FDIC Speeches

TESTIMONY OF

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ON

THE GENERAL ACCOUNTING OFFICE REPORT ON
THE SECURITIES SUBSIDIARIES OF BANK HOLDING COMPANIES

SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

1:30 PM
March 19, 1990
Room 2128, Rayburn House Office Building

Mr. Chairman and members of the Subcommittee, we appreciate the opportunity to present our views on the GAO's report entitled "Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies" and related issues.

Last July, this Subcommittee requested that the GAO study the activities of what are commonly called section 20 companies. These entities, which are securities subsidiaries of bank holding companies, are permitted under section 20 of the Glass-Steagall Act to underwrite and deal in certain bank-ineligible securities. To date, the Federal Reserve Board has approved applications granting section 20 companies the authority to underwrite and deal in: municipal revenue bonds, mortgage-related securities, commercial paper, consumer-receivables-related securities, corporate debt, and equity securities. The Federal Reserve has imposed a number of prudential restrictions, or firewalls, on the activities of section 20 companies. Further, the Board has set the revenue limit for the bank-ineligible securities activities of section 20 companies at ten percent.

Section 20 companies are required under the Securities and Exchange Act of 1934 to register as broker-dealers. As such, they are regulated by the SEC and must comply with the SEC's capital adequacy rules. However, the Federal Reserve enforces the firewall requirements governing the activities of section 20 companies.

The Subcommittee asked the GAO to examine several issues relating to section 20 companies, including: (1) how they have affected the risk level of the bank holding company; (2) their effect on market share and pricing of the specific securities; (3) the practical impact of firewalls on bank holding companies and, (4) whether there have been any real benefits to consumers from the new powers. The GAO asked bank holding companies with section 20 subsidiaries authorized as of September 30, 1989 -- 21 in all -- to provide information on their underwriting activities. Thirteen of the 21 bank holding companies reported they had begun bank-ineligible securities activities. The GAO also interviewed or reviewed records of the bank regulators, the Securities and Exchange Commission, trade association representatives, and investment banking firms in competition with the section 20 companies.

Based on its analysis, the GAO concluded that it is too early to assess the significance of the securities activities of section 20 companies, including their impact on the market, profitability, riskiness, or the adequacy of the regulatory system in which they operate. For example, six of the 13 section 20 companies that had begun bank-ineligible securities activities had only been doing so for less than one year. The GAO indicated, however, that section 20 companies have the potential to make a significant impact on the structure of the securities industry.

The GAO identified numerous issues that require further study before changes are made in the arrangements for section 20 companies. These issues range from whether abuses would occur if banking institutions were granted expanded securities powers to whether securities companies should be allowed to enter the banking business. We will expand on these points later in our testimony.

The GAO report is most timely and raises many of the same fundamental structural issues discussed in the FDIC's study published more than two years ago, titled Mandate for Change. Our study discusses how financial markets and competitive forces, both domestic and international, have changed dramatically since 1933 when the Glass-Steagall Act first imposed a partial separation between banking and securities activities and since 1956 when the Bank Holding Company Act further limited the activities of bank affiliates. Existing restrictions on banking activities clearly have handicapped the banking industry in today's rapidly changing financial environment. Indeed, one area that the GAO study recommends that the Congress and the regulators should consider further is the interrelationship of domestic and international aspects of bank holding company regulation. In devising and authorizing permitted international operations of U.S. banking organizations, the GAO suggests that the regulators should strive to ensure the competitiveness of banks and the safety and soundness of the banking system.

The inability of banks to compete effectively with other financial firms concerns the FDIC since the situation could lead to a less safe and sound banking system. Without a doubt, banks are special. Because of deposit insurance, banks essentially borrow on the credit of the United States Government. Moreover, the banking system provides a safe harbor for the savings of consumers, reserve liquidity, and the funds-transfer mechanism in this country -- all of which are essential to the United States economy. Thus, any threat to the banking system is a threat to the intermediation process, private-sector liquidity, the payments system and our economy.

A strong and more efficient banking system benefits consumers as well. One area that the Subcommittee asked the GAO to look at specifically was the benefit to consumers from the section 20 companies. Increased competition and economies of scale and scope result in economic efficiency which, in turn, results in lower costs to banks and bank customers. The public also benefits from increased levels of safety and soundness in our nation's banks. But, the system must prosper in order to be safe and sound, and prosperity can be achieved only if banks are free to attract capital and compete effectively, at home and abroad. The FDIC believes that structural reform of our financial system -- far beyond the mere approval of section 20 subsidiaries -- is necessary to permit banks to compete and prosper.

A number of key objectives should guide any structural reform effort. Those objectives are: a viable and competitive financial system and a safe and sound banking system, increased benefits for consumers through enhanced competition, and sufficient flexibility to respond to technological change. One final goal is to find the financial restructuring alternative that is the simplest and least costly to the economic system, consistent with these other objectives. Those objectives guided the development of our Mandate for Change study. We believe that the same objectives should guide the Congress in considering financial reform.

From our perspective as the deposit insurer, the most important issue in restructuring the banking industry is the appropriate role of banking safety supervision in the evolving financial-services sector. The pivotal question to that issue is: Can a bank be insulated from those who might misuse or abuse it? Is it possible to create a supervisory wall around banks that insulates them and makes them safe and sound, even from their owners, affiliates and subsidiaries? If the answer is "yes," there is no reason to legislate the separation of commercial banking from securities activities and, for that matter, from other financial and nonfinancial activities.

The conclusion of the FDIC study is that such a supervisory wall can be created and that supervising conflicts of interest is the key to an effective wall. The tools needed for insulating banks and establishing the "supervisory wall" are only a logical extension of safeguards contained in existing law to protect banks from insider abuse and conflicts of interest. Those tools, which are discussed in detail in our study, include: (1) the transaction limitations contained in sections 23A and 23B of the Federal Reserve Act; (2) the exclusion of equity investments in subsidiaries in determining bank regulatory-required capital; (3) the authority to audit both sides of any transaction between a bank and its affiliates or subsidiaries; (4) flexibility for bank supervisors to collect financial data from affiliated nonbanking entities, to prohibit any transactions deemed to jeopardize the safety and soundness of banks and to require that activities which pose undue risk be housed outside the bank; and (5) additional penalties for those who violate the rules.

Even with these or more stringent insulation mechanisms, abuse cannot be prevented in <u>all</u> cases. No matter what kind of structure is in place, abuses will occur. While most people play by the rules -- particularly if the rules are reasonable -- some will seek to avoid them. Thus, the supervisory challenge is to identify and restrain the minority who do not follow the rules and abuse the system. We believe that regulators can meet that challenge and, thus, ensure that the system is safe and sound. While it is the responsibility of supervisors to <u>seek</u> <u>to</u> ensure the safety and soundness of every bank, it must be emphasized that the primary objective is to keep the system safe and sound.

Given adequate supervisory insulation of the bank, direct banking regulatory and supervisory authority over bank owners and nonbanking affiliates and subsidiaries is neither necessary nor desirable. Bank regulation and safety supervision should be focused on the bank --

and on the bank alone. There may need to be increased regulation and supervision of banks -- thereby focusing and enhancing regulation where the Government has a financial interest. However, any required regulation of the entities affiliated with that bank should be performed along functional lines. In other words, a supervisory wall that provides adequate insulation for the bank would permit the dismantling of banking laws that regulate the activities of nonbanking entities -- namely, Glass-Steagall, including its section 20, and much of the Bank Holding Company Act.

The dismantling of such statutes, as opposed to a piecemeal approach to restructuring (such as the approval of section 20 subsidiaries), allows financial restructuring to be a two-way street. Not only could banks affiliate with most corporate entities, but those corporate entities could own banks as well. For example, if the affiliation restrictions of Glass-Steagall are eliminated (as opposed to the mere authorization of a few additional securities activities to bank affiliates), then theoretically securities companies could own banks. It should be recognized, however, that by eliminating only Glass-Steagall, a two-way street between banks and securities firms is not ensured since many securities firms now are affiliated with companies engaged in activities not permitted under the Bank Holding Company Act to bank affiliates. Total competitive equality and a two-way street can be established only if the activity restrictions of the Bank Holding Company Act also are removed. The GAO report recommends that one of the issues that should be studied regarding the section 20 arrangement is whether there should be comparable opportunity for securities firms to expand into banking.

The dismantling of Glass-Steagall and the Bank Holding Company Act also attains the objective of functional regulation and supervision. Functional supervision eliminates the costly layers of regulation and supervision that exist when companies are subject to the jurisdiction of both the banking agencies and the appropriate functional regulators. In addition, functional regulation is fundamental to providing competitive equality among all securities firms, irrespective of whether they are affiliated with a bank. Functional supervision also permits bank regulators to focus their attention on the bank -- which is where the focus should be.

Our views on functional supervision differ from those set forth in the GAO study. In its discussion of section 20 companies, the GAO states that the use of a separate SEC-regulated subsidiary and regulation of the entire holding company by the Federal Reserve are essential in permitting the affiliation of the banking and securities businesses. We believe that supervision of section 20 companies by the SEC would be sufficient, and that banks should be able to establish securities subsidiaries outside the holding company structure.

With the establishment of an adequate supervisory wall, bank regulators need only supervise the bank itself and the bank's dealings with its affiliates, subsidiaries and owners. Internally, bank operations would continue to be supervised to ensure that bank funds are handled in an appropriate manner and that the bank is being run on a sound business basis. Enhanced bank supervision also would see that the bank is not dealing preferentially with outsiders, conflict-of-interest rules are being observed and transactions with affiliates are at arm's length.

Structural flexibility is another benefit of the supervisory wall. The "wall" permits nonbanking activities to be undertaken either in subsidiaries or holding company affiliates of banks. There are approximately 4,300 banks that are not in holding companies. Such companies should not be forced to incur the additional corporate and regulatory costs of establishing a holding company in order to affiliate with nonbanking entities. Provided the "wall" is in place and it imposes the same conditions on banks' dealings with subsidiaries that apply to dealings with holding company affiliates, banks should be permitted to opt for the corporate structure that best suits their business plans.

Furthermore, as the GAO report recognized, there are advantages to the bank subsidiary structure. Earnings of a bank subsidiary flow through the bank. In addition, if the bank runs into financial difficulty, the subsidiary can be sold to raise capital for the bank. The GAO raised two points in the bank subsidiary structure that deserve some discussion. First, the GAO stated that one concern with the subsidiary structure is that losses in the bank subsidiary would pass immediately to the bank and reduce its capital. Further, the GAO implied that a section 20 company somehow would be more directly linked to the federal deposit insurance safety net and Federal Reserve discount loans than would a bank affiliate. We would dispute the GAO's concerns. If the subsidiary runs into difficulty, the bank has control over divestiture of the subsidiary and need not upstream losses to the bank. On the holding company versus bank subsidiary issue, we believe the real question is whether the bank subsidiary is a separately capitalized corporate entity separate and apart from the bank. If it is, then the subsidiary would not be any more directly linked to the federal safety net of deposit insurance than would a holding company affiliate.

Given the basic structural framework recommended here and in <u>Mandate for Change</u>, numerous questions still would have to be addressed. One of the most pressing issues is what activities should be permitted to be conducted directly in an insured depository institution. In this regard, there are credible views that range from restricting the insured bank's investments to short-term government or government-guaranteed obligations to permitting the insured entity to do what is permitted to national banks under existing rules to expanding on those national bank-permitted activities so as to include all agency activities. Also, thought needs to be given as to whether separate rules are necessary or appropriate for small banks.

Earlier in my testimony, I enumerated the basic tools that are needed for insulating banks. Given the ever-changing nature of the financial services landscape, we need to consider whether additional limitations are necessary to insulate banks and how restrictive they should be. For example, should there be any limits at all on the activities permitted to organizations that own or are owned by banks -- or should all affiliations be permitted? What should be the reporting frequency for holding companies and their affiliated organizations? What restrictions should be placed on direct subsidiaries of holding companies? What types of subsidiaries should holding companies be permitted to own and how can banks be made independent in an operational sense?

In considering how to control excessive risk-taking in the banking industry, we need to examine further the issue of "golden parachutes" and "poison pills." These mechanisms provide management with perverse incentives -- often rewarding management when bank failures occur.

Last but not least, discussions of restructuring the financial services industry necessarily give rise to the issues of deposit insurance reform and changes in the depository institution regulatory agency structure. These issues are all interrelated and deserve careful thought and attention.

To conclude, banking is experiencing and will continue to experience rapid and critical changes. The existing system is inequitable and inefficient. Government's presence must be modernized. Long-range financial services industry restructuring should be undertaken, far beyond the mere establishment of section 20 securities subsidiaries, to improve competitiveness, reduce regulatory costs and provide increased safety and soundness for the financial system.

Thank you. I will be pleased to respond to any questions.