavily on risk management and internal controls, the Fed has acknowledged that both bank holding companies and banks have engaged in activities at least as risky as underwriting and dealing securities in a Section 20 affiliate without the restrictions currently imposed by the Section 20 firewalls—for example, venture capital activities in the U.S. and Section 20-like activities in foreign subsidiaries of U.S. bank holding companies.

In addition, we have periodic contact with Fed staff concerning issues we may have in order not to violate the Fed's regulatory framework.

We have also been asked to comment on the adequacy of other customer protections.

Modifications currently proposed when combined with existing disclosure requirements for customers of all securities firms simply do not increase the likelihood of customer abuse. There are numerous securities laws and regulations that generally govern disclosures to customers. There are also numerous legal and regulatory protections concerning potential misuse of nonpublic customer information.

Virtually all institutional customers are capable of protecting themselves from abusive or coercive business practices. Given the competition within the industry, these customers generally preserve far too many options to be forced into using products they do not want or could obtain from other institutions at lower prices.

Retail customers of bank holding companies, on the other hand, receive the added benefit of special disclosures required by the Interagency Statement. Even a number of consumer advocates have conceded that banks have greatly improved in warning customers about the risks attendant with securities investments.

Moreover, studies have indicated that adherence to the existing disclosure requirements actually work well with customers when actually used. The anti-tying rules for banks add additional customer protections which should not be overlooked in considering the risks of abuse or coercion.

Thus, we do not believe that the proposed changes increase the risk of coercion of customers or that those customers will not be adequately protected by the various statutes, regulations, and supervisory oversight to which our country's banking companies are subject.

The Chairman has also asked for comment on the potential competitive advantages that might result to Section 20 companies from this relief.

The proposed modifications will not lead to an advantage for Section 20's. The changes merely work to help level the regulatory playing field which has been generally tilted against Section 20's as compared to other firms since their inception in 1987. A Section 20's relationship with affiliate banks can sometimes represent a reputational hurdle to be overcome rather than an advantage relative to nonbank competitors.

In addition, the different areas of the financial services industry have continued to converge, bank holding companies' nonbank securities competitor firms are becoming formidable in traditional banking areas, such as the syndicated lending business.

It should also be noted that banks have never dominated over the securities firms in the eligible securities fields in which they have been permitted to operate for the past 65 years. Section 20's will still continue to carry a higher degree of regulatory burden relative to other firms.

Moreover, given the various other protections which exist under Sections 23A and 23B and the anti-tying rules, the ability of bank affiliates to directly or indirectly support Section 20 activities on anything less than an arm's-length basis is highly dubious. Ultimately, the Fed's proposal helps open the door to a freer and fairer system of competition.

It is also interesting to note that no nonbank securities firm or their traditional industry groups submitted a comment letter to the Fed in opposition to its proposed changes.

Mr. Chairman, you asked for comment on the existence of other statutes or regulations to act as substitutes for the firewalls.

There are numerous statutory and regulatory protections outside the firewalls framework that will serve to address the fundamental risks associated with the underwriting and dealing activities of Section 20's. Any of the firewalls that duplicate or overlap the protections afforded by Section 23B, which was not adopted at the time of the Fed's initial approval of Section 20's, can reasonably be eliminated.

Section 23B clearly requires affiliate transactions to be conducted at arm's length, typically requiring pricing and other economic terms to essentially mirror those found in the marketplace in dealing with other customers.

In addition, the current risk-based capital standards utilized by banks and their holding companies were not in effect in 1987. They provide a clear and concise way to measure the safety and soundness of the bank holding company.

Last, the Interagency Statement was only adopted in 1994. This statement has become the primary means by which the Federal banking agencies attempt to ensure that retail customers are not misled about the nature of Nondeposit Investment Products.

Finally, you have also sought our comment on other recent Fed action impacting Section 20's. NationsBank fully supports the Fed's recent actions to modify or to eliminate some of the other regulatory constraints affecting Section 20's, including raising the ineligible revenue ratio from 10 person to 25 percent, the elimination of the cross-marketing restrictions, and the relaxation of the firewalls permitting dual employees between a Section 20 and its bank affiliates.

The regulatory relief recently adopted or currently proposed by the Fed concerning Section 20 activities is long overdue. In an increasingly competitive and globalized financial system, our Nation's economy will benefit from the increased flexibilities these changes will bring. NationsBank broadly supports the Fed's proposal and applauds its efforts in continuing to modernize the financial services industry. We believe that the Fed has acted extremely prudently in evaluating these matters and in proposing these changes.

Mr. Chairman, I appreciate the opportunity the Subcommittee has given me to present views on these important developments to the banking and securities industry and for our Nation's consumers, businesses, and economy.

Thank you.

Senator FAIRCLOTH. Thank you, Mr. Warnement.

Now, we will hear from Mr. Roberts from Wachovia.

OPENING STATEMENT OF RICHARD B. ROBERTS EXECUTIVE VICE PRESIDENT AND TREASURER WACHOVIA CORPORATION ON BEHALF OF THE ABA SECURITIES ASSOCIATION AND THE AMERICAN BANKERS ASSOCIATION ACCOMPANIED BY RACHEL ROBBINS GENERAL COUNSEL AND MANAGING DIRECTOR J.P. MORGAN & CO., INCORPORATED

Mr. ROBERTS. Thank you, Mr. Chairman.

I am Richard Roberts, Executive Vice President and Treasurer of Wachovia Corporation headquarters in Winston-Salem, North Carolina, and in Atlanta, Georgia. I am also Chairman of the Board of the ABA Securities Association.

Accompanying me today is Ms. Rachel Robbins, General Counsel and Managing Director of J.P. Morgan & Co., Incorporated. Ms. Robbins is on the ABASA Board and is also Chair of the ABASA Lawyers' Committee. Under her leadership that committee has carefully reviewed all of the Fed's recent proposed changes in the Section 20 activities.

The ABASA is a separately chartered affiliate of the American Bankers Association formed in 1995, to develop policy and provide representation for banks underwriting and dealing in securities, proprietary mutual funds, and derivatives.

Mr. Chairman, I commend you for holding this oversight hearing on the Federal Reserve's proposal to modify existing Section 20 firewalls and I appreciate the opportunity to appear here today to discuss these very important issues.

For the approximately 40 bank holding companies and foreign banks that have established Section 20 firms, the existing firewall provisions impose tremendous regulatory burdens and costs on doing business today. For many other banking organizations that have not yet established Section 20 firms, the costs and the burdens associated with these firewalls have effectively prevented them from establishing Section 20 firms.

I should point out that Wachovia has not established a Section 20, and the reason for not having done so is that the current firewalls represent an impediment to conducting business in an efficient manner.

As I will discuss more fully later in my testimony, the ABA Securities Association and their 21 members, including the Wachovia Corporation, strongly favor the recent Board's action proposing to modify the existing firewalls. These modifications, when adopted, will allow all Section 20 firms to operate much more efficiently and effectively, which can only inure to the benefit of our customers. We believe that these modifications are also an important step toward bringing vigorous new competition to the financial services industry, but, Mr. Chairman, they are only that, a first step.

The bank regulatory structure needs to be modernized to allow all institutions the option to offer all financial services to our customers. All financial service providers should have the ability to offer all services free from unnecessary legislative barriers and costly regulatory hoops. Not all providers will choose to offer all services. But the decision of what products and services to offer should be a business judgment that each individual institution is free to make. Given all the changes in today's financial services marketplace, it simply makes no sense to create a system that limits free and fair competition.

Consequently, ABASA's strong endorsement of the Board's proposal should not, in any way, detract from our position that truly comprehensive financial services reform is needed. Only Congress has the power to adopt such reform and ABASA would strongly encourage the Subcommittee to assist in moving these reform efforts forward.

The firewall restrictions were designed more than 20 years ago for securities underwriting and dealing risks from being passed from a Section 20 subsidiary to an affiliate insured deposit institution. In addition, these restrictions addressed the potential for conflicts of interest, unfair competition, and other adverse effects that might, it was thought at the time, arise from the conduct of these bank ineligible securities activities.

I will say that these very conservative firewalls were put in place with the idea that they would be periodically reviewed. And there's a pattern of that, as you can see, from 1987 coming forward.

The Board's proposal, after undertaking a complete review of the firewall restrictions, with 10 years' experience, has now determined to propose comprehensive changes to these firewall restrictions. Specifically, the Board has proposed to retain eight firewall provisions by incorporating them into a statement of operating standards and to eliminate the remainder. The Federal Reserve Board has had considerable opportunity to analyze the perceived risks posed by these activities to affiliated insured depositories and has concluded that any perceived risks posed by securities underwriting and dealing activities have proven to be manageable.

They have seen first-hand how bank affiliates operate in the real world and have come to recognize the impediments the firewalls have imposed. And at this same time, the Board has gained greater familiarity and experience in the operation of the Federal securities laws and the protections afforded by those laws through the super-

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vision and regulation of broker-dealers by the Securities and Exchange Commission and the National Association of Securities Dealers. That experience has allowed the Board to conclude that many of the firewall provisions are unnecessary in light of the Federal securities law requirements.

Finally, legislative and regulatory initiatives put in place after the original firewalls were established have also demonstrated that many of the firewall restrictions are largely redundant of these other provisions. These initiatives include Section 23B of the Federal Reserve Act, the Interagency Statement on Retail Sales of Nondeposit Investment Products, and the Risk-Based Capital Standards. Clearly, these new safeguards, in combination with preexisting regulatory limitations applicable to all nonbanking subsidiaries, squarely address the fundamental concerns that precipitated the initial establishments of the firewalls.

Your letter of invitation, Mr. Chairman, asks whether proposed firewall modifications can be made while still preserving the safety and soundness of the banking system and protecting affiliated insured deposit institution. We are convinced that they can.

There is no evidence that security activities are more risky than traditional commercial banking activities. The weight of evidence suggests that these activities do not raise the risk profile of a banking institution. In fact, just the opposite is true. These activities lower risk profiles and provide even more protection for the bank.

We firmly believe safety and soundness of the insured depository institution will be safeguarded by existing Federal security law capital requirements enforced by both the SEC and the NASD, and requiring bank holding companies to maintain, consistent with GAAP, adequate capital on a fully consolidated basis. Benefits to the banking organizations will include reduced regulatory burdens and the ability to compete on a more equal footing, at least with respect to capital requirements, with other nonbank affiliated investment banking services providers.

The Board has also proposed to eliminate the firewalls which generally prohibit bank holding companies and their subsidiaries from extending credit to the Section 20 firm. These restrictions were originally to prevent a bank or its parent from exposing itself to loss in order to benefit the Section 20 firm's underwriting and dealing activities. In truth, however, these firewalls have hampered the ability of bank holding companies to serve as full-service financial services providers and have reduced funding options available to our customers.

For example, it is not uncommon for bank corporate customers to fund their activities by accessing the capital markets through a commercial paper issuance. In these situations, the bank will refer its customer to its Section 20 affiliate. Under the current firewall restrictions, the bank would be prohibited from providing credit enhancement to commercial paper even though the bank itself may be the institution best suited to perform a credit analysis or, worse yet, for smaller companies, the only institution willing to perform the necessary credit analysis.

Many of the conflict of interest concerns are more than adequately addressed by other existing statutory and regulatory safeguards. Duplicative and redundant firewall restrictions are simply not needed.

For example, as the Board has recognized, the current risk-based capital system would require the bank to hold capital against the exposure on any credit enhancements extended to Section 20 customers. Loan-to-one borrower rules would also limit the amount of credit that a bank could extend to an issuer of securities underwritten by the Section 20 firm. Perhaps more significantly, any transaction or series of transactions between a member bank and a third party would be subject to the arm's-length dealing requirements of Section 23B of the Federal Reserve Act where an affiliate of the member bank is a participant.

As a consequence, even without these firewalls, member banks would still be strictly prohibited from extending or granting credit to customers on preferential terms. In short, the stated purpose of these firewalls can be, and is, accomplished without the added operational burden of specific firewall restrictions.

Mr. Chairman, you have asked whether the modifications proposed will provide adequate protection to customers of the bank or securities affiliate. I believe the above demonstrates most strongly that both bank and Section 20 customers are provided with significant protections under the Federal securities laws and banking laws to justify the Board's proposed elimination of many of these firewall provisions.

All the disclosure requirements of the Federal securities laws apply to banking organizations' securities activities. In addition, the Federal banking regulators require certain disclosures to be made when retail customers purchase investment products from the bank lobby. These statutory and regulatory requirements provide added protections to many bank and Section 20 firm customers.

Mr. Chairman, I think it's important to understand the historical context in which these original restrictions were established. At the time the original firewalls were adopted the Board was facing litigation, which it subsequently won. As a result, the Board adopted a very conservative framework of firewall restrictions that it recognized could, like the initial 5 percent income limitation, over time be loosened. And we know the pattern it subsequently has followed.

Generally speaking, the restrictions were very conservative and were often geared to the characteristics of the money-center banks and the burdens and inefficiencies that, it was thought, those institutions could afford to carry.

Regional bank holding companies, such as mine, have been unable to carry the same burdens with the inefficiencies. As a result, issuers and would-be issuers of securities in cities and towns all over the country were forced to go to New York and other money centers to raise capital. In far too many instances, they bypassed the regionals with whom they had done business for years, who knew their needs, knew their communities, but could not provide the needs because of regulatory impediments.

The Board has endeavored to ease some of the most burdensome firewall restrictions, including eliminating the cross-marketing prohibition and significantly modifying the personal interlock prohibition. These actions, taken in concert with raising the cap on the revenue earned from 10 percent to 25 percent for ineligible security underwriting, have already encouraged several banks to seek authorization either to establish a Section 20 firm, or to expand the authorization for existing Section 20's.

In conclusion, Mr. Chairman, ABASA appreciates the opportunity to appear before the Subcommittee to discuss the Board's recent proposal to modify its firewall provisions applicable to Section 20's. While ABASA is hopeful that the modifications, when adopted, will encourage other bank holding company firms to establish Section 20 underwriting firms, these modifications are only a first step toward comprehensive reform of our financial system. ABASA encourages the Subcommittee and its Members to work with all appropriate parties in order to enact meaningful financial reform legislation. We stand ready to work with you and other Members of your Subcommittee.

Once again, thank you, Mr. Chairman.

Senator FAIRCLOTH. Thank you, Mr. Roberts.

Mr. Calomiris.

OPENING STATEMENT OF CHARLES W. CALOMIRIS PAUL M. MONTRONE PROFESSOR OF FINANCE AND ECONOMICS, GRADUATE SCHOOL OF BUSINESS COLUMBIA UNIVERSITY

Mr. CALOMIRIS. Thank you, Mr. Chairman.

It is a pleasure to appear here today. Let me briefly summarize my written testimony.

The last decade has seen dramatic and beneficial bank deregulation, especially the relaxation of geographical and activity limitations on bank holding companies.

Deregulation has sparked little controversy among scholars of banking or banking history. There is a remarkable degree of agreement among these scholars, supported by an extensive body of research, that historical limits on bank locations and activities have served no legitimate economic purpose. Rather, these costly limits, especially the separation of commercial and investment banking in 1933, are artifacts of specific historical political battles in which facts and economic logic have often taken a backseat to populist passions or special interest politics.

Competitive pressure, especially the loss of U.S. banks' domestic and international market shares in the 1980's, helped to push the Federal Reserve Board in 1987, and subsequently to use its authority to relax restrictions on bank underwriting activities. Initially, the Fed proceeded with extreme caution. It allowed very limited underwriting of private debt, and later equity, but attached to those activities a host of firewalls intended to prevent the transfer of loss from a Section 20 underwriting affiliate to a chartered bank, and to prevent dishonest business practices.

The first goal reflected a legitimate concern. The Fed correctly worried about the abuse of deposit insurance and the discount window—the possibility of Government subsidization of risk in new activities. The second goal reflected unsubstantiated and misguided concerns, which the Fed has subsequently learned about.

Experience has proven that accusations about dishonest behavior resulting from combining commercial and investment banking historically were unfounded, and that limitations on combining these activities are very costly.

The Federal Reserve Board has recently circulated a set of proposals to relax or eliminate many of the firewalls that limit connections between banks and the nonbank affiliates of bank holding companies.

The principal question I will address today is the desirability of the Fed's recent proposals to reduce firewalls for Section 20 affiliates of bank holding companies. More broadly, however, I will assess the desirability of expanding bank activities into securities markets and related areas, and the importance of relaxing firewalls to allow efficiency gains from such an expansion.

I support enlarging the range and size of permissible nonbank activities within banks or bank holding companies, and scaling back firewalls as the Federal Reserve Board now proposes to do. Doing so will allow banks to compete more effectively for corporate relationships, and will benefit bank customers and their stockholders, at least as much as it will benefit banks.

Let me begin with some historical perspective on the origins of the separation of commercial and investment banking, which is essential to the debate over bank activity limits and firewalls.

In the United States, banks became interested in underwriting and holding corporate debt and equity in the 1920's. The relaxation of branching laws during that period created new opportunities for banks to become large. As they became large, they turned increasingly to industrial as opposed to only commercial finance, and they found it profitable to mix bank lending with underwriting. Doing so made it possible to better serve their corporate clients' funding needs, providing better access to investments for their trust customers, and reduce banks' cost of funds, since the new activities were highly diversified.

The mixing of lending and underwriting activities had produced similar synergies in German universal banking around the turn of the 20th century, which were well understood in the United States by the 1920's.

The synergies for mixing lending, equity holding, and underwriting in the United States and Germany historically are present and visible in the United States today, even under the current limited incarnation of universal banking. Evidence from the last decade of U.S. experience suggests that Section 20 underwriting affiliates increase average returns and reduce risk for their bank holding companies.

The primary sources of these gains are the repeat use of information, the enhancement of corporate control over clients, and the diversification of bank income.

It is important to keep in mind that in a competitive banking system these reduced costs of intermediation accrue mainly to bank customers—that is, banks' clients' stockholders and bank depositors. It is also important to note that these synergies are often undermined by firewalls.

If firewalls require separation of types of activities into different entities—that is, entities with separate corporate identities, liabilities, and capital—then some of the cost of funds advantages from diversification across activities will be limited. If firewalls require that lending and underwriting by the bank not be allowed for the same client firm, then any potential information synergies across activities will be foregone. If firewalls prevent banks from being actively involved in controlling the firms they finance—via boards of directors, or trust account and mutual fund holdings of stock—then control synergies will be limited.

The current Fed proposals to repeal firewalls would improve the efficiency of the financial system mainly by increasing the multiple use of information within the bank and by enhancing bank involvement in corporate control.

It is worth noting that the Fed is not proposing to remove all protections. The Fed proposes to retain the limitations on the mixing of bank and nonbank risks—specifically, Sections 23A and 23B of the Federal Reserve Act, which limit the extent of lending from banks to nonbank affiliates, and require that it be fully collateralized and priced as an arm's-length loan. Chairman Greenspan argues that Sections 23A and 23B provide essential protection against the abuse of deposit insurance protection by bank holding companies.

I share Chairman Greenspan's concern that under the current deposit insurance system the absence of financial firewalls like 23A and 23B could lead to abuse of deposit insurance. But I do not agree with his solution. A better alternative would be to remove the possibility that banks would receive subsidized insurance, which would thereby remove any incentive problem from mixing the risks of lending and underwriting, and thus, allow banks and their customers to reap the enormous diversification gains from relaxing Sections 23A and 23B.

Chairman Greenspan also argues that the holding company structure is a superior mechanism for administering firewalls, and that thus it is essential to restrict Section 20 activities and other nonbank activities to bank holding company affiliates—that is, regulated by the Fed. Thus, he does not support the Comptroller's initiative to allow new activities to occur within subsidiaries of national banks. I do not share his view. There is no reason I can discern why any particular firewall cannot be administered as well within a bank subsidiary structure as it is within a bank holding company affiliate structure; and in fact, the AJAC subsidiaries are a good example of just what I'm talking about.

And I want to emphasize, too, that it is my understanding that the Comptroller would exactly replicate the Fed's policies in firewalls and their enforcement.

The argument for retaining a Federal Reserve monopoly on regulating Section 20 activities seems to rest on the view that there's a need to have an "umbrella" regulator, namely, the Fed, that overseas all holding company risks. That is only necessary if potential subsidies from deposit insurance cannot be eliminated and if firewalls cannot insulate banks from the risks undertaken by nonbank subsidiaries or affiliates.

Since neither of these necessary conditions need be true, I do not support the Fed's view that it should retain a regulatory monopoly. Indeed, there are advantages, I think, to allowing the Comptroller and the Fed to compete over bank activity regulation.

In conclusion, I strongly support the Fed's proposal to roll back firewalls. I also encourage the Fed, the Comptroller, and Congress to consider reforms to deposit insurance that would permit additional rolling back of firewalls. Finally, I encourage Congress to retain the current healthy competition that exists between the Office of the Comptroller and the Fed.

If we succeed in freeing the banks from costly and unwarranted limitations on their powers, significant gains will follow for banks and their customers. The banks that stand to gain will increasingly include super-regional and regional banks, in addition to money-center banks. As the technology for placing securities improves, and barriers to low-cost public issues of securities are removed, more and more regionals and super-regionals will find it advantageous to establish Section 20 affiliates or subsidiaries. The social gains of that expanded access to private and public equity finance for all banks' corporate clients could be large.

Thank you.

Senator FAIRCLOTH. Thank you, Mr. Calomiris.

A couple of things have appeared so far in this hearing. One of them is that, for all of the Senators who have been here and I think for everyone else, it is an absolute necessity that we maintain the public's confidence in banks. That's paramount in anything we do and that we don't do anything to erode that.

Another thing that has bothered me, and as I heard from other Members, is the somewhat evidence of a rush between the Federal Reserve and the Comptroller of the Currency to come forth with some rules and regulations, and who gets there first and whose are the most impressive.

I intend to have a hearing immediately after recess and ask Mr. Ludwig, the Comptroller of the Currency, to come and explain some of his proposals. I think it will serve us well to do that.

One thing that I have heard from each of our witnesses today, Mr. Roberts, Mr. Warnement, Mr. Calomiris, and also Ms. Phillips, is that the securities business and dealing in securities and underwriting is no more dangerous an activity than is ordinary lending. In general, ordinary lending in most banks is spread among many, many customers. The underwriting is spread among fewer customers of the bank.

Many years in the automobile business and several dealerships, and I was taught this by some very good bankers, and this was a time in which all paper was recourse paper, before the banks became so generous that they took over the risk, but the fundamental rule was don't worry about the retail paper. You'll lose some, but it will take care of itself. Watch the floor plan, that is where you can go broke and lose it all rather rapidly. The retail paper—is there any, and I will start with Mr. Warnement. Since this seems to be a theme, is there any rationale to such an analogy?

Mr. WARNEMENT. Well, I think, historically, you can look at the scenario you have posed.

Developments in the business have allowed the underwriting and the distribution of corporate bonds as essentially a more efficient means of delivering liquid credit than delivering long-term illiquid loans to the same borrower.

If we look at a corporate customer and instead of making it a very sizable loan that we hold on our balance sheet—the equivalent of holding the floor plan with an auto dealer—and the enduring risks inherent in holding that illiquid loan for a long time, where market conditions can change, the business can go away, and a whole lot of things can impair the quality of that credit over time, compared to taking and structuring the same level of credit in the bond market, where the financial institution goes in, makes a decision based on due diligence, credit quality, and a lot of other things, first, whether to underwrite, and then it goes on to distribute that debt across investors across the country, resulting in less financial risk to the institution.

Now, I would be remiss not to acknowledge that large corporate bank credits can now be distributed, syndicated across other financial institutions, although such loans are not as liquid as bonds.

I would also point out that our nonbank competitors have entered into that syndicated lending business in a very significant way. For example, in the "Who's News" sections of *The Wall Street Journal* or *The American Banker* or other industry publications, you can see a movement and a recruiting process going on by our competitors to continue to delve into the traditional banking businesses.

There is a convergence of all of these activities in the financial products that result and are engineered for customers.

Senator FAIRCLOTH. Thank you, Mr. Roberts.

Yes, Ms. Robbins.

Ms. ROBBINS. Could I just add something to that?

Senator FAIRCLOTH. You certainly may.

Ms. ROBBINS. I would just like to follow up on that comment. I would say that the syndicated lending business is actually riskier than the underwriting business.

The process is almost identical, as Mr. Warnement said, in that the bank makes a decision to extend a large amount of credit to one customer and then sells this off to other banks. The same process in the underwriting of the corporate bond. The difference is that in the underwriting of the corporate bond, you are dealing with a rated instrument. You are dealing with an instrument that is going to be sold in a broader, more liquid market, about which there is lots of research being written. So you have a creditworthy rated instrument in a more liquid market. And if anything, the corporate bond is nothing more than a more liquid loan that is rated.

Senator FAIRCLOTH. Thank you. That answers it.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Mr. ROBERTS. Mr. Chairman, if I might?

Senator FAIRCLOTH. Yes, go ahead.

Mr. ROBERTS. I thought I might add a little comment to what we have heard here.

I take a view on diversification of portfolio reduces risk for a bank. That action has proved true over many, many years. And to use an example, let's go back to the floor plan and the individual notes that are purchased.

If you have two banks, or it could be a bank and an insurance company or an investment company. I am just going to use the example of two banks. Let's say you have Bank A where all they have is floor plan paper; you have Bank B where all they have is indirect notes, which has covered many, many customers. The securitization process and so forth allows an equilibrium and diversification to take place between these entities, of which you can get a diversified portfolio on the bank's balance sheet, if that's what you want.

I take another view, too, that a financial intermediary being a bank, can conduct business in two ways. One, originate and book for your own account. Therefore, you have that asset and it is in a less liquid form, as Ms. Robbins just mentioned. Or you can take a purist view of the financial intermediary process of originate, underwrite, and sell, and thus, distributing the risk. And so I believe, if anything, this process reduces the risk for the financial institution called the bank.

Senator FAIRCLOTH. Thank you, Mr. Roberts.

And if you will allow me just one minute, we will ask Mr. Calomiris if he has a thought on it.

Mr. CALOMIRIS. Well, I also wanted to point out, banks' risks are not encompassed by lending and underwriting, and neither are their profits. There are a couple of other activities that are at least as risky within bank holding companies as underwriting that haven't even been discussed and are currently regulated very differently. Removing these firewalls would simply bring the Section 20 affiliates into the same playing field as those other ones.

A good example is venture capital affiliates under Regulation Y, which perfectly illustrate Mr. Roberts' point about diversification. Venture capital profits and bank holding companies, some of the largest ones, have been larger than Section 20 profits. They have, in fact, saved many of the largest bank holding companies in the United States during the 1980's, First Chicago, Continental. They have made an enormous contribution to the profits of CitiCorp, of Chase, of Chemical, even of Norwest.

Senator FAIRCLOTH. Did you say, I'm sorry, Chicago?

Mr. CALOMIRIS. First Chicago.

Senator FAIRCLOTH. First Chicago.

Mr. CALOMIRIS. And Continental of Illinois.

Senator FAIRCLOTH. Yes.

Mr. CALOMIRIS. For some of these banks, for all the ones I mentioned other than Norwest, their contribution to the bottom line of the banks over the last 20 years has been greater than 20 percent. That's the venture capital subsidiaries no one's been talking about.

So my point, they are regulated under Regulation Y. Sections 23A and 23B apply to them, but not all of these other superfluous firewalls. They seem to have done very well. Not only have they done well, but they have contributed an enormous amount of profit that has saved some of the banks that were threatened during the 1980's. I could say the same thing about the foreign subsidiaries, which are not affiliates. They're subsidiaries of some of the largest American banks.

So I think we could talk about derivative activities and interest rate risk speculation. Banks are engaged in a lot of risks. Section 20 risk has been discriminated against, and I think quite unfairly.

Senator FAIRCLOTH. Thank you.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Professor Calomiris, perhaps one reason that Section 20 risks have been discriminated against is that, in the history of the 1920's, which you point to, note that it helped diversify activities. Also there were some abuses in terms of affiliates making loans to bail-out troubled companies, the equities being sold by the securities affiliate, all these things. I am just wondering, in a fair sort of capitulation of the 1920's, aren't there some dangers we still have to be aware of and look to?

Mr. CALOMIRIS. Senator, I'm glad you raised that question. I was very frustrated, frankly, by many of the comments of the Senators who have left the room who apparently have not read the last 10 years of research on the 1920's.

In my written comments, I have an extensive footnote which summarizes probably a dozen different research products. One is a book by George Benston specifically on the Pecora hearings and the allegations of conflicts of interest and dishonest behavior. The others have been very detailed statistical studies by several people published in the best economics journals that basically refute this argument. Let me give you just a very brief flavor of it.

The argument that the banks were giving their worst risks to the customers who were buying their bonds or their stocks in order to bail themselves out as lenders, would imply that the ex-post performance of the bonds that were sold by the banks would have been worse than the performance of the bonds sold by the independent investment banks. The opposite is the case, even after controlling for the initial yields or ratings of those bonds. Banks, if anything, were much more careful in their underwriting behavior in the 1920's. There just is no basis for this argument. So I hope you will look at some of the references and read some of that work.

Senator REED. Thank you for drawing our attention to footnotes, which are often overlooked in our deliberations.

Let me ask another general question and anyone on the panel who feels willing can jump in.

A lot has been said about risk-based capital as a development since the first authorization of Section 20 subsidiaries as a major check in place today that was not in place originally that will provide protection for the banking system. I wonder if anyone can just comment upon risk-based capital in terms of how it will be a check in this regard.

Mr. Roberts, Ms. Robbins.

Mr. ROBERTS. I'll be glad to respond first to that.

I think that the objective of risk-based capital goes back to, I think, the Basil Accord that established standards which were to be applied on a global basis. They're very specific standards with regard to not only the quantity of capital, but also the quality of capital as well by defining what is Tier 1, the highest quality, basically, equity capital, and allowance for reserves, and then your more junior-type capital, being the Tier 2, which includes things like subordinated debt and all.

These are standards which must be upheld. And you also have used the term, well capitalized, throughout the documents that you have had here, that if these high standards are not met, then I will tell you that the pulling of the plug of the relief of the firewalls on those particular institutions would more than likely take place by the Federal Reserve.

Senator REED. Let me follow that question. First, would a bank holding company with a Section 20 subsidiary be required to have more capital because of the risk of the Section 20 subsidiary?

Ms. ROBBINS. The Section 20 is, as Governor Phillips mentioned, a registered broker-dealer with the SEC. So it complies with all the SEC capital rules.

Senator REED. Right.

Ms. ROBBINS. In addition, it's subject to the overall consolidated risk-based capital requirements that apply to the whole holding company. It would not have higher risk-based capital requirements than any other.

Senator REED. No. My question was would the bank holding company be required to have higher capital?

Ms. ROBBINS. It has to be well capitalized in order to have a Section 20 in the first place.

Senator REED. So, essentially, the test of the Federal Reserve is they look first at the capital of the holding company and determining if it's well capitalized.

Ms. ROBBINS. Right.

Senator REED. And then authorize the Section 20 subsidiary.

Ms. ROBBINS. Exactly.

Senator REED. Will that be the procedure going forward with these firewall changes?

Ms. ROBBINS. Yes.

Mr. WARNEMENT. I think to the extent, Senator Reed, that you think about increased competition and more regional banks being able to come into this field, it's important to understand the rigorous tests that the Fed puts a bank holding company through in order to establish a Section 20 company.

There are significant costs to it. Some of us in the industry view it as probably the most difficult power or activity to get permission to engage in from the Federal Reserve. And you have to go through a rigorous process of building out your infrastructure and hiring people, developing policies and procedures, putting in computer systems, and a number of other things before the Fed comes in and looks at your readiness to begin to engage in the business.

Senator REED. Let me ask a final question. Mr. Roberts alluded to it. If the capital of a holding company declines for any reason, is there provisions in the law today where the authority to operate a Section 20 subsidiary would be circumscribed?

Mr. ROBERTS. The Fed has the empowerment or the authority to do such.

Senator REED. Let me take it from another perspective. If the Section 20 subsidiary was engaged in underwriting that proved to be bad and generated losses, what remedy would the Federal Reserve then have?

Ms. ROBBINS. They could stop the activities. They could require you to shut down the Section 20.

But I think it's important to recognize that not only the history in the last 10 years of the activities of all of these companies, but also the history for two decades abroad, where, by the way, there are no firewalls, not even 23A and 23B, has demonstrated that these activities are done safely and prudently and are not riskier than banking.

Senator REED. Can I just ask one other question?

Senator FAIRCLOTH. Yes, you can. Go ahead.

Senator REED. One other comment that Ms. Phillips made with respect to the proposed new firewalls or new walls, fireproof or otherwise, is the advertising prohibition today, which basically says that the bank cannot imply, nor anyone in the holding company system imply, that these securities are somehow sponsored by the bank or related to the bank, to me seems to be a very critical one because consumers who are going out and looking at a product and all they will see is the bank name. They won't see underneath the bank, subsidiary of such and such. They will see the Wachovia term, or whatever. And then her response was this is all protected now by the Interagency Statement. Would you comment?

Ms. ROBBINS. Let me just clarify that. That firewall was lifted from proposed 23B, which was not yet enacted at the time the Fed imposed their first set of firewalls. Section 23B, as has since been enacted, has that identical language. So it's there in the law.

It's important to remember that 23B was enacted by Congress 10 years ago when Congress was debating, and one of the many times Congress was debating increasing bank powers. Section 23B was designed as the safeguard necessary to enable banks to expand through holding company affiliates into the securities business.

What ultimately happened was that the new powers were never granted, but the safeguards that were intended to go along with them came in place in 23B. So it was really Congress' version of firewalls for securities activities before the Fed's.

Mr. WARNEMENT. Senator Reed.

Senator REED. Yes, please.

Mr. WARNEMENT. I would also add on the advertising front that Section 20 companies are subject to the NASD's rules concerning advertising. We in no way are allowed to imply that a bank is guaranteeing or is responsible for any instrument being underwritten or dealt in by the Section 20 company.

As part of that process, advertising gets reviewed at most institutions by their compliance people, and if it is a large advertising campaign, the disclaimers or statements that are included in advertising are reviewed by their legal departments and, ultimately, are submitted to and reviewed regularly by the NASD's regulatory staff or supervisory staff.

We have received a number of calls by regulators about our advertising saying, we would like you to adjust—we think it's OK, but we would like it to be a little clearer this way and that way. It's not an area in which, I believe, financial institutions are going to mess around with those risks.

Senator REED. Professor.

Mr. CALOMIRIS. At the same time, I think it's important to mention that cross-marketing is extremely important. In some studies of some bank mergers that I have done, I found that revenue synergies, if you like, synergies from cross-marketing building upon relationships, can be at least as large and at least as important for the gains from consolidations as simple cost-cuttings.

So, again, as in many of these firewalls, you don't want to throw away the baby with the bathwater. You want to limit the potential abuses in the advertising. But you can't go so far that you destroy the relationship advantage.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Senator FAIRCLOTH. Thank you, Senator Reed.

I have two little wind-up questions. I assume the answers will be pretty brief.

Mr. Warnement and Ms. Robbins, have you had to turn away some customers because their relationship as a customer of the bank would make it too burdensome to do business, I mean with the Section 20? Have you had to turn away customers? Are you aware of any problems this has created?

Ms. ROBBINS. I think there have been a number of situations where the best solution to a customer's problems would have involved a loan from the bank or some credit from the bank combined with a capital markets transaction in the Section 20. And yes, there have been times where we have had to say to a customer, we can't do it all for you.

Senator FAIRCLOTH. Mr. Warnement, has NationsBank had the same problem?

Mr. WARNEMENT. NationsBank has certainly had the same general experiences as J.P. Morgan.

I think further in this realm, that it can increase the cost to the customer because the cost of doing due diligence at multiple institutions is not insignificant. The sharing of information about one overall transaction within one institution is more efficient and represents a significant savings to those customers.

Furthermore, when you explore, as NationsBank is very big in, small- and mid-sized corporate customers, they have probably fewer options than some of the largest corporate customers in America. They need access to relationships with financial institutions who are able to bring a full array of services efficiently to them, as opposed to having to turn them away, saying, we would love to do it. We are capable of doing it. We are just not allowed to do it.

Therefore, we have to deliver the customer over to a competitor, which, frankly, is usually lurking somewhere in the background, ensuring that we are delivering adequate and fair pricing.

Senator FAIRCLOTH. Well, First Union said they appreciated the customers.

[Laughter.]

Mr. WARNEMENT. It's one of the benefits of being headquartered three or four blocks away.

[Laughter.]

Senator FAIRCLOTH. Thank you.

This is the last question and it is not exactly a question. But if each of you would address it, I'll start with Mr. Roberts.

Of course, all of you represent the Nation's best in banks. Wachovia is unquestioned in every way, maybe one of the better banks in the country. All of you are. But what I'm asking you now is a question that other Senators have requested that I ask.

I don't think anyone is worried about J.P. Morgan or NationsBank or Wachovia. But all of you are aware of a much, much smaller tier of banks. Is there a possibility that relaxing the firewalls will invite and encourage people into this business who are simply not up to the task and have the capability of handling all of the things you have discussed here today? I think that it's not the top tier. What do you think of that?

Mr. ROBERTS. Mr. Chairman, that is an excellent question because it kind of hits at the very heart of some things with my own company.

As you recall in my opening comments, I made the statement that the firewalls heretofore have been a big impediment to us conducting business in an efficient manner and, therefore, we have not done a Section 20.

Now, being quite truthful, intellectually honest—and I use the word, encumbrances, coming down somewhat, the firewalls, or being eliminated in many cases, of course. It has made it more palatable for Wachovia to enter into this. However, in making this decision, there is a tremendous amount of due diligence that one has to go through. There is a tremendous cost still associated with setting up the infrastructure to make this work. Management cannot lightly just decide to turn the switch on tomorrow morning and become a Section 20 and jump into the business.

The word infrastructure covers a tremendous amount of ground. I am referring when I say that to the back office, the operating systems, the computer systems, the resources that are needed that must be in place, such as people with the right skill sets and talents, and licensing as well. You also must have very thorough and very clear controls and policies in place.

Now what's the acid test in all of this? The acid test is when you go for an infrastructure review. It is very detailed and very specific and all of these elements must be in place before, even with the lower firewalls being dissipated.

Senator FAIRCLOTH. Mr. Roberts, who would conduct the infrastructure review?

Mr. ROBERTS. I will tell you, on our cells, we are, number one, doing it, due diligence ourselves. Then hiring a third-party consultant to double-check us. And the final test is the regulatory Federal Reserve System themselves.

Ms. ROBBINS. Yes. And then in addition, of course, because this is a regulated subsidiary by the SEC and the NASD, you also have reviews and have to meet their requirements for systems and infrastructure.

Senator FAIRCLOTH. Mr. Warnement.

Mr. WARNEMENT. I think that the protection of the overall Federal safety net, as it regards thinking about smaller firms who are not quite ready or who have different risk management philosophies, ultimately resides in the supervisory activities of both the securities regulators who have jurisdiction over these firms, as well as the Federal Reserve.

Frankly, if the firewalls are brought down, we expect to see even more rigorous reviews of affiliate transactions than we faced in the past, evidencing safety and soundness.

We spend a great deal of time focusing on affiliated transactions, including some of the types that were described today, because we know that: first, we don't want to take undue risk that threatens our institution; and second, we also know that our regulators are going to look very carefully at those transactions.

Senator FAIRCLOTH. Thank you.

Mr. Calomiris.

Mr. CALOMIRIS. I suppose the only thing that I thought of that wasn't said is that capital requirements are still being instituted. Banks don't have some sort of a carte blanche to establish these affiliates whenever they want.

I would add to that, though, and this really isn't just pertaining to the Section 20 issue, that I think there are some issues, not just having to do with Section 20 affiliates, but more broadly, about whether FIRREA and the FDIC really finished the job of deposit insurance reform, especially in a world of increasing complexity and increasing opportunities for very rapid risk-taking.

Section 20 isn't the place that I'm most worried about that. And I'm not worried about it right now because the capital of our banks is very large. But I see some potential problems down the road. So, I would encourage you to think more broadly about revisiting the safety net issue, which I know is on the front burner for the bankers' roundtable. It is on the front burner for a lot of other organizations, who want to have greater freedom and are worried about the deposit insurance being used as an excuse not to give it to them. But I think that provides us with an opportunity to improve the safeguards for the taxpayers, too.

Senator FAIRCLOTH. Thank you.

I want to thank all of you for being here today. This is something that is very much in the forefront of the thinking and the interest, and especially as there's been some concern, as you heard today, maybe at some point of competitive position between the regulators, and that simply is going to have to be eliminated and ironed out. We intend to see that it is.

As I say, as soon as we reconvene after the Easter recess, I expect to have a hearing in which I intend to ask Comptroller of the Currency Ludwig to appear and explain.

There isn't anyone more interested than I am, and I think most of the Members of the Subcommittee, to see needless regulations and expensive regulations eliminated. We have done too much in the past 40 years in the Federal Government of piling them on without regard to the cost factor involved in regulations. And that applies not only to banking. That is business in general.

So one place to start eliminating any possible rules and regulations would be in the banking industry, and I intend to move in that direction.

I thank each of you for being here.

The Subcommittee is adjourned.

[Whereupon, at 12:38 p.m., the Subcommittee was adjourned.]

[Prepared statements, response to written questions, and additional material submitted for the record follow:]

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, you are certainly to be commended for convening this hearing of the Subcommittee on Financial Institutions and Regulatory Relief. It is your first as Chairman of the Subcommittee and you have chosen an important subject—the wisdom of the proposal by the Federal Reserve to eliminate safeguards—so-called "firewalls"—that it has developed and implemented as a condition of allowing bank holding companies to diversify into the securities business.

Mr. Chairman, I believe strongly in the need for "firewalls" and other safeguards between an insured bank and its securities affiliates. Not only is the taxpayer who ultimately stands behind FDIC insurance protected, but fair competition is also assured between Section 20 affiliates of bank holding companies and other securities and investment banking firms. To underscore the importance of firewalls as a core element of financial modernization, my proposal—S. 298—and virtually every other legislative alternative introduced in the House or Senate over the past decade is predicated upon effective firewalls and other safeguards to insulate the bank from excessive risks.

Congress may be partially to blame for the Fed's imprudent proposal concerning firewalls as well as for the Comptroller of the Currency's ill-advised proposal to allow operating subsidiaries of a bank to conduct "nonbanking" activities. I believe both of these actions are unwise. By our failure to act on a modernization proposal, we have initiated an unwholesome rivalry between bank regulators.

Regulatory actions by the Fed and the OCC will never be a substitute for comprehensive and balanced action by Congress to modernize our outdated laws. The Fed's action on firewalls—the focus of your hearing today—demonstrates once again why Congress must assert itself in this important area. If we do not, I am afraid competition between the regulators will not produce a more competitive marketplace or protect the American taxpayer from a repeat of future financial crises similar to the S&L's in the late 1980's.

Mr. Chairman, I join you in urging the Fed to reconsider its proposal to eliminate the firewalls between commercial banks and their securities affiliates.

PREPARED STATEMENT OF SUSAN M. PHILLIPS

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MARCH 20, 1997

I am pleased to be here today to discuss the Board's Section 20 firewalls—that is, the restrictions the Board has imposed on bank holding companies engaged in underwriting and dealing in securities. As the name suggests, the purpose of firewalls is to insulate a bank and its customers from the potential hazards of combining commercial and investment banking.

Since last year the Board has been engaged in a comprehensive review of the 28 firewalls it erected in the late 1980's, and the Board has recently proposed to eliminate a majority of those restrictions. This oversight hearing provides a constructive opportunity for comment and analysis of the Board's proposal. Furthermore, if financial modernization is to move forward, the issue of firewalls will have to be confronted again. I hope that the Board's review and the public comment process can inform the legislative process as well.

Today, I would like to explain why the Board proposed changes to the firewalls. I will also discuss the final changes the Board made last year to the revenue test that the Board uses to determine compliance with Section 20 of the Glass-Steagall Act, and to firewalls regarding cross-marketing between a bank and a securities affiliate, and officer, director and employee interlocks between two such companies.

The Firewalls in Context: Independent Protections for Banks and Consumers

Before I begin this discussion, I think it is important to place the firewalls in their historical and regulatory context. Although the firewalls have served an important role, they are not the only protection against the hazards of affiliation of commercial and investment banks.

One important protection is the placement of securities activities in a separate subsidiary of the bank holding company, rather than in the bank itself or a subsidiary of the bank. Because nonbank subsidiaries of a bank holding company operating under Section 20 of the Glass-Steagall Act are affiliates of a bank, they are not under the bank's control, do not have their profits or losses consolidated with the bank's, and are less liable to have their creditors recover against the bank. A bank, therefore, has less incentive to risk its own reputation or to expose itself or its customers to loss in order to assist a troubled Section 20 affiliate or a failed underwriting by that affiliate.

Also, because securities activities are conducted in an affiliate, banks are limited in their ability to fund those activities by Sections 23A and 23B of the Federal Reserve Act. These restrictions are vitally important. Section 23A limits the total value of transactions with any one affiliate to 10 percent of the bank's capital and limits transactions with all affiliates to 20 percent of capital. It also requires that substantial collateral be pledged to the bank for any extension of credit. Section 23B requires that inter-affiliate transactions be at arm's length and on market terms, and imposes other restrictions designed to limit conflicts of interest.

Thus, affiliate status prevents the bank from passing along the Federal subsidy inherent in the Federal safety net to its Section 20 affiliate by extending credit. The regulators could conceivably limit a bank's ability to use credit to subsidize a direct securities subsidiary of the bank as well, by applying Sections 23A and 23B. But the equity investment in the subsidiary would still be funded from subsidized resources backed by the Federal safety net. Even if the investment were deducted from the capital of the bank, the subsidy inherent in the transfer would remain.

A second protection is examination of the bank holding company, including the effect of securities activities on insured depository institution subsidiaries. The Federal Reserve as holding company regulator monitors compliance with Sections 23A and 23B and other aspects of the relationship between a bank and its Section 20 affiliate. In its supervision of bank holding companies, the Board increasingly pays attention to risk-management systems and policies that are centralized at the holding company level and govern both the bank and its Section 20 affiliate.

A final series of protections is the regulatory regime that applies to all broker-dealers, including Section 20 subsidiaries. The Securities Act of 1933 and the Securities Exchange Act of 1934 impose registration, capital and disclosure requirements, anti-fraud protections, and other investor-protection measures. These laws, and their enforcement by the Securities and Exchange Commission, address many of the safety and soundness and the conflict-of-interest concerns about affiliation of commercial and investment banks.

I note that most of these important protections were not in place when the Glass-Steagall Act passed in 1933. Thus, although proponents of high firewalls frequently cite the subtle hazards of affiliation discussed in the legislative history of that Act, the regulatory environment was far different then. I believe that the drafters of the Glass-Steagall Act would have had a very different discussion—passed a very different Act—had today's statutory and regulatory protections been present in 1933.

Not only were these protections largely absent in 1933, some were not even present in 1987 when the Board first erected its firewalls. Section 23B of the Federal Reserve Act had not been adopted at the time of the Board's first Section 20 order in 1987. As a result, many of the firewalls overlap the restrictions of Section 23B, which as I noted requires inter-affiliate transactions to be at arm's length and on market terms, but also prohibits a Section 20 affiliate from representing that an affiliated bank is responsible for its obligations, and prohibits a bank from purchasing certain products from a Section 20 affiliate. Similarly, risk-based capital standards did not exist in 1987, and those standards now require a bank to hold capital against many of the on- and off-balance-sheet exposures it maintains in conjunction with a Section 20 affiliate. And finally, the Interagency Statement on Retail Sales of Nondeposit Investment Products was not adopted until 1994. The Interagency Statement includes disclosure and other requirements that are now the primary means by which the Federal banking agencies seek to ensure that retail customers are not misled about the nature of nondeposit products they are purchasing on bank premises.

The Board's Review

Thus, when the Board last year decided to re-examine the firewalls, we felt it important to do so with a fresh eye, benefiting from our 10 years of experience supervising the Section 20 affiliates, acknowledging regulatory and legal developments since 1987, and focusing on the relevance of the firewalls in today's financial markets. As we began to look at the concerns the firewalls were designed to address, we asked two questions. Does the affiliation of a commercial and an investment bank cause safety and soundness or other concerns not present with any other commercial bank affiliation—concerns not addressed by general bank holding company regulation? Does operation of a broker-dealer within a bank holding company cause concerns that independent operation does not—concerns not addressed by broker-dealer regulation? In some areas—most notably, consumer protection—we believed that the answer was "yes." In most other areas, however, the Board believed, at least pending public comment, that the answer was "no."

The answers to these questions are important because the firewalls are far from costless. They impose operational inefficiencies on bank holding companies that increase their costs and reduce their competitiveness, and they limit a bank holding company's ability to market its products in a way that is both most profitable and desired by its customers. As such, the firewalls have served as a significant barrier to entry for small- and mid-size bank holding companies because those companies cannot realize sufficient synergies or achieve adequate operating revenues to justify establishing a Section 20 subsidiary. The loss is not just to these companies but also to their customers and market competition.

Let me now discuss the most important of the firewalls to which the Board has proposed changes. The comment period closed on this proposal last week, and the comments were overwhelmingly favorable. I will not discuss all 28 firewalls but have attached a summary list and their proposed disposition.

Restrictions on Funding

The Board proposed to eliminate a series of firewalls that constitute a blanket prohibition on a bank's funding its Section 20 affiliate, and to rely instead on the protections of Sections 23A and 23B of the Federal Reserve Act. The firewalls in question prohibit a bank from extending credit to a Section 20 affiliate, purchasing corporate and other nongovernmental securities being underwritten by the Section 20 affiliate, or purchasing from the Section 20 affiliate such securities in which the affiliate makes a market. These firewalls were intended to prevent a bank from assisting a troubled affiliate by lending to it on preferential terms or by bailing out a failed underwriting by purchasing securities that cannot otherwise be sold.

Except for the prohibition on purchasing securities during this underwriting period, none of these funding firewalls was applied under the Board's original 1987 order, but were added in 1989 when the range of permissible securities activities was expanded. Bank subsidiaries of the 14 companies operating under the 1987 order have therefore been free to, and have in fact, funded their Section 20 affiliates subject to Sections 23A and 23B. The Board has not encountered problems arising from such funding.

If the Board were to eliminate the funding restrictions for the remaining Section 20 subsidiaries, Sections 23A and 23B would continue to impose quantitative and qualitative restrictions on inter-affiliate transactions. In addition to requiring that the transaction be on market terms, Section 23B specifically prohibits a bank from purchasing any security for which a Section 20 affiliate is a principal underwriter during the existence of the underwriting or selling syndicate, unless such a purchase has been approved by a majority of the bank's board of directors who are not officers of any bank or any affiliate. If the purchase is as fiduciary, the purchase must be permitted by the instrument creating the fiduciary relationship, court order, or State law. We believe these are substantial protections, and have proposed to rely on them in place of a firewall.

Prohibitions on a Bank Extending or Enhancing Credit in Support of Underwriting or Dealing by a Section 20 Affiliate

Three of the Board's firewalls restrict the ability of a bank to assist a Section 20 affiliate *indirectly,* by enhancing the marketability of its products or lending to its customers. These firewalls prohibit a bank from extending credit or offering credit enhancements in support of corporate and other nongovernmental securities being underwritten by its Section 20 affiliate or in which the Section 20 affiliate makes a market; extending credit to issuers of securities to repay principal or interest on securities previously underwritten by a Section 20 affiliate; or extending credit to customers to purchase securities currently being underwritten by a Section 20 affiliate. The firewalls share a common purpose: to prevent a bank from imprudently exposing itself to loss in order to benefit the underwriting or dealing activities of its affiliate.

However, as financial intermediation has evolved, corporate customers frequently seek to obtain a variety of funding mechanisms from one source. By prohibiting banks from providing routine credit or credit enhancements in tandem with a Section 20 affiliate, these firewalls hamper the ability of bank holding companies to serve as full-service financial services providers. The firewall thereby reduces options for their customers. For example, existing corporate customers of a bank may wish to issue commercial paper or issue debt in some other form. Although the bank may refer the customer to its Section 20 affiliate, the bank is prohibited from providing credit enhancements even though it is the institution best suited to perform a credit analysis—and, with smaller customers, perhaps the only institution willing to do so. As another example, the restriction on lending for repayment of securities causes a bank compliance problems when renewing a company's revolving line of credit if a Section 20 affiliate has underwritten an offering by that company since the credit was first extended. The bank must either recruit other lenders to participate in the renewal or amend the line of credit in order to specify that its purpose does not include repayment of interest or principal on the newly underwritten securities.

Notably, even if these firewalls were lifted, a bank would still be required to hold capital against all credit enhancements and credit extended to customers of its Section 20 affiliate. Section 23B of the Federal Reserve Act would require that such credit and credit enhancements be on an arm's-length basis. Similarly, the Federal anti-tying statute would prohibit a bank from offering discounted credit enhancements on the condition that an issuer obtain investment banking services from a Section 20 affiliate. Thus, for example, a bank could not offer such credit enhancements below market prices, or to customers who were poor credit risks, in order to generate underwriting business for a Section 20 affiliate.

The firewall prohibiting lending to retail customers for securities purchases during the underwriting period addresses one of the most important potential conflicts of interests arising from the affiliation of commercial and investment banking: the possibility that a bank would extend credit at below-market rates in order to induce consumers to purchase securities underwritten by its Section 20 affiliate. The concern here is not only safety and soundness but customer protection.

The Securities Exchange Act of 1934 already prohibits a broker-dealer (including a Section 20 affiliate) from extending or arranging for credit to its customers during the underwriting period. Still, we recognize the Act would not apply in the absence of arranging and, unlike the firewall, would not cover loans to purchase a security in which a Section 20 affiliate makes a market. Section 23B of the Federal Reserve Act, and to some extent Section 23A, would address some of these remaining concerns, but perhaps not all. The Board will be reviewing the comments on this firewall carefully.

Capital Requirements

The next group of firewalls that I will discuss imposes capital requirements on a bank holding company and its Section 20 subsidiary. These firewalls require a bank holding company to deduct from its capital any investment in a Section 20 subsidiary and most unsecured extensions of credit to a Section 20 subsidiary engaged in debt and equity underwriting; they also require the Section 20 subsidiary to maintain its own capital in keeping with industry norms. These requirements apply only to Section 20 subsidiaries and not to any other nonbank subsidiary of a bank holding company.

The Board proposed to eliminate the capital deductions for investments in, or credit extended to, a Section 20 subsidiary. The original purpose of the deduction was to ensure that the holding company maintained sufficient resources to support its Federally-insured depository institutions. In practice, however, the deductions have created regulatory burden without strengthening the capital levels of the insured institutions.

The deduction is inconsistent with the Generally Accepted Accounting Practices, which require consolidation of subsidiaries for accounting purposes. The deduction, therefore, has created confusion and imposed costs by requiring bank holding companies to prepare statements on two bases. The deduction does not strengthen the capital of either the bank or its Section 20 affiliate, and elimination of the deduction would not create or expose any incentive for a bank holding company to divert necessary capital from a depository institution to a Section 20 subsidiary. One of the purposes of the system of prompt corrective action adopted in 1992 is to ensure that a bank holding company maintains the capital of its subsidiary banks.

The Board also sought comment on whether it should continue to impose a special capital requirement on Section 20 subsidiaries in addition to the SEC's net capital rules. The purpose of this requirement was to prevent a Section 20 subsidiary from being able to leverage itself more than, and gain a competitive advantage over, its independent competitors by trading on the reputation of its affiliated bank. Although the SEC imposes capital requirements on all broker-dealers, these are minimum levels that are far below the industry norm.

This capital firewall has proven confusing and controversial, as "industry norms" are difficult to determine. Federal Reserve examiners have expected Section 20 subsidiaries to maintain capital to cover risk exposure in an amount approximately twice what the SEC requires, but some Section 20 subsidiaries have complained that this is more than their competitors maintain. They also argue that whereas SEC capital requirements allow all capital to be concentrated in the broker-dealer and dedicated to meeting capital requirements, a bank holding company must meet capital requirements at the bank and holding company levels as well.

Indeed, bank holding company capital is measured on a consolidated basis, and thus includes the capital and assets of the Section 20 subsidiary. Therefore, the Board believes it may be unnecessary to impose a separate capital requirement on the bank holding company's Section 20 subsidiary.

Remaining Restrictions

Before leaving the Board's proposal, I should also note which restrictions the Board proposed to *retain*. The Board proposed to reserve its authority to reimpose the funding, credit extension, and credit enhancement firewalls in the event that an affiliated bank or thrift becomes less than well capitalized and the bank holding company does not promptly restore it to the well-capitalized level. The Board considered proposing to reimpose the firewalls on less than well capitalized banks automatically—as some recent bills introduced in the Congress would—but decided against it because a decline in a bank's capital ratios may be wholly unrelated to the bank's dealings with its Section 20 affiliate. Thus, for example, forcing a bank suffering serious losses on real estate lending to desist from credit enhancements may be unproductive or—if the business is profitable—counterproductive.

The Board also proposed to retain existing firewalls requiring adequate internal controls and documentation, including a requirement that a bank exercise independent and thorough credit judgment in any transaction involving an affiliate. Although we expect banking organizations to have such internal controls and look for them during examinations, we believe that they are sufficiently important to warrant reinforcement through the operating standards. They are especially important in the Section 20 context because of the likelihood that a bank and its Section 20 affiliate may be selling similar products to the same customer.

Because of the potential for customer confusion as to which products are Federally-insured, the Board proposed to require a Section 20 affiliate to make disclosures to customers similar to those that the Interagency Statement requires of a bank selling nondeposit products on bank premises. The proposal would also continue to prohibit an affiliated bank from knowingly advising a customer to purchase securities underwritten or dealt in by a Section 20 affiliate unless it notifies the customer of its affiliate's role. The proposal also continues to prohibit a bank and its Section 20 affiliate from sharing any nonpublic customer information without the customer's consent.

Earlier Board Action on Other Firewalls and the Revenue Limit

In addition to describing the Board's recent proposal, you also asked me to discuss other changes the Board finalized last year: increasing the Section 20 revenue limit from 10 percent to 25 percent; allowing cross-marketing between a bank and a Section 20 affiliate; permitting employee interlocks between a bank and a Section 20 affiliate; and scaling back a restriction on officer and director interlocks.

The review that led to changes to the cross-marketing and interlocks firewalls was akin to what the Board recently went through for all the firewalls. The Board acted on these firewalls before the rest because it had previously sought comment on them some years ago and because they were identified by commenters as among the most unduly burdensome of all the firewalls. After reviewing its experience administering these firewalls, the Board decided that they caused inefficiencies that could not be justified by any benefit to safety and soundness, and commenters agreed overwhelmingly. Repeal of the interlocks and cross marketing restrictions allows increased synergies in the operation of a Section 20 subsidiary and its bank affiliates. Persons may be employed by both companies, and the trend toward coordinated management of like business functions can accelerate, with reporting lines running between companies. Companies need not fund dual back offices or trading floors, for example. To the extent that senior bank managers may now oversee related operations at a Section 20 affiliate, risk management and safety and soundness may be improved.

Moreover, existing disclosure requirements adequately address concerns about customer confusion arising from increased cross-marketing and employee interlocks. Most notably, the Interagency Statement on Retail Sales of Nondeposit Products states that, prior to the initial sale of a nondeposit product by a bank employee or on bank premises, the customer must receive and acknowledge a written statement that the product being sold is not Federally-insured, is not a deposit or other obligation of the bank, is not guaranteed by the bank, and is subject to investment risks including loss of principal.

Finally, with regard to the revenue limit, Section 20 of the Glass-Steagall Act prohibits a bank from being affiliated with any company "engaged principally" in underwriting and dealing, and the Board was obliged to make a narrow, legal determination of the level of revenue at which a company becomes "engaged principally." The Board interpreted the statute to allow 25 percent of total revenue to be derived from underwriting and dealing in bank-ineligible securities. In reviewing the revenue limit, the Board was not deciding what level of underwriting and dealing was consistent with safety and soundness or public policy. If it were, the Board may well have raised the limit to 100 percent, which would have been consistent with the Board's support of repeal of Section 20.

I am pleased to report that early indications of the effects of these changes have been favorable. The Board currently has pending three applications to establish a Section 20 subsidiary. As we had anticipated, two of these are small- to mid-size bank holding companies which may previously have either found it too expensive to fund the dual staffing required by the interlocks restrictions or too difficult to generate sufficient eligible revenue to maintain compliance with a 10 percent revenue limit. Furthermore, existing Section 20 subsidiaries have indicated that they have been able to rationalize their organization and expand their activities given the added flexibility with respect to both staffing and revenue.

SUMMARY OF THE FEDERAL RESERVE BOARD'S EXISTING AND PROPOSED SECURITIES FIREWALLS

General Provision

The Board's proposal retains the authority of the Board to reimpose these restrictions on banks that are not well capitalized, but does not do so automatically. For example, the Board could restrict an undercapitalized bank from credit enhancing securities underwritten by a securities affiliate if such funding had caused a depletion of capital at the bank, but could allow such credit enhancements to continue if they were profitable (and the bank's troubles were due to, for example, real estate lending and/or a regional economic downturn).

Firewall-by-Firewall Comparison

I. Capital Adequacy Conditions

FIREWALL 1(a)—DEDUCTION OF INVESTMENT IN SUBSIDIARY FROM BANK HOLDING COMPANY CAPITAL

Existing Firewall. A bank holding company must deduct from its regulatory capital any investment it makes in the Section 20 subsidiary that is treated as capital in the Section 20 subsidiary.

Board's Proposal. The Board proposed to eliminate this restriction. The deconsolidation requirement is inconsistent with GAAP and has therefore created confusion and imposed costs by requiring bank holding companies to prepare statements on two bases. Meanwhile, the deduction does not strengthen the capital of any insured depository institution affiliate of the Section 20 subsidiary or the Section 20 subsidiary itself, which is already subject to SEC-imposed capital requirements. Elimination of the deduction would not create or expose any incentive for a bank holding company to take capital necessary to support a depository institution and reinvest it in a Section 20 subsidiary. Finally, the Board has recently adopted a system for analyzing market risk that will better measure the capital adequacy of a banking organization.

FIREWALL 1(b)—DEDUCTION OF EXTENSIONS OF CREDIT FROM HOLDING COMPANY CAPITAL

Existing Firewall. A bank holding company must deduct from its regulatory capital any credit it or a nonbank subsidiary extends directly or indirectly to the Section 20 subsidiary unless the extension of credit is fully secured by U.S. Treasury securities or other marketable securities and is collateralized in the same manner and to the same extent as would be required under Section 23A(c) of the Federal Reserve Act if the extension of credit were made by a member bank.

Board's Proposal. The Board proposed to eliminate the deduction required by this firewall for the same reasons as Firewall 1(a), but retain the requirement that a bank holding company maintain adequate capital on a fully consolidated basis as a condition for operating a Section 20 subsidiary.

FIREWALL 2—PRIOR APPROVAL REQUIREMENT FOR INVESTMENTS IN SUBSIDIARY

Existing Firewall. Neither a bank holding company nor its nonbank subsidiaries may provide capital, credit, or any other funds to a Section 20 subsidiary without prior notice to and approval by the Board.

Board Action. The Board has repealed this restriction.

FIREWALL 3—REQUIREMENT OF CAPITAL PLAN

Existing Firewall. Before commencing bank-ineligible securities activities, each bank holding company must submit to the Board acceptable plans to raise additional capital or demonstrate that it is strongly capitalized and will remain so after making the capital adjustments authorized or required by this Order.

Board's Proposal. The Board proposes to eliminate this firewall as superfluous, since the Board fully analyzes each application, including available capital.

FIREWALL 4—CAPITAL ADEQUACY REQUIREMENT

Existing Firewall. The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.

Board's Proposal. The Board sought comment on whether to retain this firewall, which has been understood to require Section 20 subsidiaries to maintain capital levels consistent with industry norms for independent investment banks. The purpose of this capital requirement was to prevent a Section 20 subsidiary from operating below industry capital standards by trading on the reputation of its affiliated bank. The requirement thus seeks to prevent Section 20 subsidiaries from being able to leverage themselves more than, and gain a competitive advantage over, their independent competitors and to serve as a buffer to protect the affiliated bank. However, the restriction has proven confusing and controversial, as "industry norms" are difficult to determine.

II. Credit Extensions to Customers of the Underwriting Subsidiary

FIREWALL 5—RESTRICTION ON CREDIT ENHANCEMENT

Existing Firewall. No bank holding company or its subsidiary shall extend credit, issue, or enter into a stand-by letter of credit, asset purchase agreement, indemnity, guarantee, insurance, or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten or distributed by the underwriting subsidiary.

Board's Proposal. The Board proposed to eliminate the credit enhancement firewall, as other protections (capital requirements that now include off-balance-sheet obligations, loan-to-one-borrower restrictions, internal controls, the "arms-length" requirement of Section 23B) adequately serve its purposes, and its burden on Section 20 subsidiaries and their customers therefore cannot be justified. A requirement for internal controls relating to such credits is retained.

FIREWALL 6—RESTRICTION ON FUNDING PURCHASES OF SECURITIES

Existing Firewall. No bank holding company or subsidiary (other than the underwriting subsidiary) shall knowingly extend credit to a customer in order to purchase an ineligible security that an affiliated underwriting subsidiary underwrites during the period of the underwriting or for 30 days thereafter, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.

Board's Proposal. The Board sought comment on whether to retain this firewall, noting its importance but asking whether its concerns are adequately addressed by Section 11(d) of the Securities Exchange Act of 1934 and Section 23B of the Federal Reserve Act.

FIREWALL 7—RESTRICTION ON EXTENSIONS OF CREDIT FOR REPAYMENT OF UNDERWRITTEN SECURITIES

Existing Firewall. No bank holding company or any of its subsidiaries may extend credit to issuers of the ineligible securities underwritten by a Section 20 affiliate for the purpose of the payment of principal, interest, or dividends on such securities. Exception if substantial participation by other lenders or if terms of loan make clear it has another purpose.

Board's Proposal. The Board proposed to eliminate this restriction. The firewall has proven burdensome and has had unintended effects. For example, banks face compliance problems renewing a company's revolving line of credit if a Section 20 subsidiary has underwritten an offering by that company since the credit was first extended; the bank must either recruit other lenders to participate in the renewal or amend the line of credit in order to specify its purpose. In addition, Section 23B of the Federal Reserve Act would generally apply to extensions of credit for the purpose of payment of principal, interest, or dividends that are currently covered by Firewall 7. A requirement for internal controls relating to such credits is retained.

FIREWALL 8—PROCEDURES FOR COMPLYING WITH RESTRICTION OR EXTENSIONS OF CREDIT

Existing Firewall. Each bank holding company shall adopt appropriate procedures, including maintenance of necessary documentary records, to assure that any extension of credit by it or any of its subsidiaries to issuers of ineligible securities underwritten or dealt in by an underwriting subsidiary are on an arm's length basis for purposes other than payment of principal, interest, or dividends on the issuer's ineligible securities being underwritten or dealt in by the underwriting subsidiary.

Board's Proposal. The Board proposed to eliminate this firewall. Section 23B, enacted since this firewall was initially adopted, requires extensions of credit by a bank in conjunction with an issuance of securities underwritten by a Section 20 affiliate to be on arm's-length terms.

FIREWALL 9—RESTRICTION ON THRIFTS

Existing Firewall. In any transaction involving an underwriting subsidiary, Applicants' thrift subsidiaries shall observe the limitations of Sections 23A and 23B of the Federal Reserve Act as if the thrifts were banks.

Board's Proposal. This condition became superfluous when the Home Owners' Loan Act was amended to apply Sections 23A and 23B of the Federal Reserve Act to a thrift as if were a member bank. The Board proposed to eliminate it.

FIREWALL 10—RESTRICTION ON INDUSTRIAL REVENUE BONDS

Existing Firewall. The requirements relating to credit extensions to issuers noted in paragraphs 5–9 above shall also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds.

Board's Proposal. As the Board is proposing to eliminate the incorporated restrictions, the Board is proposing to eliminate this restriction as well.

FIREWALL 11—LOAN DOCUMENTATION AND EXPOSURE LIMITS

Existing Firewall. Bank holding companies shall cause their subsidiary banks and thrifts to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in financing transactions underwritten or arranged by an underwriting subsidiary as set forth in this Order. The Reserve Banks shall ensure that these policies and procedures are in place at Applicants' subsidiary banks and thrifts and Applicants shall assure that loan documentation is available for review by Reserve Banks to ensure that an independent and thorough credit evaluation has been undertaken in connection with bank or thrift participation in such financing packages and that such lending complies with the requirements of this Order and Section 23B of the Federal Reserve Act.

Board's Proposal. The Reserve Board proposed to retain this restriction in slightly amended form.

FIREWALL 12—PROCEDURES FOR LIMITING EXPOSURE TO ONE CUSTOMER

Existing Firewall. Bank holding companies should establish appropriate policies, procedures, and limitations regarding exposure of the holding company on a consolidated basis to any single customer whose securities are underwritten or dealt in by the underwriting subsidiary.

Board's Proposal. The Board is seeking comment on whether to include this restriction in its operating standards for Section 20 subsidiaries. The firewall restricts the ability of a holding company to expose itself to one issuer in support of its Section 20 subsidiary. However, the need for internal limits and the appropriate sophistication of those limits varies greatly from company to company, and might be better addressed through the examination process.

III. Limitations to Maintain Separateness of an Underwriting Affiliate's Activity

FIREWALL 13—INTERLOCKS RESTRICTION

Existing Firewall (as amended).[1] Directors, officers, or employees of a bank or thrift shall not serve as a majority of the board of directors or the chief executive officer of an affiliated Section 20 subsidiary, and directors, officers, or employees of a Section 20 subsidiary shall not serve as a majority of the board of directors or the chief executive officer of an affiliated bank or thrift. The underwriting subsidiary will have separate offices from any affiliated bank or thrift.

Board's Proposal. The Board recently amended the restriction on interlocks, and did not propose further changes to that restriction. The Board did propose to elimi-

[1] 61 FR 57679, 57683 (1996).

nate the separate office requirement, relying on the Interagency Statement on Retail Sales of Nondeposit Investment Products.

IV. Disclosure by the Underwriting Subsidiary

FIREWALL 14—CUSTOMER DISCLOSURES

Existing Firewall. A Section 20 subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its bank and thrift affiliates and pointing out that an affiliated bank or thrift could be a lender to an issuer and referring the customer to the disclosure documents for details. In addition, the statement shall state that securities sold, offered, or recommended by the underwriting subsidiary are not deposits, are not insured by the Federal Deposit Insurance Corporation, are not guaranteed by an affiliated bank or thrift, and are not otherwise an obligation or responsibility of such a bank or thrift (unless such is the case). The underwriting subsidiary should also disclose any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.

Board's Proposal. The Board proposed to amend the disclosure firewall to follow the Interagency Statement on Retail Sales of Nondeposit Investment Products that applies to sales by bank employees or on bank premises. A Section 20 subsidiary would be required to provide each of its retail customers the same disclosures that the Interagency Statement mandates for retail customers of banks, even when it was operating off bank premises. This would narrow the firewall by no longer requiring disclosures to institutional customers (who should be aware of whether a product is Federally-insured or bank guaranteed) but broaden the firewall to require an acknowledgement of the disclosure by retail customers.

V. Marketing Activities on Behalf of an Underwriting Subsidiary

FIREWALL 15—RESTRICTION ON ADVERTISING BANK CONNECTION

Existing Firewall. Prohibits a Section 20 or any other affiliate from suggesting that an affiliated bank or thrift is responsible in any way for the underwriting subsidiary's obligations.

Board's Proposal. This restriction has been superseded by Section 23B(c) of the Federal Reserve Act, and the Board proposed to eliminate it.

FIREWALL 16—CROSS-MARKETING AND AGENCY ACTIVITIES BY BANKS

Existing Firewall. Already deleted.[2]

VI. Investment Advice by Bank/Thrift Affiliates

FIREWALL 17—INVESTMENT ADVICE

Existing Firewall. An affiliated bank may not express an opinion on the value or the advisability of the purchase or the sale of ineligible securities underwritten or dealt in by a Section 20 affiliate unless the bank or thrift notifies the customer that the underwriting subsidiary is underwriting, making a market, distributing or dealing in the security.

Board's Proposal. The Board proposed to retain this restriction.

FIREWALL 18—RESTRICTION ON FIDUCIARY PURCHASES DURING UNDERWRITING PERIOD OR FROM MARKET MAKER

Existing Firewall. No bank holding company or its bank subsidiaries shall purchase, as a trustee or in any other fiduciary capacity, for accounts over which they have investment discretion ineligible securities: (a) underwritten by the underwriting subsidiary as lead underwriter or syndicate member during the period of any underwriting or selling syndicate, and for a period of 60 days after the termination thereof; and, (b) from the underwriting subsidiary if it makes a market in that security, unless, in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.

Board's Proposal. The Board proposed to eliminate this restriction, which is now largely duplicated by Section 23B(b)(1)(B) of the Federal Reserve Act.

[2] 61 FR 57679, 57683 (1996).

VII. Extensions of Credit and Purchases and Sales of Assets

FIREWALL 19—RESTRICTIONS ON PURCHASES AS PRINCIPAL DURING UNDERWRITING PERIOD OR FROM MARKET MAKER

Existing Firewall (as amended). No bank holding company or its subsidiaries shall purchase, as principal, ineligible securities that are underwritten by a Section 20 affiliate during the period of the underwriting and for 60 days after the close of the underwriting period, or shall purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.

Board's Proposal. The Board proposed to eliminate this restriction, which precludes bank and nonbank subsidiaries of a bank holding company subsidiary from obtaining attractive issues underwritten or dealt in by a Section 20 affiliate. As with Firewall 18, Section 23B prohibits a bank from purchasing, as principal or fiduciary, any security for which a Section 20 affiliate is a principal underwriter during the existence of the underwriting or selling syndicate, unless such a purchase has been approved by a majority of the bank's board of directors who are not officers of the bank or any affiliate.

FIREWALL 20—RESTRICTION ON UNDERWRITING AND DEALING IN AFFILIATES' SECURITIES

Existing Firewall (as amended).[3] A Section 20 subsidiary may not underwrite or deal in any ineligible securities issued by its affiliates or representing interest in, or secured by, obligations originated or sponsored by its affiliates. (There are a few exceptions for rated securities and GSE securities.)

Board's Proposal. The Board proposed to eliminate this restriction, which prohibits a Section 20 affiliate from underwriting securities issued by an affiliated bank. Rule 2720 of the National Association of Securities Dealers already imposes substantially the same restriction.

FIREWALL 21(a)—PROHIBITION ON EXTENSIONS OF CREDIT TO SECTION 20 SUBSIDIARY

Existing Firewall. Bank holding companies shall ensure that no bank subsidiary extends credit to a Section 20 affiliate, or issues a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, for the benefit of the Section 20 affiliate.

Board's Proposal. The Board proposed to eliminate this restriction except insofar as it applies to intra-day extensions of credit for clearing purposes. Because this firewall was not applied under the *1987 Order,* bank subsidiaries of the 14 companies operating under that order have therefore been free to, and have in fact, funded their Section 20 affiliates. In 9 years of supervising companies operating under the 1987 Order, the Board has not encountered significant problems arising from such funding. Such transactions are also subject to Sections 23A or 23B of the Federal Reserve Act, which address potential conflicts of interest.

FIREWALL 21(b)

Existing Firewall. [This firewall is an exception to Firewall 21(a) for clearing.]

Board's Proposal. The Board proposed to eliminate Firewall 21(b).

FIREWALL 22—FINANCIAL ASSETS RESTRICTION

Existing Firewall (as amended).[4] A bank may not, for its own account, purchase financial assets of an affiliated underwriting subsidiary or a subsidiary thereof or sell such assets to the underwriting subsidiary or subsidiary thereof. This limitation shall not apply to the purchase and sale of assets having a readily identifiable and publicly available market quotation and purchased at that market quotation, provided that they are not part of a repurchase or reverse repurchase agreement.

Board's Proposal. The Board proposed to eliminate this firewall. Section 23B of the Federal Reserve Act would still require that all such purchases be made on arm's-length terms, and Section 23A would impose quantitative limits. Moreover, the National Bank Act limits the type of investment securities that a national bank may hold, generally to investment grade securities. Elimination of this restriction would allow repurchase and reverse repurchase agreements as a funding vehicle between a Section 20 subsidiary and its affiliated banks.

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[3] 75 Federal Reserve Bulletin 751 (1989).

[4] 61 FR 57679, 57683 (1996).

VIII. Limitations on Transfers of Information

FIREWALL 23—DISCLOSURE OF NONPUBLIC INFORMATION

Existing Firewall. No bank or thrift shall disclose to an underwriting subsidiary, nor shall an underwriting subsidiary disclose to an affiliated bank or thrift, any nonpublic customer information (including an evaluation of the creditworthiness of an issuer or other customer of that bank or thrift, or underwriting subsidiary) without the consent of that customer.

Board's Proposal. The Board proposes to include this restriction in its operating standards, as it constitutes an important customer protection.

IX. Reports

FIREWALL 24—REPORTS TO FEDERAL RESERVE

Existing Firewall. Bank holding companies shall submit quarterly reports to the Federal Reserve, the NASD, and other self-regulatory organizations.

Board's Proposal. The Board proposed to retain this requirement.

X. Transfer of Activities and Formation of Subsidiaries of an Underwriting Subsidiary to Engage in Underwriting and Dealing

FIREWALL 25—SCOPE OF ORDER

Existing Firewall. The Board's approval extends only to the subsidiaries described above for which approval has been sought in the instant applications.

Board's Proposal. The Board proposes to eliminate this firewall. Each order approving Section 20 activities can make plain the scope and organizational structure of the activities approved.

XI. Limitations on Reciprocal Arrangements and Discriminatory Treatment

FIREWALL 26—PROHIBITION ON RECIPROCITY ARRANGEMENTS

Existing Firewall. No Applicant nor any of its subsidiaries may, directly or indirectly, enter into any reciprocal arrangement. A reciprocal arrangement means any agreement, understanding, or other arrangement under which one bank holding company (or subsidiary thereof) agrees to engage in a transaction with, or on behalf of, another bank holding company (or subsidiary thereof), in exchange for the agreement of the second bank holding company (or any subsidiary thereof) to engage in a transaction with, or on behalf of, the first bank holding company (or any subsidiary thereof) for the purpose of evading any requirement of this Order or any prohibition on transactions between, or for the benefit of, affiliates of banks established pursuant to Federal banking law or regulation.

Board's Proposal. The Board proposed to eliminate this firewall. Anticompetitive reciprocity arrangements are prohibited by the antitrust laws, and reciprocity arrangements involving a bank are subject to a special *per se* prohibition in Section 106 of the Bank Holding Company Act Amendments of 1970. The Board could also rely on the examination process to identify any evasions of the proposed operating standards that do not run afoul of a statutory prohibition.

FIREWALL 27—PROHIBITION ON DISCRIMINATORY TREATMENT

Existing Firewall. No bank or thrift affiliate of an underwriting subsidiary shall, directly or indirectly: (a) extend or deny credit or services if the effect of such action would be to treat an unaffiliated securities firm less favorably than its affiliated underwriting subsidiary; or (b) extend or deny credit or services with the intent of creating a competitive advantage for a Section 20 affiliate.

Board's Proposal. The Board proposed to eliminate the firewall because other laws adequately address the potential conflict. Whereas securities firms had been restricted by Section 8(a) of the Securities Exchange Act of 1934 in the types of lenders from which they could obtain loans secured by securities collateral—generally, to banks and other broker-dealers—Section 8(a) was recently repealed, and such restriction thereby eliminated.

XII. Requirement for Supervisory Review Before Commencement of Activities

FIREWALL 28—INFRASTRUCTURE REVIEW

Existing Firewall. An Applicant may not commence the proposed debt and equity securities underwriting and dealing activities until the Board has determined that the Applicant has established policies and procedures to ensure compliance with the requirements of this Order.

Board's Proposal. The Board proposed to continue to require an infrastructure review in the context of each application rather than including it as an "operating standard" for Section 20 subsidiaries.

PREPARED STATEMENT OF VICTOR A. WARNEMENT

GENERAL COUNSEL

NATIONSBANC CAPITAL MARKETS, INC., SUBSIDIARY OF NATIONSBANK CORPORATION

MARCH 20, 1997

Mr. Chairman and Members of the Subcommittee, I welcome this opportunity to offer my views on the Federal Reserve Board's proposed modifications to the firewalls applicable to "Section 20 subsidiaries" of bank holding companies. I commend the Subcommittee for holding this oversight hearing and its interest in understanding more about the Fed's proposals to generally reduce the regulatory burdens currently imposed on Section 20 companies.

As General Counsel to NationsBanc Capital Markets, Inc., one of the largest and most active Section 20 companies in the country and a subsidiary of NationsBank Corporation, the fourth largest bank holding company in the United States, and given my prior outside law firm experience in representing numerous issuers and investment banks in various securities transactions, I believe I can provide some insights with respect to these proposed modifications from both a regulatory and business perspective.

In my testimony here today, I will first provide some background perspective and thoughts about the Fed's proposed changes. I will then provide a brief overview of the proposals. And finally, I will respond to the six points raised in Senator Faircloth's March 11th letter requesting my testimony.

As the financial services industry has grown and changed at an accelerating pace over the past several decades, driven over the past 10 or so years by dynamic market forces and technological change, our Nation's bank holding companies have become more and more constrained by what in many respects has become an antiquated legal and regulatory framework. The American economy, our industries, our consumers, and our communities will gain from the kinds of reforms and modifications initiated by the Federal Reserve Board over the past several months to permit bank holding companies to deliver efficiently more competitive products and services to their customers. This is a primary goal of the Federal Reserve which the industry applauds. There is little doubt that the additional cost, expense, and inefficiency associated with compliance within the existing constraints, which are not applicable to nonbank securities firms, realistically prevents or inhibits Section 20 companies ultimately from being able to provide better pricing for their products and services.

The Federal Reserve Board's recent and proposed changes, and additional changes that we at NationsBank and others throughout the industry believe are both rational and prudent, will allow Section 20 companies to operate and compete more efficiently and effectively. This in turn will ultimately work to the benefit of both retail and institutional customers of all types through increased competition, lower costs, increased access to financial products and services, and improved service and continuing innovation, all of which will aid in our country's economic growth.

It is undeniably in the public interest to allow bank holding companies to compete on a level playing field with their nonbank financial service industry competitors. Those competitors have made great inroads into areas where customers would have in the past sought out traditional bank services, either by entering directly into competitive activities (such as the syndicated loan business for large corporate customers) or by engineering and developing substitute products and markets.

The time for these changes has clearly come, and many believe they could have prudently been made several years ago. Clearly, advances in communications and technology continue to increase competition in the financial services industry, both domestically and internationally. The continuing strength, vitality, and potentially, the long-term viability of our Nation's banking system depends on the avoidance or elimination of governmentally-imposed burdens that impede competition and create or foster inefficiencies that serve no strong public policy purpose. If our bank holding companies are to continue to serve the public, play a vital role in our Nation's economy, compete here and around the world in this rapidly changing environment, their management must have the ability to meet competition and to adapt their unique businesses to their selected markets. These businesses should not continue to be constrained by firewalls that have been rendered obsolete by real world experience and developments, or by constraints that have become generally redundant due to the existence of other laws or regulatory schemes.

The long-term vitality and vibrancy of our Nation's banking system necessitates flexibility to adapt to the marketplace. If bank holding companies, in part through their Section 20 company activities, remain highly profitable, then they remain a better "source of strength" for their subsidiary banks. Appropriate, but not overly burdensome supervision and regulation and the flexibility to move the business into new or growing areas of the financial services industry provides the greatest opportunity to maintain a safe and sound, yet strong and vibrant banking system within our country.

Since 1987, the Fed has permitted various bank holding companies to establish Section 20 companies to engage in underwriting and dealing in certain securities not eligible for underwriting and dealing by a bank which is a member of the Federal Reserve System. In 1989, as it gained experience, the Fed began to allow Section 20 companies to underwrite and deal in all types of debt and equity securities. Since then, the Fed has imposed a series of prudential restrictions, commonly known as firewalls, as a condition to establishing a Section 20 company. These firewalls were intended to isolate the Section 20 companies from affiliated depository institutions and to prevent the risks perceived to be associated with such securities activities from adversely impacting an affiliated insured depository institution or its bank holding company and, consequently, to the Federal safety net which supports such institutions. Further, the firewalls were created to mitigate potential conflicts of interest, unfair competition, and other adverse effects thought to be associated with such activities.

The Fed has acknowledged that the existing firewalls are a conservative set of rules. However, many of us who live and breath daily in the interplay among these and other overlapping regulatory constraints and the realities of running successful businesses competing with firms not similarly constrained believe the current firewalls are extremely conservative. While accomplishing their original purpose of isolating a Section 20 company from most of its affiliates, the firewalls have impeded dramatically the synergies and efficiencies that bank holding companies should gain from operating permissible investment banking and capital markets businesses.

Originally, the Fed's approach was an understandable regulatory approach given the Fed's unfamiliarity with these securities activities and the supervision of investment banking operations, its perception that there were or might be substantial unknown risks associated with these activities in a bank holding company and the Fed's concern over how existing broker-dealer securities regulation would overlap with broker-dealer subsidiaries of a bank holding company.

The Fed has been very active in supervising and monitoring the Section 20 activities of bank holding companies. NationsBank, along with all other bank holding companies, undergo significant periodic examinations by the staffs of the applicable Federal Reserve Banks. These examinations are in addition to the frequent contact many of us in the industry have with our Federal Reserve examiners or the staff of the Federal Reserve Board to ensure our compliance with these firewalls. All of this is in addition to the regulatory supervision brought to bear by the NASD/SEC regulatory scheme on NationsBanc Capital Markets, Inc. and other Section 20 companies. In fact, next month NationsBank will be hosting both Fed and NASD examiners during their reviews of our Section 20 company's activities.

As the Fed has gained experience with supervising and overseeing the activities of Section 20 companies, the Fed has concluded that the risks attendant with securities underwriting and dealing activities are manageable by Section 20 companies and its management at the bank holding company level. In no way should the Fed's conclusion that many of the current firewalls be eliminated, or greatly modified, be viewed as being undertaken too rapidly or without careful consideration. In addition to the Fed's own experience, additional laws and regulations have been implemented rendering many of the firewalls obsolete or generally redundant, and, therefore, unnecessarily burdensome.

Of equal significance is the absence of abuses by bank holding companies in utilizing their underwriting powers over the past 10 years. The strong record of performance and compliance with regulatory and statutory constraints by Section 20 subsidiaries is also reflected in the number of bills that have been introduced in the current and prior Congressional sessions that would permit bank holding companies to underwrite and deal in securities to an even greater degree. This record is particularly noteworthy in light of the fact that Section 20 subsidiaries are among the most regulated companies in the financial services industry. In addition to detailed inspections by the Fed, Section 20 subsidiaries are also inspected and/or regulated by the Securities and Exchange Commission, the National Association of Securities Dealers, Inc., and State securities regulators. Because of their historical significance, Section 20 subsidiaries have also been subject to close scrutiny by the Congress, acting through the General Accounting Office, and receive a large amount of public attention.

In my view and that of many of my colleagues from the industry, this absence of abuse and record of performance has been fostered by prudent risk taking and risk management by senior management of our respective institutions and by continuing developments and innovation in risk-management systems and techniques that permit relevant risks to be assessed in a more precise manner. The use of these systems and techniques, which are followed and encouraged by our various regulators, permit risk to be assessed and managed in terms of interest rate, market, and counterparty risk across the entire holding company. Risk management plays a significant and vital role within the structure of NationsBank and I am confident, with most of our bank holding company competitors. In addition, most bank holding companies operating significant Section 20 companies have hired numerous experienced personnel in management, legal, and compliance functions to properly support and foster the prudent growth of their businesses. Many of us, hired over the past 10 years to focus on our firms' respective securities activities, have had to essentially take a crash course in bank regulatory matters governing securities activities, often feeling like we have learned a substantially different regulatory scheme, and it is only where our activities fit fully within the confines of each regulatory scheme that we are permitted to play, so to speak, in the business.

For the reasons stated above, NationsBank supports the Federal Reserve Board's proposed firewalls modifications and believes them to be fully appropriate in light of other protections which prudently manage the risks inherent in the securities activities permitted to be engaged in by Section 20 companies.

GENERAL OVERVIEW OF THE FEDERAL RESERVE BOARD'S FIREWALLS MODIFICATION PROPOSAL

The Fed is proposing to replace its 28 firewalls with eight operating conditions. Essentially, the Fed's objective is to repeal all firewalls except those whose concerns are not addressed by other statutes or regulations. In large part, the Fed's action may be interpreted as an acknowledgment that securities underwriting and dealing activities are not inherently riskier than other banking and nonbanking activities and, therefore, should not be subject to more burdensome limitations.

Thus, rather than flatly prohibit a bank from lending to a Section 20 affiliate as the current firewalls do, under the new operating standards, these loans would be permitted, but subject to the same limitations that would apply to a loan by a bank to a leasing or consumer finance affiliate. The eight remaining conditions address such areas as capital adequacy, internal controls, interlocks between a Section 20 company and its bank affiliates, customer disclosures, and confidential customer information.

I would like to briefly review each of the Fed's proposed modifications, all of which we support.

Proposed Amendments to Firewalls

The Fed's proposed modifications to the Firewalls are best summarized into five principal categories:

1. Bank Holding Company Capital Requirements
2. Section 20 Company Capital Requirements
3. Credit-Related Activities Supporting a Section 20 Company's underwriting or Dealing Activities
4. Restrictions on Funding of Section 20 Company
5. Disclosure Requirements

Bank Holding Company Capital Requirements

The Fed has proposed to eliminate the firewalls that have previously required the bank holding company to deduct from its capital any investment made in its Section 20 subsidiary and any extension of credit it may have made to its Section 20 subsidiary unless the credit were fully secured by marketable securities. These firewalls were intended to ensure that holding companies maintained sufficient capital as a source of strength in supporting its Federally-insured depository institutions by eliminating any exposure to its Section 20 affiliate for regulatory capital calculations. As the Fed has noted, this requirement has created regulatory burdens without any apparent strengthening of capital levels of bank holding companies.

Section 20 Company Capital Requirements

The Fed is seeking comment on whether to eliminate, modify, or retain a separate restriction on a Section 20 company which would require it to "maintain at all times capital adequate to support its activities and cover reasonably expected expenses and losses in accordance with industry norms." This firewall was originally created due to a concern that in some manner a Section 20 subsidiary would be able to leverage itself more effectively and therefore gain a competitive advantage over its nonbank securities competitors based on some ability to capitalize on the reputation of its affiliated banks or thrifts. This requirement has proven confusing and controversial as "industry norms" have proven to be too nebulous a standard to accurately apply.

CREDIT-RELATED ACTIVITIES SUPPORTING A SECTION 20 COMPANY'S UNDERWRITING OR DEALING ACTIVITIES

The Fed has proposed to eliminate two of the three firewalls restricting the ability of a bank to extend credit or offer credit enhancement in support of securities being underwritten by a Section 20 company. Both of these firewalls are intended to prevent a bank from imprudently exposing itself to risk of losses in order to benefit the securities activities of its Section 20 affiliate. A bank has no greater incentive to make loans or extend credit to customers of its Section 20 subsidiary than it does to customers of subsidiaries engaged in other activities, such as leasing, factoring, derivatives-related activities or consumer finance. In addition, Section 23B of the Federal Reserve Act requires that any loans made to enhance the credit of issuers whose securities are being underwritten by a Section 20 affiliate or extending credit to issuers of securities previously underwritten by a Section 20 affiliate for the purpose of paying principal, interest, or dividends on those securities must be made on an arm's length basis. As a further protection, the anti-tying rules applicable to banks under the Bank Holding Company Act Amendments of 1970 prohibit banks from offering discounted credit enhancements or loans on the condition that issuers obtain capital markets services from Section 20 affiliates.

RESTRICTIONS ON FUNDING OF SECTION 20 COMPANY

The series of firewalls prohibiting a bank from funding a Section 20 affiliate directly through a loan or indirectly through a purchase of assets, firewalls 18–19 and 21–22, are proposed to be largely eliminated. Given the Fed's supervision of a number of Section 20 companies operating under orders that permit such funding and not encountering significant problems therefrom, and given the protections afforded by Sections 23A and 23B of the Federal Reserve Act's constraints on inter-affiliate transactions, these modifications are highly appropriate.

DISCLOSURE REQUIREMENTS

Current firewall 14 establishes specific disclosure requirements for Section 20 companies to provide help in ensuring that their customers understand the products offered by the Section 20 company are not Federally-insured or otherwise guaranteed by an affiliated bank. The Board's proposal would amend firewall 14 to follow the Interagency Statement, which generally applies to sales to retail customers by bank employees or occurring on bank premises. As compared to the current firewall, the Board's proposal would appropriately eliminate the disclosure requirement for institutional customers of Section 20 companies, but would require an acknowledgment of the special disclosures provided to retail customers of Section 20 companies, even when occurring off the bank's premises.

I would like to now provide specific responses to the issues raised by Senator Faircloth in his March 11th letter requesting testimony with respect to six particular areas.

SPECIFIC RESPONSES TO THE CHAIRMAN'S REQUEST FOR TESTIMONY ON PARTICULAR AREAS

Support or Lack of Support of the Federal Reserve's Proposal

For the reasons I have stated above in my testimony, NationsBank supports the Federal Reserve's proposed modifications, with two exceptions.

First, NationsBank believes that the Fed should not extend the interagency Statement, as proposed, to require the acknowledgment by a retail customer of a Section 20 of special disclosures in connection with sales occurring off the bank's premises. To require special disclosure by retail accounts in conjunction with sales occurring off bank premises is unduly burdensome in light of the low level of risk of customer confusion about the status of nondeposit investment products where customers are not exposed to traditional "bank" signage and traditional bank products. The low level of risk of confusion under such circumstances simply does not warrant the imposition of the added burden of obtaining special customer acknowledgments beyond those that are generally required by securities regulators.

Second, NationsBank opposes the retention of firewall 23 as an operating standard. Firewall 23, which prohibits the sharing of nonpublic customer information between a Section 20 company and its bank/thrift affiliates without customer consent, was formulated to address concerns that Section 20 subsidiaries might have an unfair competitive advantage over securities firms unaffiliated with banks if access to bank information was freely available. Such special concerns are simply unfounded. Since that time, securities firms have expanded rapidly into all areas of commercial lending unhampered by firewall 23. Thus, firewall 23 only ensures that securities firms engaged in such businesses have an unfair competitive advantage over Section 20 companies. In addition, it is inconsistent and highly impractical on the part of the Board to permit banks and Section 20 affiliates to have dual officers, directors, and employees yet not expect such personnel to utilize customer information gained from acting in one capacity to better serve the customer's needs when acting in his or her other permitted capacity. Moreover, there is no similar limitation on sharing such information between banks and other affiliated nonbank entities. Finally, existing securities laws and regulations are clearly sufficient to address other potential abuses by a Section 20 company of earlier concern to the Fed through the use of Chinese walls, deal teams and the like to separate personnel having nonpublic information from those who sell and trade securities based on publicly available information.

A number of industry groups and other institutions have indicated in their comment letters to the Fed concerning these proposals that other operating standards based on existing firewalls proposed to be retained, in fact, be eliminated or greatly modified as being: (i) redundant of existing requirements to maintain appropriate policies and procedures governing all transactions, not special ones for dealing with an affiliated Section 20 company (firewall 11); and, (ii) duplicative of or potentially conflicting with certain SEC/NASD requirements, where a depository institution may not give investment advice regarding securities underwritten or dealt in by an affiliated Section 20 company unless (firewall 17) the relationship is disclosed (with such groups and institutions believing that such disclosure obligation if not eliminated, then at a minimum being based on a "knowledge" standard rather than acting as an absolute prohibition).

Safety and Soundness Concerns

The Federal Reserve's proposed changes to the firewalls may clearly be implemented while preserving the safety and soundness of our Nation's banking system and the integrity of its insured depository institutions. In fact, reducing the regulatory burdens imposed on Section 20 companies and permitting them to be more actively and efficiently engaged in the securities business should have the effect of enhancing safety and soundness principles.

First, the experience of the past 10 years has demonstrated that bank holding companies can operate profitable and sound investment banking businesses. Thus, there is the potential greater diversification in the lines of business pursued by bank holding companies.

Second, the removal of certain firewalls that overlap with or are generally redundant of other statutory or regulatory protections does not on balance, increase risks in any manner that is not dramatically outweighed by the benefits to many institutions, and ultimately to the public, of removing unnecessary and in many instances outdated regulations. It is important to note that even if firewalls were totally eliminated, numerous layers of regulations and supervision would still apply to Section 20 companies.

Third, the Federal Reserve Board and its staff and examiners have gained immeasurable experience in understanding and supervising our Section 20 activities. Moreover, the regulators are moving in the direction of a more functional regulatory approach and we have observed greater cooperation among the various regulators having supervisory jurisdiction over Section 20 companies. The regulators now place great emphasis on evaluating, understanding, and making recommendations concerning the soundness of our processes for assessing, managing, and controlling the risks.

Fourth, senior management at NationsBank and at other institutions have also placed great emphasis on risk management systems and techniques. At NationsBank, the head of all risk management is a Vice Chairman of our Company and a member of its five-person policy committee. Our senior management has indicated that if we cannot operate our Section 20 company in a manner that does not impair or present undue risk to the entire company, then we should not engage in the business.

Finally, as the Fed's examinations have focused more heavily on risk management and internal controls, the Fed has acknowledged that both bank holding companies and banks have engaged in activities "at least as risky as underwriting and dealing securities in a Section 20 affiliate . . . without the restrictions currently imposed in the Section 20 firewalls."

It is also important to note that the Fed has proposed to reserve the right to reimpose certain key restrictions—the funding, credit extension, and credit enhancement firewalls—on an institution-by-institution basis should particular circumstances warrant. We also have little doubt that the Fed would impose these or other restrictions on all Section 20 companies should it perceive undue risks affecting the entire industry that might systemically harm the bank holding companies. We find this approach vastly preferable to a system that is more rigid and outmoded in today's marketplace.

Adequacy of Customer Protections

The modifications currently proposed to the firewalls when combined with existing disclosure requirements concerning customers of all securities firms, simply do not increase the likelihood of customer abuse. First, for purposes of considering customers protections in the securities field, customers of financial institutions should be divided into essentially two classes—institutional and retail. Under existing securities law concepts, retail (individual) customers can be further divided between those who are deemed to be sophisticated enough to "fend for themselves" in terms of the need for additional levels of disclosure about the nature of potential investments and those customers who may need additional protections.

Virtually all institutional customers are capable of protecting themselves from abusive or coercive business practices. Given the level of competition generally within the financial services industry, these customers have or preserve far too many options to be forced into using products or services they do not desire or could obtain from other institutions at lower prices. Retail customers, on the other hand, receive the benefit of special disclosures required by the Interagency Statement (for retail sales of nondeposit investment products) that require an acknowledgment of special disclosures about a lack of Federal insurance supporting certain products any time such sales are made by bank personnel or from bank premises. The Fed has further proposed extending those disclosure requirements to retail accounts even with respect to sales occurring off bank premises. In addition, the securities laws and regulations require that all statements or information supplied to a customer, whether institutional or retail, not contain any material misstatements or omissions with respect to any proposed investment. Further, the NASD has filed with the Securities and Exchange Commission for approval certain rules governing fair practices in which the NASD is attempting to eliminate inconsistencies and conflicts between the NASD's rules and the Interagency Statement. Finally, given the litigious nature of the securities business and certain degree of regulatory pressure, banking institutions have taken steps to offer better and clearer customer information. Even a number of consumer advocates have conceded that banks have improved greatly in warning customers about the risks attendant with securities investments.

Moreover, the anti-tying statute applicable to all national banks prohibits the banks from requiring customers to obtain any additional products or services as a condition to obtaining a particular product or service that they may desire. The exceptions in the tying statute for certain traditional banking products are not applicable to permit the tying of any bank product or service on obtaining a different securities-related product or service. The tying statute also prohibits the banks from entering into exclusive dealing arrangements with its customers.

As a result, we do not believe that the proposed firewall modifications increase the risk of coercion of customers or that those customers will not be adequately protected by the various statutes, regulations, and supervisory oversight to which our country's banking companies are subject.

Risks of Unfair Advantage for Section 20 Companies

In our view and the view of many of my colleagues in the industry, the proposed modifications will not lead to an advantage for Section 20 companies. The changes will merely work to help level the regulatory playing field which has been generally tilted against Section 20 companies as compared to other firms. Due to the myriad of bank regulations with which we must comply, some of which are admitted by regulators to be conservative and in some respects redundant with other regulations and much of which our nonbank competitors do not face, Section 20 companies have been at a competitive disadvantage since their inception relative to other firms in trying to build and establish their Section 20 companies as meaningful players in the securities business.

The process of building our securities underwriting and dealing activities has been a challenging and sometimes arduous process in significant part because our nonbank competitors for institutional business often point to the relationship with a bank as demonstrating some lack of competence or experience in the securities business. In other words, a Section 20 company's relationship with affiliate banks can sometimes represent a hurdle to be overcome, not an advantage relative to our nonbank competitors.

Moreover, Section 20 companies will continue to carry a higher degree of regulatory burdens than other firms. Further, given the various other protections which exist, the ability of bank affiliates to directly or indirectly support Section 20 activities on anything less than an arm's length basis is highly dubious. Ultimately, the Section 20 companies simply believe and desire that the Fed's proposals will help open the door to a more open, free, and fair system of competition. It is also interesting to note that no nonbank securities firm or their traditional industry groups submitted a comment letter to the Fed in opposition to these proposed changes.

Adequacy of Other Statutory and Regulatory Protections

You have also sought comment on the existence of other statutes or regulations to act as "substitutes" for the firewalls. There are numerous statutory and regulatory protections outside of the firewalls proposed for elimination that will serve to address the fundamental risks associated with the underwriting and dealing activities of Section 20 affiliates.

A number of these "protections" did not exist at the time of the adoption of the initial or current firewalls and were thus not available to address certain of the Fed's concerns about the potential risks of these activities.

First, Section 23B of the Federal Reserve Act was not adopted at the time of the Fed's initial approval of Section 20 companies in 1987. It is significant that many of the firewalls are duplicate or overlap the constraints of Section 23B. Section 23B requires affiliate transactions to be conducted at arm's length, typically requiring pricing and other economic terms to essentially mirror those found in the marketplace, thus greatly protecting the affiliated banks. Section 23B further prohibits representing that an affiliated bank is responsible for a Section 20 company's obligations and it prohibits a bank from purchasing certain products from a Section 20 affiliate.

Second, the current risk-based capital standards utilized by banks and their holding companies were not in effect in 1987. Pursuant to the separate measurement of the capital adequacy of bank holding companies and their affiliated banks, undue concentration of resources in Section 20 activities is effectively limited. Because these standards address some of the risks which may be present in a bank's affiliation with an investment banking operation, those standards may be viewed as overlapping with some of the current firewalls.

Third, the Interagency Statement on Retail Sales of Nondeposit Investment Products was adopted in 1994. This statement has become the primary means by which the Federal Banking Agencies attempt to ensure that retail customers are not misled about the nature of any Nondeposit Investment Product that those customers may be considering for purchase. Thus, a great deal of the disclosure risk over which the Fed has been concerned is effectively addressed thus making the special disclosure requirements contained within the firewalls duplicative and, therefore, unnecessary.

A couple of other important protections have existed for some time. The anti-tying rules of the Bank Holding Company Act Amendments of 1970 prohibits banks from offering discounts on products on the condition that an issuer obtain investment banking services from a Section 20 affiliate or requiring the use of a Section 20 affiliate in order to obtain some banking product that the customer seeks. The anti-tying rules thus address a great deal of the "coercion risk" that so many nonbank competitors like to point out. In addition, the antitrust provisions of the Sherman Act also apply to address noncompetitive practices.

In addition, Section 23A of the Federal Reserve Act will limit and control any arm's-length transactions a bank does engage in with a Section 20 affiliate. Under Section 23A, transactions with any one affiliate are limited to 10 percent of a bank's capital and transaction, with all affiliates limited to 20 percent of that capital, and are required to receive collateral covering any extension of credit to its affiliates.

Other Recent Fed Action Impacting Section 20 Activities

You have also sought our comment on other recent Federal Reserve action impacting Section 20 activities. NationsBank generally support the Fed's recent actions to modify or eliminate some of the regulatory constraints affecting Section 20 activities, including raising the ineligible revenue ratio from 10 percent to 25 percent, the elimination of the cross-marketing restrictions, and the relaxation of the firewalls permitting dual employees between a Section 20 company and its bank affiliates.

First, with respect to increasing the revenue limit, we believe the Federal Reserve Board acted within the deference afforded to reasonable judgments of Governmental agencies with regard to the meaning of ambiguous terms in any statute that is charged with administering. The Fed prudently and consistently with safety and soundness principles reasonably raised the ineligible revenue limit to 25 percent of a Section 20 company's total revenue.

We concur with the Board that based on its experience, a 10 percent revenue limitation had unduly restricted the underwriting and dealing activity of Section 20 companies to a level that fell short of statutory limits involved with being "principally engaged" for purposes of § 20 of the Glass-Steagall Act. The Fed was also correct in our view in observing that product mix of Section 20 companies had changed and that developments in the securities markets more generally had also affected the relationship between revenue and appropriate activities since the establishment of the 10 percent limit in 1989.

Second, the cross-marketing firewall was initially adopted in an attempt to adequately address concerns about customer confusion. However, as mentioned above, the risks of such confusion with respect to the sale of any nondeposit product is mitigated by the existence of the Interagency Statement, adopted in 1994, which provides that for any sale or attempted sale by a bank employee or occurring on bank premises, the customer must receive and acknowledged a written statement that the product being sold is not Federally-insured, is not a deposit or other obligation of the bank, it is not guaranteed by the bank, and is subject to investment risks including loss of principal. While some may suggest that banks may be able to package products in a manner to gain an unfair competitive advantage, we agree with the Fed's perspective that these dangers are addressed by existing antitrust laws including the Sherman Act and the anti-tying rules of the Bank Holding Company Act Amendments of 1970. Further, as a practical matter, the cross-marketing firewall would not serve to create some alleged competitive equality between Section 20 companies and other securities firms since under the cross-marketing firewall personnel could simply be moved into the Section 20 company from where they could market the activities of both the Section 20 company and their bank affiliates. In addition, existing securities regulations limit the ability of bank personnel to attempt to sell or offer to sell securities underwritten or dealt in by a broker-dealer in potential violation of the registration and supervisory requirements governing all such personnel.

Finally, with respect to the modifications to the interlocks firewall which now will permit dual employees or officers between banks and their Section 20 affiliates, except with respect to Chief Executive Officer and a majority of the Board of Directors of each type of entity, NationsBank believes such a firewall was outdated in light of the Section 20 company history and the opportunity such a modification permits in terms of the operational efficiency for bank holding companies overall. This modification may also allow easier entry into the business by smaller banking organizations that otherwise could not afford to bear the costs of staffing a separate Section 20 company separate from its bank affiliates. We also recognize the Fed's concern that while the interlocks firewall is unnecessary to prevent customer confusion or to ensure appropriate corporate separateness, proper risk management may require a revisitation of the interlocks between a Section 20 and its bank affiliates for certain sensitive custodial or fiduciary areas.

Conclusion

The regulatory relief recently made or currently proposed to be made by the Fed concerning Section 20 activities is long overdue. In an increasingly competitive and globalized financial system our Nation's consumers, their communities, and our economy will benefit from the increased flexibility these changes will bring and our banking system should not remain subject to somewhat static and now unnecessary regulatory burdens on its activities. NationsBank along with a number of industry groups and their respective members broadly support the Fed's proposal and applauds its efforts in continuing to modernize the financial services industry. We believe that the Fed has acted extremely prudently in evaluating these matters and in proposing these changes in light of Section 20 company history, the Federal Reserve's experience in supervising their activities and today's market conditions.

Mr. Chairman, I appreciate the opportunity the Subcommittee has given me to present views on these important developments to the banking and securities industries and for our Nation's consumers, business, and economy. I would be happy to answer any questions that you or other Members of the Subcommittee may have.

PREPARED STATEMENT OF RICHARD B. ROBERTS

EXECUTIVE VICE PRESIDENT AND TREASURER OF WACHOVIA CORPORATION
ON BEHALF OF THE
ABA SECURITIES ASSOCIATION AND THE AMERICAN BANKERS ASSOCIATION

MARCH 20, 1997

Mr. Chairman, I am Richard Roberts, Executive Vice President and Treasurer of Wachovia Corporation headquartered in Winston-Salem, North Carolina, and in Atlanta, Georgia. Wachovia is the parent bank holding company of four nationally-chartered banks and a Federal savings bank. While Wachovia does not have a Section 20 firm,[1] I am very familiar with Section 20 firms and their operations as I have closely watched and studied their development over the last 10 years.

I am also Chairman of the Board of the ABA Securities Association ("ABASA"). Accompanying me today is Ms. Rachel Robbins, General Counsel and Managing Director of J.P. Morgan & Co., Incorporated. Ms. Robbins is also associated with ABASA as the Chair of the ABASA Lawyers' Committee. Under her leadership that committee has carefully reviewed all of the recent Fed's proposed changes in Section 20 activities.

The ABASA is a separately chartered trade association of the American Bankers Association ("ABA") formed in 1995, to develop policy and provide representation for banks underwriting and dealing in securities, proprietary mutual funds, and derivatives. The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest banking trade association in the country. The view expressed herein represent the views of both the ABASA and the ABA.

Mr. Chairman, I commend you for holding this oversight hearing on the Federal Reserve Board's ("Board") proposal to modify existing Section 20 firewalls and I appreciate the opportunity to appear here today to discuss these very important issues. For the approximately 40 bank holding companies and foreign banks that have established Section 20 firms, the existing firewall provisions impose tremendous regulatory burdens and costs on doing business today. For many other banking organizations that have not yet established Section 20 firms, the costs and burdens associated with these firewalls have effectively prevented them from establishing Section 20 firms.

I should add that the reason Wachovia has not established a Section 20 is that the current firewalls represent an impediment to conducting business in an efficient manner.

As I will discuss more fully later in my testimony, the ABA Securities Association and its 21 members,[2] including the Wachovia Corporation, strongly favor the recent Board's action proposing to modify the existing firewalls. These modifications, when adopted, will allow all Section 20 firms to operate much more efficiently and effectively, which can only inure to the benefit of our customers. We believe that these modifications are also an important step forward in bringing vigorous new competition to the financial services industry, but, Mr. Chairman, they are only that—a first step.

The bank regulatory structure needs to be modernized to allow all institutions the option to offer all financial services to our customers. All financial services providers should have the ability to offer all services free from unnecessary legislative barriers and costly regulatory hoops. Not all providers will choose to offer all services. But the decisions of what products and services to offer should be a business judgment that each individual institution is free to make. Given all the changes in today's financial services marketplace, it simply makes no sense to create a system that limits free and fair competition.

Consequently, ABASA's strong endorsement of the Board's proposal should not, in any way, detract from our position that truly comprehensive financial services reform is needed. Only the Congress has the power to adopt such reform and ABASA

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[1] Wachovia Corporation offers certain underwriting and dealing services to its capital market clients through its National banks.

[2] ABASA members include: BankAmerica Corporation, BankBoston, Bank of Montreal/Nesbitt Burns, Banc One Corporation, Bankers Trust New York Corporation, Barclays Bank PLC, The Chase Manhattan Corporation, Citicorp, First Chicago NBD Corporation, First Security Corporation, First Union Corporation, Fleet Financial Group, J.P. Morgan & Co., Incorporated, KeyCorp, Mellon Bank Corporation, NationsBank Corporation, Norwest Corporation, PNC Bank Corp., State Street Bank & Trust Company, SunTrust Banks, Inc. and Wachovia Corporation.

would strongly encourage this Subcommittee to assist in moving these reform efforts forward.

Background

As the Subcommittee is aware, Section 20 of the Glass-Steagall Act provides that a member bank of the Federal Reserve System may not be affiliated with a company that is "engaged principally" in underwriting and dealing in securities. In 1987, the Board first authorized bank holding companies to establish "Section 20 subsidiaries" to engage to a limited extent in underwriting and dealing in securities not eligible for underwriting and dealing by a member bank, including municipal revenue bond, commercial paper, certain mortgage-back and other asset-back securities ("Tier I powers").[3] Subsequent Board orders expanded the list of ineligible securities authorized for Section 20 firms to include corporate debt and equity securities ("Tier II powers").[4]

In connection with issuing these orders, the Board established a series of restrictions as conditions for approving underwriting and dealing in ineligible securities. The Board's 1987 order contained 20 restrictions applicable to those firms seeking authorization to underwrite and deal in Tier I products. With the 1989 Board order approving Tier II powers, the number of restrictions expanded to 28. These restrictions are commonly known as "firewalls."

The firewall restrictions were designed to prevent any perceived securities underwriting and dealing risk from being passed from a Section 20 subsidiary to an affiliated insured depository institution. In addition, these restrictions addressed the potential for conflicts of interest, unfair competition, and other adverse effects that might, it was thought at the time, arise from the conduct of these bank ineligible securities activities.

The Board's Proposal

After undertaking a complete review of the firewall restrictions, the Board has now determined to propose comprehensive changes to these firewall restrictions. Specifically, the Board has proposed to retain 8 firewall provisions by incorporating them into a statement of operating standards and to eliminate the remainder.

Mr. Chairman, these modifications are not being proposed in a vacuum. Rather, they are being undertaken after almost 10 years of Board experience supervising Section 20 firms and their bank ineligible securities underwriting and dealing activities. In that time, the Board has had considerable opportunity to analyze the perceived risks posed by these activities to affiliated insured depositories and has concluded that any perceived risks posed by securities underwriting and dealing activities have proven to be manageable.[5]

In this same time period, the Board has gained greater familiarity and experience with the operation of the Federal securities laws and the protections afforded by those laws through the supervision and regulation of broker-dealers by the Securities and Exchange Commission ("SEC") and the National Association of Securities Dealers ("NASD"). That experience has allowed the Board to conclude that many of the firewall provisions are unnecessary in light of the Federal securities law requirements.

Finally, legislative and regulatory initiatives put in place after the original firewalls were established have also demonstrated that many of the firewall restrictions are largely redundant of these other provisions. These initiatives include Section 23B of the Federal Reserve Act,[6] Risk-Based Capital Standards,[7] and the Interagency Statement on Retail Sales of Nondeposit Investment Products.[8] Clearly, these new safeguards, in combination with pre-existing regulatory limitations applicable to all nonbanking subsidiaries, squarely address the fundamental concerns that precipitated the initial establishment of the firewalls.

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[3] *Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp.*, 73 Federal Reserve Bulletin 473 (1987).

[4] *J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp.*, 75 Federal Reserve Bulletin 192 (1989).

[5] *Bank Holding Companies and Change in Bank Control (Regulation Y); Review of Restrictions in the Board's Section Orders,* Docket No. R–0958, 62 Fed. Reg. 2622, 2623 (January 17, 1997).

[6] 12 U.S.C. Section 371c–1.

[7] *See* 54 *Federal Register* 4186 (January 27, 1989).

[8] Interagency Statement on Retail Sales of Nondeposit Investment Products (FRB, FDIC, OCC, OTS), February 15, 1994; OCC Bulletin 94–13, February 24, 1994; as clarified and interpreted in Joint Agency Release dated September 12, 1995.

Safety and Soundness Issues

Your letter of invitation, Mr. Chairman, asks whether the proposed firewall modifications can be made while still preserving the safety and soundness of the banking system and protecting affiliated insured depository institutions. We are convinced they can.

There is no evidence that securities activities are more risky than traditional commercial banking activities. The weight of evidence to date suggests that these activities **do not** raise the risk profile of the banking institution. In fact, just the opposite is true. These activities will ***lower*** the risk profile and provide even ***more*** protection for the bank.

Banks have offered so-called "nontraditional" products for many years, through many different operational structures. Foreign banks have engaged in securities and insurance activities for years, and many U.S. banking companies have similar operations overseas. A recent study analyzing available data concluded: "Our study of the evidence leads us to conclude that moderate increases in private securities activities have not increased either the riskiness or failure rate of commercial banks in the past nor promise to do so in the future."[9]

For example, the Board has proposed to eliminate as unnecessary or redundant the firewalls which generally pertain to capital requirements for bank holding companies, insured bank subsidiaries, and Section 20 firms. In place of these firewall provisions, the Board has proposed to require that a bank holding company maintain adequate capital on a fully consolidated basis.[10]

This modification recognizes that certain firewalls that required bank holding companies to deduct from capital any investment in, or credit extended to, the Section 20 subsidiary did not achieve their intended goal of strengthening the capital of the insured depository institution or the Section 20 subsidiary. Rather, these firewalls effectively created regulatory burdens by forcing bank holding companies to prepare two sets of financials—one to satisfy GAAP accounting principles and one to satisfy the Board's firewall restrictions.[11]

Moreover, as registered broker-dealers, Section 20 firms are already subject to the SEC's net capital requirements, thus obviating the need for an additional layer of capital requirements merely because the Section 20 firm is part of a bank holding company. Finally, eliminating any firewalls that effectively required the Section 20 firm to maintain levels of capital in excess of those required by nonbank affiliated investment firms would place Section 20 firms on a parity, at least with respect to capital, with those firms.

In sum, the safety and soundness of the insured depository institution will be ensured, in this context, by existing Federal security law capital requirements enforced by both the SEC and the NASD, and requiring bank holding companies to maintain, consistent with GAAP, adequate capital on a fully consolidated basis. Benefits to the banking organizations will include reduced regulatory burdens and the ability to compete on a more equal footing, at least with respect to capital requirements, with other nonbank affiliated investment banking services providers.

Conflicts of Interest and Consumer Protection Issues

The Board has also proposed to eliminate the firewalls which generally prohibit bank holding companies and their subsidiaries from extending credit to the Section 20 firm. These restrictions were originally intended to prevent a bank or its parent from exposing itself to loss in order to benefit the Section 20 firm's underwriting and dealing activities. In truth, however, these firewalls have hampered the ability of bank holding companies to serve as full-service financial services providers and have reduced funding options available to our customers.

For example, it is not uncommon for bank corporate customers to fund their activities by accessing the capital markets through a commercial paper issuance. In these situations, the bank will refer its customer to its Section 20 affiliate. Under the current firewall restrictions, the bank would be prohibited from providing credit enhancement to the commercial paper even though the bank itself may be the institution best suited to perform a credit analysis or, worse yet, for smaller corporations, the only institution willing to perform the necessary credit analysis.

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[9] George J. Benston (John H. Harland Professor of Finance, Accounting and Economics, Goizueta Business School, Emory University) and George G. Kaufman (John F. Smith Professor of Finance and Banking, School of Business Administration, Loyola University): *"Commercial Banking and Securities Activities: A Survey of the Risks and Returns,"* October 1995, page 1.

[10] The operating standard specifically gives the Board authority to reimpose certain funding and other firewalls if the bank or thrift affiliate becomes less than well capitalized.

[11] The inability to consolidate Section 20 capital with that of the parent holding company is inconsistent with GAAP accounting principles.

Significantly, many of the conflict of interest concerns that underlie Firewalls 5–12 are more than adequately addressed by other existing statutory and regulatory safeguards. Consequently, no need exists to maintain duplicative and redundant firewall restrictions that achieve the same results.

For instance, as the Board has recognized, the current risk-based capital system would require the bank to hold capital against the exposure on any credit enhancements extended to Section 20 customers. Loan-to-one borrower rules would also limit the amount of credit that a bank could extend to an issuer of securities underwritten by a Section 20 firm.[12] Perhaps more significantly, any transaction or series of transactions between a member bank and a third party would be subject to the arm's-length dealing requirements of Section 23B of the Federal Reserve Act where an affiliate of the member bank is a participant.[13]

Loans extended to customers for the purpose of purchasing, during an underwriting, ineligible securities underwritten by the Section 20 affiliate are also covered by other statutory provisions. Section 11(d) of the Securities Exchange Act of 1934 prohibits any broker-dealer, including a Section 20 firm, from extending or arranging credit to customers during the underwriting period. Loans extended to customers during an underwriting or selling syndicate for the purpose of purchasing securities from an affiliated Section 20 firm and loans for purchases of securities from the inventory of the Section 20 firm are required by Section 23B of the Federal Reserve Act to be conducted on market terms.

As a consequence, even without these firewalls, member banks would still be strictly prohibited from extending or granting credit to customers on preferential terms. In short, the stated purpose of these firewalls can be, and is, accomplished without the added operational burden of specific firewall restrictions.

Mr. Chairman, you have asked whether the modifications proposed will provide adequate protection to customers of the bank or securities affiliate. I believe the above discussion demonstrates most strongly that both bank and Section 20 customers are provided with significant protections under the Federal securities laws and banking laws to justify the Board's proposed elimination of many of these firewall provisions.

In addition, I would point out that many other protections are afforded to customers of both the bank and the Section 20 firm. Specifically, the numerous disclosure requirements of the Federal securities laws apply to banking organizations' securities activities. In addition, the Federal banking regulators require certain disclosures to be made when retail customers purchase investment products from the bank lobby. These statutory and regulatory requirements provide added protections to many bank and Section 20 firm customers.

Firewall Restrictions and Regional Bank Holding Companies

Mr. Chairman, I think it is important to understand the historical context in which these original firewall restrictions were established. At the time the original firewalls were adopted the Board was facing litigation, which it subsequently won. As a result, the Board adopted a very conservative framework of firewall restrictions that it recognized could, like the initial 5 percent income limitation, over time be loosened.

Generally speaking, the restrictions were established in connection with money-center bank holding company applications to establish Section 20 firms. As a result, the specific firewall provisions were often geared to the characteristics of the money-center banks and the burdens and inefficiencies that, it was thought, those institutions could afford to carry.

Regional bank holding companies, such as mine, have been unable to carry these same burdens and inefficiencies. This can be attributable to a number of factors:

- First, regional institutions generally do not have large, steady sources of eligible revenues to support a meaningful amount of ineligible activities. Without revenues from, for example, primary Government securities dealer operations, regional firms must rely on less predictable sources of revenue such as bank-eligible public finance activities or brokerage services.
- The costs of doing business through a Section 20 company carry a high threshold of fixed costs, while the primary benefit (*i.e.,* bank-ineligible revenues) is currently subject to strict firewall limitations. Few regional institutions find this to be an attractive business prospect. This point is most evident by the fact that of the ap-

[12] For example, national banks may only lend an amount equal to 15 percent of their capital on an uncollateralized basis and an additional 10 percent of their capital on a collateralized basis, and credit enhancements generally would be aggregated long with all other credit extended to an issuer in measuring compliance with these limits. *See* 12 U.S.C. 84; 12 C.F.R. 32.2.

[13] 12 U.S.C. Section 371c–1(a)(2)(E).

proximately 17 regional bank holding companies authorized to establish Section 20 firms, only four are authorized to exercise Tier II powers and, thus, willing to operate under the most burdensome firewall provisions.

- Regional bank holding companies are more likely to need to proceed gradually in establishing and expanding Section 20 operations, but this is inconsistent with current requirements. Senior managements of regional institutions are often reluctant to abruptly move some of their most valuable businesses out of their banks and into separate companies that must be isolated from the banks by firewalls, especially when those firewalls leave little room for fine tuning, monitoring, achieving economies or simply rethinking a decision.
- Although the Tier I firewalls are less restrictive than the Tier II firewalls, the powers associated with Tier I firewalls (*e.g.*, municipal revenue bond, commercial paper, certain mortgage-back and other asset-back securities underwriting) are no longer economically viable options for many regional institutions. The thinner spreads on these products make Tier I status too costly, even as a transitional step to Tier II corporate debt and equity powers.
- As discussed above, safety and soundness require that there be coordination throughout a bank holding company system on such matters as credit policies, rate risk and other risk management, regulatory compliance, and management accountability. This coordination tends to be more direct for regional institutions. These requirements, while fostering independence of operation in larger institutions, can actually interfere with safe and sound operating practices in regional institutions.

Some of the problems associated with the firewall restrictions and revenue cap limitations have dissipated somewhat over the last couple of months as the Board has endeavored to ease some of the most burdensome firewall restrictions, including eliminating the cross-marketing prohibition and significantly modifying the personnel interlock prohibition. These actions taken in concert with raising the cap on revenue earned from 10 to 25 percent for ineligible securities underwriting activities have already encouraged several banks to seek authorization either to establish a Section 20 underwriting firm or expand the authorization for existing Section 20 firms. Much more is needed, however, if other regional banking firms are to engage in securities underwriting activities. We believe that the Board's proposed modifications to existing firewalls are a step in that direction.

Conclusion

In conclusion, Mr. Chairman, ABASA appreciates the opportunity to appear before the Subcommittee to discuss the Board's recent proposal to modify its firewall provisions applicable to Section 20 firms. While ABASA is hopeful that the modifications, when adopted, will encourage other bank holding company firms to establish Section 20 underwriting firms, these modifications are only a first step toward comprehensive reform of our financial system. ABASA encourages the Subcommittee and its Members to work with all appropriate parties in order to enact meaningful financial reform legislation. ABASA stands ready to work with you and other Members of your Subcommittee, Mr. Chairman.

PREPARED STATEMENT OF CHARLES W. CALOMIRIS

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MARCH 20, 1997

Mr. Chairman and Members of the Subcommittee on Financial Institutions and Regulatory Relief, it is a pleasure to appear here today. The last decade has seen dramatic and beneficial bank deregulation. Of particular importance have been the relaxation of geographical and activity limitations on bank holding companies, achieved respectively by Congressional action and new regulatory interpretations of existing law.[1] Recently, both the Federal Reserve Board and the Comptroller of the Currency have sought to further enhance the flexibility of bank operations by reducing limits on bank activities, and there is a push for Congressional action to repeal

[1] For a review of the evolution of Federal Reserve actions and court interpretations of Section 20 law, see George Kaufman and Larry Mote, "Glass-Steagall: Repeal by Regulatory and Judicial Reinterpretation," *Banking Law Journal*, September–October 1990, pp. 388–421.

outright the separation of commercial and investment banking imposed in the Banking Act of 1933.

While deregulation has been dramatic, it is worth noting that it has sparked little controversy, or even surprise, among scholars of banking or banking history. There is a remarkable degree of agreement among these scholars—supported by an extensive body of research—that historic limitations on bank locations and activities have served no legitimate economic purpose. Rather, these costly limits—especially the separation of commercial and investment banking in 1933—are artifacts of specific historical political battles in which facts and economic logic have often taken a back seat to populist passions or special interest politics.[2]

Competitive pressure—especially the loss of U.S. banks' domestic and international market shares in the 1980's—helped to push the Federal Reserve Board in 1987 and subsequently to use its authority to relax restrictions on bank underwriting activities. Initially, the Fed proceeded with extreme caution. It allowed very limited underwriting of private debt, and later equity, but attached to those activities a host of "firewalls" intended to serve two different sets of purposes—(1) to prevent the transfer of loss from a Section 20 underwriting affiliate to a chartered bank, and (2) to prevent "conflicts of interest" from arising from the mixture of commercial and investment banking. The first concern was largely that of economists who correctly worried about the abuse of deposit insurance and the discount window—the possibility of Government subsidization of risk in new activities. The second concern was that banks might use their new powers to coerce client firms or cheat purchasers of securities (despite clear and strong economic incentives not to do so). This second concern reflected the unsubstantiated and misguided arguments that underlay the Pecora Hearings of 1932, and the limitations imposed on the mixing of commercial and investment banking in 1933.[3]

The Federal Reserve Board has recently circulated a set of proposals to relax or eliminate many of the "firewalls" that limit connections between banks and the nonbank affiliates of bank holding companies.[4] It is worth noting that if the Fed proceeds with these proposed changes, the consequences will stretch beyond the holding company affiliates regulated by the Fed, since the Office of the Comptroller of Currency, which has invited banks to channel their "nonbanking" activities through

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[2] For a critical discussion of the hearings leading to the passage of Glass-Steagall, see George Benston, *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered,* Norwell: Kluwer Academic Press, 1989. For evidence that conflicts of interest between commercial and investment banking were absent in the 1920's, see Randall S. Kroszner and Raghuram G. Rajan, "Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933," *American Economic Review,* Vol. 84 (September), 1994, pp. 810–832; Randall S. Kroszner and Raghuram G. Rajan, "Organization Structure and Credibility: Evidence from Commercial Bank Securities Activities before the Glass-Steagall Act," *Journal of Monetary Economics,* forthcoming; Manju Puri, "The Long-Term Default Performance of Bank Underwritten Securities Issues," *Journal of Banking and Finance,* 1994. On the political economy of the passage of the 1933 Act more generally, see Charles W. Calomiris and Eugene N. White, "The Origins of Federal Deposit Insurance," in *The Regulated Economy: A Historical Approach to Political Economy,* edited by Claudia Goldin and Gary Libecap, Chicago: University of Chicago Press, 1994. For a discussion of the historical costs to the United States of limiting banks' powers, see Eugene N. White, "Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks," *Explorations in Economic History,* Vol. 23 (January), 1986, pp. 33–55; Charles W. Calomiris, "Regulation, Industrial Structure, and Instability in U.S. Banking: An Historical Approach," in *Structural Change in Banking,* edited by Michael Klausner and Lawrence J. White, Homewood, Illinois: Business One-Irwin, 1993, pp. 19–115; Charles W. Calomiris, "The Costs of Rejecting Universal Banking: American Finance in the German Mirror, 1870–1914," in *The Coordination of Activity Within and Between Firms,* edited by Naomi Lamoreaux and Daniel Raff, Chicago: University of Chicago Press, 1995, pp. 257–315; Charles W. Calomiris and Carlos Ramirez, "The Role of Financial Relationships in the History of American Corporate Finance," *Journal of Applied Corporate Finance,* Volume 9, Number 2 (Summer), 1996, pp. 52–73; J. Bradford De Long, "Did J.P. Morgan's Men Add Value?," in *Inside the Business Enterprise: Historical Perspectives on the Use of Information,* edited by Peter Temin, Chicago: University of Chicago Press, 1991, pp. 205–236; Carlos D. Ramirez, "Did J.P. Morgan's Men Add Liquidity? Corporate Investment, Cash Flow, and Financial Structure at the Turn of the Twentieth Century," *Journal of Finance,* Vol. 50 (June), 1995, 661–678; Randall S. Kroszner, "The Evolution of Universal Banking and Its Regulation in Twentieth Century America," in *Universal Banking: Financial System Design Reconsidered,* edited by Anthony Saunders and Ingo Walter, Homewood, Illinois: Business One-Irwin, 1996, pp. 70–99.

[3] For a discussion of why banks face a strong incentive to behave honestly, and how this leads to voluntary structural constraints (or "firewalls") within bank holding companies to ensure greater credibility, see Randall S. Kroszner and Raghuram G. Rajan, "Organization Structure and Credibility: Evidence from Commercial Bank Securities Activities before the Glass-Steagall Act," *Journal of Monetary Economics,* forthcoming.

[4] Federal Reserve Board, "Review of Restrictions in the Board's Section 20 Orders," January 9, 1997.

national bank subsidiaries, is almost sure to follow the Fed's lead on firewalls, at least in the near term.

The principal question I will address today is the desirability of the Fed's recent proposals to reduce firewalls. More broadly, however, I will assess the desirability of expanding bank activities into securities markets and related areas, and the importance of relaxing firewalls to allow efficiency gains from such an expansion. Mr. Chairman, at the end of my remarks, I will also provide responses to the specific written questions you posed in your letter of March 14.

To summarize, I support enlarging the range and size of permissible "nonbank" activities within banks or bank holding companies, and scaling back the firewalls that the Federal Reserve Board established in 1987 and in 1989, as the Federal Reserve Board now proposes to do. Doing so will allow banks to compete more effectively for corporate relationships, and will benefit bank customers and their stockholders at least as much as it will benefit banks. I will also argue that outright repeal of Glass-Steagall prohibitions and further relaxation of firewalls should be considered by Congress and bank regulators.

Let me begin with some historical perspective on the origins of the separation of commercial and investment banking, which is essential to the debate over bank activity limits and firewalls. In the United States, banks became interested in underwriting and holding corporate debt and equity in the 1920's. The relaxation of branching laws during that period created new opportunities for banks to become large. As they became large, they turned increasingly to *industrial* as opposed to only *commercial* finance, and they found it profitable to mix bank lending with underwriting. Doing so made it possible to better serve their corporate clients' funding needs, provide better access to investments for their trust customers, and reduce banks' costs of funds, since the new activities were highly diversifying.[5]

The mixing of lending and underwriting activities had produced important synergies in German universal banking around the turn of the 20th century, which were well understood in the United States by the 1920's. German banks offered very rich portfolio opportunities to their trust customers, charged very little (even by late 20th century standards) for equity underwriting, and managed to promote high-tech, large-scale industrialization in Germany at an unprecedented speed.[6]

Both the American and the German historical experiences support the view that allowing banks to lend, underwrite, and manage securities accounts substantially reduced bank costs of intermediation. The synergies from mixing lending, equity holding, and underwriting in the United States and Germany historically are present and visible in the United States today, even under the current limited incarnation of universal banking. Evidence from the current U.S. experience suggests that Section 20 (underwriting) affiliates increase average returns and reduce risk for their bank holding companies.[7] Venture capital finance is another area in which there are strong corporate finance synergies, both with lending and with underwriting, since venture capital finance precedes public stock offerings.

The primary synergies are the repeat use of information, the enhancement of corporate control, and the diversification of bank income.[8] By lending and underwriting, banks are able to use knowledge about the performance and risk of their corporate borrowers to reduce the cost of underwriting and marketing securities. Furthermore, informed banks' involvement as holders of equity (mainly via trust account proxies) can enhance their control over firms and helped them to protect trust customers' interests, which also makes it easier to market equity. Finally, because lending and underwriting tend to be imperfectly correlated risks, combining the

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[5] Evidence on diversification advantages is presented in Eugene N. White, "Before the Glass-Steagall Act . . ." *(op. cit).* A review of the literature on efficiency gains in serving corporate clients is provided in Charles W. Calomiris and Carlos Ramirez, "The Role of Financial Relationships . . ." *(op. cit).*

[6] For a discussion of the German case, see Charles W. Calomiris, "The Costs of Rejecting Universal Banking . . ." *(op. cit.).*

[7] See Elijah Brewer, "Relationship Between Bank Holding Company Risk and Nonbank Activity," *Journal of Economics and Business,* Vol. 41 (November), pp. 337–353; Myron Kwast, "The Impact of Underwriting and Dealing on Bank Return and Risks," *Journal of Banking and Finance,* Vol. 13, pp. 101–125; Vincent P. Apilado, John G. Gallo, and Larry J. Lockwood, "Expanded Securities Underwriting: Implications for Bank Risk and Return," *Journal of Economics and Business,* Vol. 45, pp. 143–158; Simon H. Kwan, "Securities Activities by Commercial Banking Firms' Section 20 Subsidiaries," Federal Reserve Bank of San Francisco, Working Paper, January 1997.

[8] For a more detailed discussion, see Charles W. Calomiris, "Comments on Steinherr, Kroszner, and Benston Papers," in *Universal Banking: Financial System Design Reconsidered,* edited by Anthony Saunders and Ingo Walter, Homewood, Illinois: Business One-Irwin, 1996, 109–117.

activities can help banks to diversify their assets, which economizes on bank capital and reduces banks' costs of funds.

It is very important to keep in mind that in a competitive banking system these reduced costs of intermediation accrue mainly to bank customers (that is, banks' clients' stockholders and bank depositors). It is also important to note that these synergies are undermined by firewalls.

If firewalls require separation of types of activities into different entities (that is, entities with separate corporate identities, liabilities, and capital) then cost of funds advantages from diversification across activities will be severely limited. If firewalls require that lending and underwriting by the bank not be allowed for the *same client firm,* then any potential information synergies across activities will be foregone. If firewalls prevent banks from being actively involved in controlling the firms they finance (via boards of directors, or trust account and mutual fund holdings of stock), then control synergies will be limited.

The current Fed proposals to repeal firewalls would improve the efficiency of the financial system mainly by increasing the multiple use of information within the bank and by enhancing bank involvement in corporate control. These proposals reflect a growing realization that concerns over conflicts of interest are largely unfounded (as they were in 1933) because dishonest behavior is contrary to the interests of the bank, especially in the highly competitive financial services industry, and is already proscribed by other laws and regulations.

It is worth noting that the Fed is not proposing to remove all firewalls. The Fed proposes to retain the limitations on the mixing of "bank" and "nonbank" risks (specifically, Sections 23A and 23B of the Federal Reserve Act, which limit the extent of lending from banks to nonbank affiliates, and require that it be fully collateralized and priced as an arm's-length loan). Chairman Greenspan argues in his testimony of February 13, 1997, that Sections 23A and 23B provide essential protection against the abuse of deposit insurance protection by bank holding companies.[9]

I share Chairman Greenspan's concern that under the current deposit insurance system the absence of financial firewalls (like 23A and 23B) could lead to abuse of deposit insurance.[10] But I do not agree with his solution to the problem. A better alternative would be to remove the possibility that banks would receive subsidized insurance, which would thereby remove any incentive problem from mixing the risks of lending and underwriting, and thus allow banks and their customers to reap the gains from relaxing Sections 23A and 23B. Such reform is feasible and the relative merits of various approaches for doing so—including subordinated debt requirements and other deposit insurance reforms—are currently being debated among bankers, academics, and regulators.

Chairman Greenspan also argued that the holding company structure is a superior mechanism for administering firewalls, and that thus it is essential to restrict Section 20 activities (and other "nonbank"activities) to bank holding company affiliates. Thus, he does not support the Comptroller's "Part Five" initiative to allow new activities to occur within subsidiaries of national banks. I do not share his view. There is no reason I can discern why any particular firewall cannot be administered as well within a bank subsidiary structure as it is within a bank holding company affiliate structure.[11] Also, it is my understanding that there is little merit to the argument that legally, the "corporate veil" of a subsidiary is more easily pierced than that of an affiliate.

The argument for retaining a Federal Reserve monopoly on regulating Section 20 activities seems, then, to rest on the view that there is a need to have an "umbrella" regulator (namely, the Fed) that oversees all holding company risks. That is only necessary, logically, if two conditions are satisfied: First, if potential subsidies from deposit insurance cannot be eliminated; and second, if firewalls cannot insulate banks from the risks undertaken by nonbank subsidiaries or affiliates. Since I believe neither of these necessary conditions is true, I do not support the Fed's view that it should retain a regulatory monopoly over nonbank activities.

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[9] Alan Greenspan, "Statement Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services, U.S. House of Representatives," February 13, 1997.

[10] I do not agree with Chairman Greenspan's view that there is currently a subsidy enjoyed by many banks by virtue of their access to deposit insurance, but I do think there is the potential for a subsidy, particularly under the current deposit insurance laws, if Sections 23A and 23B were removed. For a discussion of whether there is a current subsidy, see Gary Whalen, "The Competitive Implications of Safety Net-Related Subsidies," Economics Department Working Paper, Office of the Comptroller of the Currency, February 1997.

[11] See also, Gary Whalen, "Bank Organizational Form and the Risks of Expanded Activities," Economics Working Paper 97–1, Office of the Comptroller of the Currency, January 1997.

An advantage to allowing the Comptroller to "compete" with the Fed over nonbank activity regulation is that such competition will promote a health tendency for both regulators to properly balance the costs and benefits of firewalls, and thus produce neither excessive caution nor imprudent deregulation. Competing regulators jealous of each other's "turf" will not be imprudent because a financial collapse of a barks under their authority would risk a significant loss of their powers. At the same time, excessive caution would produce an immediate loss of regulatory power, since banks would gravitate toward the more liberal regulator. Thus, competing regulators are likely to consider and balance both costs and benefits when making regulatory decisions.

In conclusion, I strongly support the Fed's proposal to roll back firewalls. I also encourage the Fed, the Office of the Comptroller, and Congress to consider reforms to deposit insurance that would permit additional rolling back of firewalls. Finally, I encourage Congress to retain the current healthy competition that exists between the Office of the Comptroller of the Currency and the Federal Reserve Board.

If Congress and bank regulators succeed in freeing banks from costly and unwarranted limitations on their powers, the advantages for banks and their customers will be large. I would emphasize that the banks that will gain from such expansion of powers will increasingly include super-regional and regional banks, in addition to money-center banks. As the technology for placing securities improves, and barriers to low-cost public issues of securities are removed for many firms, it seems likely that more and more regionals and super-regionals will find it advantageous to establish Section 20 affiliates or subsidiaries to publicly place their clients' debt and equity in securities markets. Those innovations and the curtailment of firewalls will also encourage regionals and super-regionals to enter the highly profitable area of venture capital finance via SBIC's (Small Business Investment Companies) or Regulation Y venture capital affiliates. Venture capital finance is an important middle ground in the financial life cycle of firms between an early "bank lending stage" and a late "public securities financing stage." Thus, bank involvement in venture capital will magnify synergies between bank lending and public securities underwriting.

Not only will regional and super-regional banks benefit from those changes, but so will their corporate clients. Many more firms will enjoy lower costs of finance from access to private equity (in venture capital affiliates), which leads naturally to public debt and equity offerings (underwritten by Section 20 affiliates). The social gains of that expanded access to private and public equity finance could be large.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR FAIRCLOTH FROM CHARLES W. CALOMIRIS

[BELOW I PROVIDE ANSWERS TO THE QUESTIONS POSED IN CHAIRMAN FAIRCLOTH'S HEARING INVITATION OF MARCH 14, 1997]

Q.1. Provide a historical perspective on the separation of investment and commercial banking and the development of the firewalls in 1987.

A.1. The separation of commercial and investment banking in 1933 reflected two factors. The first was the Depression-era view (seemingly confirmed by the Pecora hearings) that securities underwriting by banks had been "dishonest" and had crippled banks during the Depression. This recent research (noted above) has shown that securities underwriting by banks prior to 1933 was at least as honest as securities underwriting outside of banks, and that securities activities helped to stabilize banks because they were highly diversifying. The second, and most important, factor leading to the passage of Glass-Steagall was Carter Glass's fervent commitment to separating commercial and investment banking.

The Banking Act of 1933 was a compromise between Steagall (who advocated deposit insurance as a palliative for small banks in distress) and Glass (who pushed for the separation of commercial and investment banking, and for Regulation Q). Glass was an original architect of the Federal Reserve Act of 1913, and an advocate of the "real bills doctrine," which held that banks should mainly finance commercial, rather than industrial activity. Regulation Q was designed largely to undermine reserve pyramiding in New York, and thus remove banks from financing activities in the call money market. Similarly, the separation of commercial and investment banking would encourage banks to avoid securities dealings, and industrial finance more generally. The real bills doctrine was viewed as a means to preserve the money supply from unwarranted supply fluctuations unrelated to real economic activity. Obviously, this debate is not relevant to current bank regulatory policy, since Section 20 affiliates' activities have no effect on the money supply. Furthermore, to my knowledge, the real bills doctrine has no current advocates.

Q.2. Can changes be made to firewalls while preserving the safety and soundness of the banking system and the integrity of the insured depository institution?

A.2. To reiterate, I believe that there is no threat to the safety of banks or the banking system from relaxing the firewalls the Fed is now proposing to relax. If the Fed were considering relaxing Sections 23A and 23B without making additional changes to deposit insurance law, that might pose a problem, but that is not what the Fed is proposing to do.

Q.3. Can changes be made to firewalls while adequately protecting customers of the bank or securities affiliate from coercion?

A.3. Evidence suggests that allowing closer linkages between commercial banks and underwriting operations would improve banks' information about their customers and their ability to control their financial decisions, but that does not mean it would increase "coercion" (which I would define as the power of banks to extract "rents" from their customers). Whether beneficial discipline or non-beneficial coercion results from expanded bank powers depends on how competitive the banking system is. In today's highly competitive system, discipline rather than coercion would result from greater bank powers. Indeed, one could argue that because expanding powers via relaxed firewalls would *increase* competition in financial services broadly defined, it would actually *reduce* the potential for coercion. It is important to note that corporate bank customers do not see any threat to their well being from expanding bank powers. Indeed, corporate clients of banks were among the earliest advocates of allowing banks to underwrite securities. The Fed's decision to permit banks to engage in underwriting specifically cited survey results of corporate managers, who overwhelmingly recommended doing so.

Q.4. Will the firewalls give securities firms affiliated with an insured depository institution an advantage over other firms?

A.4. The fact that there are synergies between commercial banking and investment banking implies that banks' competitive positions would be improved relative to investment banks by relaxing firewalls. But that is not to say that banks will be better off because of their access to deposit insurance, *per se*. So long as Sections 23A and 23B limit the mixing of risks between banks and nonbank affiliates (or subsidiaries) there is little potential for abuse of deposit insurance, even if deposit insurance were subsidized, and thus the presence of deposit insurance cannot provide a competitive advantage.

Q.5. If the firewalls are modified what other protections exist in statute and regulation that will serve as a substitute?

A.5. The Fed's "Review of Restrictions in the Board's Section 20 Orders" (January 9, 1997) reviews a large range of remaining safeguards, including capital requirements, Sections 23A and 23B restrictions, SEC regulations, and other laws and regulations. I agree with the Fed's view that these remaining safeguards are adequate.

Q.6. Please offer general comments on other recent modifications made by the Board to Section 20 activities, including the raising of the cap from 10 percent to 25 percent and the easing of cross-marketing restrictions.

A.6. I am in favor of both. Obviously, synergies will be larger if the volume of equity underwriting is larger, since this is one of the most important sources of the gains discussed above. I would be in favor of eliminating the revenue cap altogether. With respect to cross-marketing, it is important to note that banking is a "relationship-based," not a "product-based" business. Cross-marketing is essential to the logic of the efficiency gains from universal banking. Recent research has argued against the view that dishonest behavior would result from permitting cross-marketing.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM GOVERNOR SUSAN M. PHILLIPS

Q.1. Currently, the Federal Reserve requires a bank holding company to deduct from its capital any investments in and extensions of credit to a securities affiliate. As you testified, Governor Phillips, the purpose of this provision was to ensure that capital needed by a Federally-insured bank was not diverted instead to a securities affiliate. As I understand it, the Federal Reserve now proposes to eliminate this provision, so that investments by a bank holding company in a securities subsidiary will be treated the same as investments in any other type of subsidiary. Should all investments in subsidiaries by bank holding companies be treated the same?

Q.2. Isn't an investment in a securities subsidiary riskier than, say, an investment in a data processing subsidiary?

A.1. & A.2. Although the Federal Reserve Board has not finalized action on its proposal, the Board has stated its preliminary belief that a bank holding company's investment in a Section 20 subsidiary should not be deducted from capital. (The firewall affects only the bank holding company's regulatory capital, not the capital of any of its subsidiary banks.) The Board noted that bank holding company investments in other subsidiaries require no such capital deduction. Bank holding companies are subject to consolidated capital requirements, and therefore capital must be held against the assets of the Section 20 subsidiary and all other subsidiaries of the bank holding company. This treatment is consistent with Generally Accepted Accounting Principles (GAAP), which requires consolidation of all wholly-owned subsidiaries, and does not provide for capital deductions for any particular type of subsidiary.

In practice, the deconsolidation requirement has created regulatory burden without strengthening the capital of the organization. Its inconsistency with GAAP has created confusion and imposed costs by requiring bank holding companies to prepare statements on two bases, while independent bank analysts have continued to focus on the consolidated bank holding company. Meanwhile, the deduction does not strengthen the capital of any insured depository institution affiliate of the Section 20 subsidiary or the Section 20 subsidiary itself, which is already subject to SEC-imposed capital requirements.

The relative risks presented by bank holding company subsidiaries, of course, vary depending on the amount and type of activities undertaken, as well as the quality of the systems and management charged with measuring and managing risk. The Federal Reserve Board's experience with Section 20 subsidiaries is that their risks are manageable and that they have not caused significant losses to any of the bank holding companies that operate them. Thus, I cannot say that operation of a Section 20 affiliate is *inherently* more risky than operation of some other bank holding company subsidiaries—including bank and nonbank subsidiaries engaged in commercial lending.

GOVERNOR SUSAN M. PHILLIPS SUBSEQUENTLY SUBMITTED THE FOLLOWING INFORMATION FOR THE RECORD AT THE REQUEST OF SENATOR PAUL S. SARBANES

Q. [D]on't some types of transactions pose such clear conflicts of interest that they should not be permitted at all? Aren't these precisely the types of transactions about which we need to be on guard, in fact, the very types of transactions that were found to be commonplace before the enactment of Glass-Steagall?

A. I agree that there are some types of transactions involving a bank and a securities affiliate that pose such serious conflicts of interest that they should be prohibited. However, I believe that the banking and securities laws generally prohibit or restrict these transactions in a way that protects customers, the insured institution, and the interests of fair competition. The Section 20 firewalls were not enacted or in any way mandated by Congress, but were rather a conservative, discretionary step taken by the Federal Reserve Board pursuant to its authority under the Bank Holding Company Act in order to make absolutely certain that underwriting and dealing risk was not passed to a bank. In evaluating the comments and deciding whether to adopt its proposal, the Board will be evaluating whether these special, additional protections continue to be necessary.

Two types of transactions that pose special concerns involve: (1) the possibility of a bank's trust department making fiduciary purchases of securities being underwritten or dealt in by a Section 20 affiliate; and, (2) the possibility of a bank lending at below-market rates to customers to induce them to purchase securities being underwritten or dealt in by an affiliate.

Fiduciary Purchases

Section 23B of the Federal Reserve Act prohibits a bank from making fiduciary purchases from a Section 20 affiliate's dealer portfolio unless the purchase is permitted by the customer's trust agreement with the bank, a court order, or State law. (This restriction parallels a very similar restriction on a national bank making fiduciary purchases of bank-eligible bonds that it is underwriting.) Furthermore, the trust officer is under a fiduciary duty to the customer, which if violated can make the trust officer and the bank liable. (For a retail customer, this would be a matter of State law. If the purchase were on behalf of a pension fund, ERISA would impose the duty.) Thus, if the asset being purchased were not a suitable investment for the customer and the customer lost money, he or she could sue for damages.

Section 23B also requires that any purchase of Section 20-underwritten securities by an affiliated bank—whether acting as fiduciary or as principal—be approved by a majority of the bank's board of directors who are not officers of any bank or any affiliate. The outside directors can satisfy this requirement either by case-by-case approvals or by the establishment in advance of specific standards for such purchases. However, any such standards must be regularly reviewed to ensure that they have been followed in practice and continue to be appropriate in light of market and other conditions.

Finally, like any other broker-dealer, a Section 20 affiliate is subject to the disclosure and anti-fraud provisions of the securities laws, the NASD, and the exchanges. Under the securities laws, a bank could be held liable for aiding and abetting any violation.

Loans to Facilitate Customer Purchases of an Affiliate's Securities

A second type of transaction that provokes concern is the potential for a bank to lend to a customer in order to allow the customer to purchase securities being underwritten or dealt in by a Section 20 affiliate. The concern is three-fold: first, that the customer might be induced or coerced into purchasing bad securities; second, that the bank might risk its own safety and soundness by lending at below-market terms in order to support an affiliate; and third, that the Section 20 affiliate might gain a competitive advantage over its independent investment banking competitors. Again, protections aside from the existing Section 20 firewalls guard against these dangers, and the Board will have to decide whether they are sufficient in all cases.

Customer Protections

The customer is protected both by regulating the terms of the transaction and by informing the customer about it. As for terms, the bank cannot entice a customer into making the purchase with easy credit terms. Section 23B of the Federal Reserve Act requires that any loan to a customer to purchase from an affiliate be on arm's-length terms, and the anti-tying laws prohibit a bank from offering discounted credit on the condition that the proceeds be used to purchase securities from an affiliate.

Disclosure requirements ensure that the customer is aware of the nature of the product being purchased. The Interagency Statement on Retail Sales of Nondeposit Investment Products requires the bank to inform the customer that any product being purchased from a securities affiliate is not Federally-insured or guaranteed by the bank. Under the Board's proposed operating standards, a bank could not recommend the purchase of securities being underwritten by an affiliate unless it notified the customer of its affiliate's role.

Finally, if a customer wishes to borrow from a bank to fund a purchase of securities from a Section 20 affiliate, the idea must originate with the customer. A Section 20 affiliate is prohibited by Section 11(d) of the Securities Exchange Act of 1934 from arranging for a bank to lend during the underwriting period. Thus, a broker could not say, "I'll make this purchase easy by arranging for you to borrow from our affiliated bank."

Bank Protections

The bank as well as the customer is protected when lending to fund securities purchases from an affiliate. (Indeed, many of the same restrictions also protect a bank when it lends directly to the Section 20 affiliate or provides credit enhancements in support of securities underwritten by an affiliate.)

Under Section 23B, any loan to a customer to fund a purchase of securities from an affiliate must be on arm's-length terms—that is, at market rates. (The same is true for loans to an affiliate or credit enhancement on behalf of securities underwritten by an affiliate.) Thus, the bank cannot expose itself to loss by underpricing credit or taking insufficient collateral in an effort to benefit its securities affiliate. To the extent that the proceeds of the loan are transferred to the Section 20 affiliate, Section 23A of the Federal Reserve Act imposes quantitative limits on the amount of the loan and specifies the collateral that must be held.

The bank must hold capital against such a loan, and against any guaranty or other off-balance-sheet contingent liability. (This was not true at the time the Section 20 firewalls were first adopted by the Board.) Furthermore, under the national bank lending limit, a bank cannot lend to any one person an amount greater than 15 percent of its capital on an uncollateralized basis and more than 10 percent of its capital on a collateralized basis.[1]

Under the Board's proposed operating standards, if the bank should become less than well capitalized, the Board would retain discretion to stop any dealings involving a securities affiliate.

COMPETITORS

The anti-tying laws prohibit a bank from conditioning the availability of a loan, or a more favorable rate on a loan, on a customer's using the proceeds to purchase securities from an affiliate. (The same laws prohibit a bank from conditioning the availability of a loan, or a more favorable rate on the loan, on an *issuer* using a Section 20 affiliate for the underwriting.)

GOVERNOR SUSAN M. PHILLIPS SUBSEQUENTLY SUBMITTED THE FOLLOWING INFORMATION FOR THE RECORD AT THE REQUEST OF SENATOR LAUCH FAIRCLOTH

SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT FEDERAL RESERVE'S SUPERVISORY EXPERIENCE

This memorandum provides information on how the Federal Reserve examines for and enforces compliance with Sections 23A and 23B of the Federal Reserve Act. Included below are a description of the examination procedures used to monitor compliance and detect violations, and the measures used to correct violations and to prevent their recurrence, and a summary of representative violations discovered. While the provisions of Sections 23A and 23B apply to all FDIC-insured depository institutions, the information provided herein pertains only to the examination procedures and supervisory experience of the Federal Reserve in enforcing these provisions.

Sections 23A/23B Examination Policies and Procedures

The Federal Reserve takes a two-pronged approach in verifying compliance with Sections 23A and 23B by reviewing transactions at the subsidiary bank level during commercial bank and trust examinations, and by reviewing intercompany transactions at the parent level (including nonbank subsidiaries) during bank holding

[1] This is the national bank lending limit, but State laws are similar.

company inspections. In instances where the Federal Reserve is not the primary Federal bank regulator, our examiners rely on the primary Federal regulator's report of examination for any violations of law applicable to intercompany transactions.

The main inspection and examination objectives with regard to Sections 23A and 23B can be summarized as follows: (1) to analyze and assess the financial impact of transactions between subsidiary banks, and their subsidiaries, and their affiliates; (2) to determine whether inter-affiliate transactions comply with the various restrictions of Sections 23A and 23B; (3) to determine if low-quality assets have been purchased by a bank; (4) to determine whether a bank has purchased, as a fiduciary, or for its own account, any securities or other assets from an affiliate (permissible under certain circumstances); (5) to determine whether any advertisement or agreement implies, in any way, that a bank will be responsible for the obligations of an affiliate; (6) to determine whether transactions are consistent with safe and sound banking practices; and (7) to initiate corrective action when policies, procedures, practices, or internal controls are deficient or when violations have been noted.

When conducting a bank holding company inspection, Federal Reserve examiners are instructed to: (1) review the holding company's policies and procedures regarding intercompany transactions of subsidiary banks; (2) focus attention on certain activities that might create problem situations; (3) review checking accounts and bank statements of the parent and nonbank subsidiaries for overdrafts; (4) review relevant accounts payable and review receivables to identify possible noncompliance with Sections 23A and 23B; (5) review other transactions that the parent or other affiliate has engaged in with affiliated banks to determine whether they are subject to Sections 23A and 23B restrictions; and (6) discuss the findings with management. Also, during Section 20 subsidiary inspections, Federal Reserve examiners: (1) verify compliance with firewalls restricting intercompany transactions; (2) review intercompany transactions noted on financial reports; and (3) review service agreements for compliance with Section 23B in instances where a Section 20 subsidiary serves as agent for an affiliated bank.

In conducting State member bank examinations, Federal Reserve examiners are requested to: (1) review information concerning fees paid and received and receivables from, and payable to, affiliates; (2) ensure compliance with the quantitative transaction limits with affiliates; (3) verify compliance with the collateral requirements of Section 23A; (4) ensure that low-quality assets have not been purchased from an affiliate; and (5) determine that all transactions with affiliates are on market terms and are consistent with safe and sound banking practices.

With respect to trust examinations, Federal Reserve examiners identify and evaluate policies and procedures related to purchasing securities from affiliates and impermissible self-dealing. Moreover, Federal Reserve trust examiners review securities transactions with affiliates for compliance with Section 23B, as well as State and common law prohibitions.

Detection of Sections 23A and 23B Violations

The vast majority of violations of Sections 23A and 23B tend to occur at small bank holding company organizations, despite the fact that the transactions between small banks and their affiliates usually are not numerous or complex. Small bank holding companies generally have less sophisticated internal control environments and compliance functions. On the other hand, the larger bank holding companies often have more complex structures, with a consequently greater potential for transactions that might violate Sections 23A and 23B. Larger organizations, however, generally have much more disciplined internal control environments and sophisticated compliance functions, thereby reducing the potential for violations.

Section 23A

Violations of Section 23A conceptually can be divided into two groups: (1) relatively simple Section 23A violations, which represent roughly 90 percent of all Section 23A violations, and which are normally detected in the examination process; or (2) more complex and, in some instances, convoluted transactions, the detection of which may require a thorough knowledge of Federal Reserve rulings and interpretations, staff opinions and interpretive letters. The latter transactions tend to be the ones that are more difficult to identify—particularly if there should be malfeasance and an attempt to evade deliberately statutory requirements. Common violations of Section 23A include: (1) overdrafts and other unsecured or inadequately secured extensions of credit, including tax overpayments of a bank to its parent holding company and failure of an affiliate to reimburse promptly the bank for advancement of expenses; (2) extensions of credit or purchases of assets in excess of the quantitative limit; and (3) purchases of low-quality assets.

All of the above violations relate to the transfer of bank funds to an affiliate in disregard for the quantitative or qualitative requirements of Section 23A. Section 23A is designed to protect insured depository institutions by ensuring that those institutions are not disadvantaged, from a liquidity or loss standpoint, in transactions with affiliates, or otherwise put at risk to the benefit of affiliates.

Section 23B

The basic premise of Section 23B is simple: A bank must engage in transactions with its affiliates that are on terms as least as favorable to the insured institution as those prevailing at the time for comparable transactions with unaffiliated companies. In the extreme, it is easy to identify readily certain transactions as abusive, such as nonpayment for services or facilities. In less extreme situations, however, it may be difficult to demonstrate that a transaction took place on market terms, because of the subjective nature of the standard. It may, for example, be difficult to find comparable transactions involving non-affiliated parties. Nevertheless, examiners have been able to detect abuses where they have occurred.

The common violations of Section 23B include: (1) extensions of credit that contain terms that could not be obtained from a nonaffiliate; (2) bank payment of an expense for the benefit of an affiliate; (3) bank prepayment of a parent-assessed management fee; and (4) no reimbursement to the bank for salaries and benefits of bank employees who perform some type of work for an affiliate.

Corrective Action

Generally, Sections 23A and 23B violations are discovered during the examination or inspection process. During favorable economic banking conditions, the preponderance of the violations found by examiners are technical in nature and do not involve abusive practices. Generally, these violations are noted and brought to the institution's attention either by the examiners meeting with the institution's management and board of directors or by inclusion in the examination or inspection report, or both. For the most part, such violations are corrected voluntarily, and generally soon after being brought to the attention of the organization. In the small number of cases where violations are not immediately corrected or recur, and are noted in the next examination or inspection report, the Reserve Banks will likely institute some type of informal supervisory action (for example, board of directors' resolutions, and memorandums of understanding). In the past several years, there have been a very small number of informal actions taken by Reserve Banks. On the other hand, when the banking industry is experiencing difficulties, violations tend to involve more abusive practices, for example, a bank's improper funding of an affiliate experiencing liquidity problems.

With respect to abusive practices or situations involving chronic violations, formal enforcement actions (such as written agreements, cease and desist orders, or civil money penalties) will be pursued. Over the past 3 years, 12 formal enforcement actions taken by the Federal Reserve have addressed violations of Sections 23A and 23B, among other problems or deficiencies, and directed future compliance with the law. These actions have addressed the following types of violations: (1) bank extension of unsecured credit to an affiliate; (2) bank payment of an affiliate's expenses; (3) an affiliate's overdrawn account at the bank; (4) bank overpayment of tax liability to the parent bank holding company; (5) bank exceeding aggregate limit on covered transactions; (6) bank transactions with an affiliate not at arm's length; (7) an affiliate's use of bank personnel without compensating the bank; and (8) unreimbursed affiliate expenses. One of these formal actions involved a Section 23B violation in connection with the fee structure associated with a Section 20 subsidiary serving as agent for its affiliated bank.

GOVERNOR SUSAN M. PHILLIPS SUBSEQUENTLY SUBMITTED THE FOLLOWING INFORMATION FOR THE RECORD AT THE REQUEST OF SENATOR MICHAEL B. ENZI

SUMMARY OF REMAINING PROTECTIONS IF THE BOARD'S FIREWALL PROPOSAL WERE ADOPTED

Capital Requirements

- Risk-based capital requirements for bank holding companies (including consolidated assets of any Section 20 subsidiary).

- Risk-based capital requirements for insured depository institutions.
- Board operating standard requiring that bank holding company or foreign bank maintain adequate capital on a fully consolidated basis.
- SEC net capital rules imposed on Section 20 subsidiary (like any other broker-dealer).
- The Generally Accepted Accounting Procedures (GAAP), which require that financial statements accurately reflect the capital strength of the holding company on a consolidated basis.

Protections For The Bank When Bank Lends Directly To Section 20 Affiliate

- Under Sections 23A or 23B of the Federal Reserve Act, a bank would not be able to expose more than 10 percent of its capital to the Section 20 affiliate directly, would have to deal with the Section 20 affiliate on arm's-length (market) terms, could not purchase low-quality assets from the affiliate, and could not purchase securities underwritten by a Section 20 affiliate during the existence of the underwriting or selling syndicate unless the bank's board of directors approves. The bank is further prohibited from engaging in any unsafe or unsound practice with an affiliate.
- The Board's proposed operating standard would also restrict intra-day extensions of credit that fall outside of Sections 23A and 23B, generally holding them to the same standard as 23B.
- Purchases of assets by a bank from its affiliate (which could be manipulated to serve as a funding vehicle) are also subject to Section 23B. Section 23A(a)(3) also generally prohibits a bank from purchasing a low-quality asset from an affiliate. A "low-quality asset" is defined to include: (A) an asset classified as "substandard," "doubtful," or "loss" or treated as "other loans especially mentioned" in the Section 20 affiliate's most recent report of examination or inspection; (B) an asset in an non-accrual status; (C) an asset on which principal or interest payments are more than 30 days past due; or (D) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

Protections To Ensure That Customers Are Not Confused When Purchasing Products Of The Section 20 Affiliate

- The Interagency Statement on Retail Sales of Nondeposit Investment Products imposes disclosure and other requirements on sales of nondeposit investment products either by bank employees or on bank premises. The required disclosures, which a Section 20 affiliate selling securities on bank premises would also have to make, are designed to ensure that customers understand that they are not dealing with a bank or thrift, and that the products they are purchasing are not Federally-insured or bank guaranteed. The Interagency Statement also requires that sales or recommendations of nondeposit investment products on the premises of a depository institution be conducted in a physical location distinct from the area where retail deposits are taken.

- Proposed operating standard would require Section 20 affiliate to make the same disclosures even when not operating on bank premises.
- Proposed operating standard would prohibit a bank from knowingly expressing an opinion on the advisability of purchasing or selling ineligible securities underwritten or dealt in by an affiliated underwriting subsidiary unless the bank notifies the customer that the underwriting subsidiary is underwriting, making a market, distributing or dealing in the security.
- Section 23B(c) of the Federal Reserve Act prohibits a bank or any Section 20 affiliate from advertising or entering into an agreement stating or suggesting that the bank is responsible in any way for the Section 20 affiliate's obligations. A parallel SEC rule (Rule 10b–10) and NASD rule (Rule 2250) would require a Section 20 affiliate to disclose that it is a market maker in a security before selling or recommending that security.

Protections For The Bank And For Fair Competition When Bank Enhances The Creditworthiness Of Securities Being Underwritten By A Section 20 Affiliate (e.g., Through A Guarantee Or Standby Letter Of Credit)

- Section 23B of the Federal Reserve Act requires that all credit enhancements extended to an issuer whose securities are being underwritten by a Section 20 affiliate be on market terms—that is the same terms it would extend to an issuer whose securities were being underwritten by an unaffiliated third-party. Consequently, for example, a bank could not offer such credit enhancements at below-market prices, or to customers who were poor credit risks, in order to generate underwriting business for a Section 20 affiliate.
- Section 106 of the Bank Holding Company Act Amendments of 1970 would prohibit a bank from offering discounted credit enhancements on the condition that an issuer obtain investment banking services from a Section 20 affiliate.
- Risk-based capital requirements require that capital be held against credit enhancements.
- Under the National Bank Act's loan-to-one borrower rules, national banks may only lend an amount equal to 15 percent of their capital on an uncollateralized basis and an additional 10 percent of their capital on a collateralized basis, and credit enhancements generally would be aggregated along with all other credit extended to an issuer in measuring compliance with these limits. State laws applicable to State banks are generally the same.
- The proposed operating standards require internal controls to ensure that any credit enhancement is extended consistent with the internal procedures of the bank, that independent credit judgment is exercised, and that documentation is maintained that would allow examiners to assess compliance with these policies.

Protections When Bank Lends To Customer To Purchase Securities From An Affiliate

- Section 23B (transaction must be on arm's-length terms), and Section 23A (in cases where the bank knows that the proceeds are being transferred to an affiliate).
- The anti-tying statute (Section 106 of the Bank Holding Company Act Amendments of 1970) prohibits a bank from conditioning a loan, or the terms thereof, on a customer's using the proceeds to purchase securities from an affiliate.
- Section 11(d) of the Securities Exchange Act of 1934 prohibits a broker-dealer (including a Section 20 affiliate) that is acting as an underwriter from extending or arranging for credit to customers purchasing the newly-issued securities during the underwriting period. Thus, a Section 20 subsidiary acting as underwriter would be prohibited from arranging for an affiliated bank to make loans to customers for purchases during an underwriting period.[1]
- Proposed operating standard, discussed above, would prohibit a bank from advising on the purchase without disclosing the affiliate's role.

Protections For The Bank When Bank Wishes To Lend To Corporate Customer For Repayment Of Securities Previously Underwritten By An Affiliate

- Section 23B.
- Capital requirements.

Protecting Bank From Being Held Liable For The Actions Of A Section 20 Affiliate (Piercing Corporate Veil Of Bank)

- Section 20 affiliate is separately incorporated and capitalized and is not controlled by the bank. Therefore, it is less likely to be held to be a "mere instrumentality" of the bank, which could lead to the bank's being held liable.
- Proposed operating standard requires that the chief executive officer and a majority of the board of directors of each company be independent of the other.
- Separate books and records.

Protections When Bank Purchases Affiliate-Underwritten Securities As Principal Or Fiduciary

- Section 23B(b)(1)(B) of the Federal Reserve Act prohibits a bank from purchasing, as principal or fiduciary, any security for which a Section 20 is a principal underwriter during the existence of the underwriting or selling syndicate. Although there is an exception if the purchase has been approved by a majority of the bank's board of directors who are not officers of any bank or any affiliate, this does not happen often.
- If the purchase is as fiduciary, the purchase must be permitted by the instrument creating the fiduciary relationship, court order, or State law.

[1] Section 11(d) would not apply in the absence of arranging and, unlike Firewall 6, would not cover loans to purchase a security in which a Section 20 affiliate makes a market or purchases from parties other than the Section 20 affiliate.

- If a fiduciary purchase were on behalf of a pension plan, then ERISA would impose a fiduciary duty on the trustee.[2] If the purchase were on behalf of a mutual fund, then Sections 10 and 17 of the Investment Company Act of 1940 would restrict the ability of the mutual fund to purchase securities from an affiliate of the investment advisor.[3] If the purchase were on behalf of an individual, State law would impose a fiduciary duty on the trustee.
- If the bank were to purchase the security as principal directly from the Section 20 affiliate, Section 23A would limit the amount of such purchases. The bank would also be required to hold capital against these exposures.
- The National Bank Act limits member banks to purchasing as principal only readily marketable securities.[4]

[2] 29 U.S.C. 1002(21), 1104.
[3] 15 U.S.C. 80a–10, 80a–17.
[4] 12 U.S.C. 24 (Seventh), 335.