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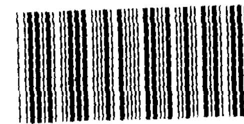
Report to the Honorable
Edward J. Markey, Chairman,
Subcommittee on Telecommunications
and Finance, Committee on Energy and
Commerce, House of Representatives

January 1988

BANK POWERS

Issues Related to Repeal of the Glass-Steagall Act



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United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

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January 22, 1988

The Honorable Edward J. Markey
Chairman, Subcommittee on Telecommunications
and Finance
House of Representatives

Dear Mr. Chairman:

On October 13, 1987, you requested answers to a number of questions relating to the extension of allowable bank powers into securities underwriting and brokerage. Generally, the questions deal with the safety and soundness of the banking industry, competition in the banking and securities industries, problems that might arise from conflicts of interest, and trends in the internationalization of the banking and securities markets.

In meetings with the Subcommittee we agreed to also provide you with our overall perspective on the issue of expanding banks' securities powers through repeal of the Glass-Steagall Act and a discussion of the ramifications of eliminating or extending the moratorium on expansion of bank powers that is contained in the Competitive Equality Banking Act (CEBA) of 1987. Our responses to your specific questions are contained in appendixes I through IX, and our views on Glass-Steagall repeal and the moratorium question are contained in this letter.

Background

The Glass-Steagall Act (sec. 16, 20, 21 and 32 of the Banking Act of 1933) was enacted in reaction to the Great Depression's banking crisis of 1933.[1], [2] It separated commercial from investment banking to enhance the safety and soundness of the financial sector and protect the consumer from conflict of interest abuses and other inequities. The Act prohibited federally chartered and state chartered Federal Reserve member commercial banks from purchasing, dealing in, or underwriting nongovernment securities for their own account, or affiliating with any corporation engaged principally in the prohibited activities. It also precluded investment banks from accepting deposits and kept banking and securities industry personnel separate.

[1] 12 U.S.C. sections 24, 377, 378, and 78, respectively.

[2] In 1933 alone, 4,000 of the nation's commercial banks were closed. Newly elected President Roosevelt declared a nationwide bank holiday in March 1933.

In recent years, commercial banks have found ways to overcome some of the Glass-Steagall restrictions and, similarly, nonbanking firms have found ways to undertake some, but not all, banking activities. In 1987, Congress, concerned about the uncoordinated and possibly inequitable process by which this extension of powers was occurring and fearing that it would threaten the safety and soundness of the financial system, placed a moratorium on any further integration of commercial and investment banking activities.[3] The moratorium, without congressional action to extend it, will expire on March 1, 1988.

Results in Brief

Expiration of the moratorium will result in a continuation of the uneven integration of commercial and investment banking activities. We believe that such integration is potentially dangerous because it does not allow for a systematic consideration of changes that need to be made to regulations or regulatory oversight in the banking and securities industries. On the other hand, extending the moratorium is potentially unfair to banks that are not grandfathered in its provisions.

Coming to grips with the question of Glass-Steagall repeal represents an opportunity to systematically address changes in legal and regulatory structures that are needed to better reflect the realities of the financial marketplace. If Congress chooses to repeal the Glass-Steagall laws, we believe that a phased approach should be adopted in which regulatory changes are implemented as the prohibitions are relaxed. The changes should be designed to preserve the safety and soundness of the banking system, to protect consumer interests, and to minimize the chances that unforeseen events will be destabilizing, so that the nation may experience the benefits of repeal. In general, these changes involve assuring adequate capitalization, specifying the holding company organizational structure, and providing necessary regulatory oversight.

If Congress wants an outright, rather than phased, repeal, we believe it should require that the regulators devise and submit, by a specified date, a plan for acquiring and bringing to bear the increased resources and technical capability needed to provide effective regulatory oversight over the revised marketplace.

[3]The bank holding company laws serve to keep banking separate from most nonbank financial enterprises and from commerce and industry. The moratorium also applies to the extension of bank powers into these areas.

In the event that the Glass-Steagall issue is not resolved by March 1, 1988, and Congress chooses to let the moratorium expire, we believe consideration should be given to a phased approach in which relaxation of activities prohibited by the moratorium is done incrementally as needed changes to regulation and oversight are put in place.

Objectives, Scope, and Methodology

As agreed with the Subcommittee, considering the very short time frame within which we were asked to respond to the questions you posed, our responses are based on our past work and our general knowledge rather than on any significant new audit work. Indeed, many of the questions that you pose involve hypothetical situations for which there is no existing empirical evidence. Although we have not previously studied the specific topic of Glass-Steagall repeal, we have undertaken a considerable amount of work—some completed and some in progress—that has relevance to this topic. Our most detailed comments draw generally from this work, which is cited in our responses to your questions and in the attached bibliography.

Although this report is based principally upon our past and ongoing work (which incorporates the views of hundreds of industry participants), we did discuss some matters with officials of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC). We also reviewed congressional hearing records, reports by federal agencies, and professional literature concerned with the Glass-Steagall issue. In addition, we analyzed data from commercial banks' reports of condition and income (call reports) and from similar information for securities firms contained in the SEC's securities industry database. We also discussed the issues with three of the nation's leading experts in this area.

Perspective on the Choices

Over the past several years, some banks have acquired substantially expanded powers. The expansion of activities has been the result of these banks (1) undertaking activities that were not explicitly prohibited or were sustained as legal by the courts, (2) introducing new products closely resembling securities, and (3) being given new powers by the regulators. In addition, some states have granted significant securities powers to state-chartered banks that are not Federal Reserve members.

A principal characteristic of the expansion that was taking place before CEBA was its unevenness. That is, not all banks shared equally the opportunity to become involved. Adopting ways to avoid the Glass-Steagall restrictions was often expensive, so only a limited number of nonbanking firms had been able to enter the banking or thrift industries by establishing separate companies such as the nonbank bank or unitary thrift holding company. Moreover, the determining factor that has enabled banks and securities firms to expand into each others' activities has been their ability to spot and take advantage of technical exceptions to the generally strict separation of commercial and investment banking activity required under the Glass-Steagall Act. This has led to a lack of established standards for admission to these industries that can be evenly applied, such as the institution's ability to engage in the new activities in a safe and sound manner. Nor have arrangements been made in some cases for the effective oversight of these activities.

Allowing the Moratorium to Expire

The moratorium imposed under CEBA put a brake on further integration of commercial banking and securities activities. If Congress allows the moratorium to expire, it seems likely that the changes that had been occurring prior to its imposition will once again proceed. There are both positive and negative aspects to this event.

- On the positive side, the nation might obtain some of the benefits that some believe are associated with repeal, such as lower prices and better service to consumers.
- One disadvantage is that the same process for determining who can participate will continue. This process is arbitrary as well as potentially both unsafe and unfair.
- A second disadvantage is that an opportunity may be missed to ensure that the expansion of bank powers is accompanied by reasoned changes in the legal and regulatory structures. In this regard we note that one of the causes of the current state of the thrift industry and its insurance fund's problems was the failure of the regulatory structure to appropriately adjust to the broad new powers given thrifts in the early 1980s.

The changes that would likely follow an expiration of the moratorium may eventually achieve the same result that would occur if Glass-Steagall were repealed. But, the transition risks of the ad hoc approach strike us as being greater than those that would exist with a carefully considered approach in which the regulatory counterbalances for expansion of powers are explicitly addressed and settled on.

Extending the Moratorium

One argument raised by those who advocate ending the moratorium is that those banking organizations that engaged in expanded lines of business prior to its imposition will continue their expanded operations, while other banking organizations will not be able to extend their activities. This situation raises a fundamental fairness question.

Arguments raised by those who are against extending the moratorium are generally the same as the arguments used by those who press for repeal of Glass-Steagall. These arguments include the possible erosion of the position of banks as financial intermediaries; the increasing importance to domestic banks of their foreign subsidiaries that are allowed to engage in activities not permitted in the United States; and the loss of potential benefits to consumers of increased competition and one-stop-shopping convenience for financial services.

Notwithstanding the force of the arguments for and against extension of the moratorium, a great deal of uncertainty surrounds many of the important questions about the benefits and costs of repeal—questions such as you raised in your request to us. This uncertainty is exacerbated by the recent serious disruptions on the stock market. If extending the moratorium by 6 months or a year would allow one to develop the information needed to answer all of the market and regulatory structure questions with certainty, this would probably be the preferred course of action. In our judgment, however, many of the questions are such that additional time may not add substantially to the certainty of the answers.

Repealing or Phasing Out Glass-Steagall

We view the decision on Glass-Steagall as essentially a judgmental one. It involves a largely nonanalytical trade-off between capturing the presumed benefits of relaxing the prohibitions and avoiding, to the greatest extent possible, the presumed dangers. Judgments about whether to proceed with repeal of the Glass-Steagall laws are bound to differ depending on one's sense of fairness, how much dissatisfaction one has with the current structure of the financial services industry, and how much uncertainty one is prepared to accept in moving forward versus attempting to maintain the status quo.

As indicated, the Glass-Steagall laws have already been eroded and the erosion is likely to continue in the future. Coming to grips with the Glass-Steagall repeal question represents an opportunity to systematically and rationally address changes in regulatory and legal structures that are needed to better address the realities of the marketplace. If the

Glass-Steagall laws are repealed or relaxed, we believe it is critical, in order for the nation to experience the potential benefits of repeal, that certain commensurate steps be taken to preserve the safety and soundness of the banking system, to protect consumer interests, and to minimize the chances that unforeseen events will have a destabilizing effect. These steps center around assuring adequate capitalization, stipulating a specific organizational structure, and providing necessary regulatory oversight.

Maintain Adequate Capital

Our work on the thrift industry indicates that it would be potentially destabilizing to allow poorly capitalized or insolvent banking institutions to engage in an expanded set of securities activities. At the end of June 1987, 491 savings and loan associations (S&Ls) that were insolvent under Generally Accepted Accounting Principles (GAAP) were still in operation.[4] On average, insolvent S&Ls placed more of their resources in activities, such as commercial, construction, and acquisition and development loans that are often regarded as more risky than the industry's traditional activity—making residential mortgages.

Moreover, at the end of June 1987, 416 commercial banks, some in the commercial bank forbearance program, were also operating with primary capital below the regulatory minimum of 5.5 percent of assets. Others, such as Continental Illinois National Bank, are functioning only because they have received an infusion of capital from the Federal Deposit Insurance Corporation.

Just as allowing poorly capitalized and insolvent thrifts to continue operating has seriously undermined the soundness of the Federal Savings and Loan Insurance Corporation, allowing poorly capitalized banking firms to enter the securities business and vice-versa would be equally dangerous. Thus, it is essential to require that those banking and securities firms desiring to engage in both banking and securities activities have and maintain a minimum level of capital sufficient to cushion against losses that might result from the expanded activities. That level should be prescribed by the regulators.

Require the Bank Holding Company Structure

Our work on the effectiveness of various insulation structures indicates that while no corporate structure is fail-safe, the bank holding company

[4]In addition, at the end of June 1987, 463 other thrifts, some in the capital forbearance program, were operating with inadequate capital (below 3 percent under GAAP).

structure provides the greatest degree of legal, economic, and psychological insulation of insured deposits from other currently permissible activities. Thus, we believe it appropriate, at least initially, to require that the bank holding company structure be established as the mechanism for organizing the association of banking and securities activities and that additional securities activities be allowed only to affiliates of banks, not to bank subsidiaries or departments. Moreover, the holding company, if subject to functional regulation, should be subject to comprehensive oversight. The Federal Reserve, in our estimation, is the agency in the best position to provide that oversight.

Placing increased reliance on the holding company structure does, however, raise several related issues which will need resolution. These issues have to do with the relationship of the federal safety net—deposit insurance, lender of last resort services, and safety and soundness regulation—to the expanded banking/securities organization and liquidity. The question is whether the focus of attention should be on the insured commercial bank or on the entire holding company organization.

Restrict the Safety Net

We believe it would be inappropriate to extend deposit insurance and lender of last resort services to the nonbank parts of the holding company. Rather, holding companies should be required to maintain levels of capital consistent with their activities. Those that fall below the minimum established should be recapitalized immediately or be forced to divest their expanded activities. We also believe that holding companies should be required to act as a source of strength to any commercial banking unit in the organization. If the holding company owns both a bank and a securities firm, the holding company's capitalization should be sufficient to serve as a major source of strength for these affiliates. We believe it is essential that a securities affiliate be allowed to impose no material threat to the solvency of the bank.

Ensure Liquidity

The liquidity needs of banks and securities firms must be met, particularly in times of crisis. In view of the liquidity problems that securities firms experienced during the market crash of October 1987, we would question an insulation approach that would attempt to achieve absolute legal, economic, and psychological separation between the insured deposit-taking function and other activities. Such an approach might abort the continuation of banks' traditional role as providers of liquidity, should the events of October 1987 repeat themselves. To preserve

that traditional role, we believe that banks should be permitted to lend to their securities affiliates, but only on an arm's length basis. In times of crises, the capital of the holding company must be sufficient and should be used as security for the liquidity needs of a bank or securities affiliate.

More Regulatory Attention to Protection of Consumer Interests

Part of the impetus for passage of the Glass-Steagall laws was to prevent many of the consumer abuses that were occurring during the late 1920s and early 1930s. Over the past few years the regulators' oversight priority has been with safety and soundness considerations. Insufficient emphasis has been placed on oversight of compliance with existing banking laws and regulations designed to protect consumer interests. It is essential that more regulatory attention be given to compliance with existing regulations. And, in a world of expanded powers, it becomes all the more important to ensure that consumers do not become confused in making choices about a wide variety of new product offerings.

Increase Regulatory Resources

Ultimately, the degree of comfort that one has in the repeal of Glass-Steagall will depend on the faith that one has in the regulators' ability to effectively oversee the newly allowed activities in terms of safety and soundness and protection of consumer interests. Our work on safety and soundness and regulatory compliance has shown that changes are needed to better assure that the regulators have sufficient capabilities to oversee the new activities that are contemplated, while at the same time ensuring compliance with conflict of interest, Bank Secrecy Act, disclosure, and consumer-oriented banking regulations as well as providing for an adequate resolution of consumer complaints.

Steps should be taken concurrent with any relaxation of Glass-Steagall prohibitions to increase both the resources of the regulatory agencies as well as their expertise. This is necessary to better assure that they have the capability to effectively examine and supervise institutions wishing to engage in both the banking and securities businesses. Fees may need to be instituted for bank holding company examinations and those charged in some cases for bank examinations may need to be increased for those firms engaging in extended activities in order to provide for increased regulatory needs.

We recognize that it may be impossible to quickly make all necessary regulatory oversight adjustments. We also recognize that it is not possible to fully contemplate all of the adjustments that might be necessary.

We believe, therefore, that if Congress chooses to repeal Glass-Steagall, it do so under a phased approach. For example, bank holding companies might be allowed to adopt only a subset of securities activities (or activities might be limited to a certain percentage of assets) while the requisite regulatory resources are being put in place.

If Congress chooses instead to fully repeal Glass-Steagall, we believe that it must assure itself that the regulators will put the requisite resources in place to adequately oversee banks' safety and soundness and compliance with consumer-oriented regulation. Therefore, at a minimum, plans should be required from the regulators for acquiring the resources needed as well as increasing their technical capability to cope effectively with a deregulated industry.

A Fourth Approach

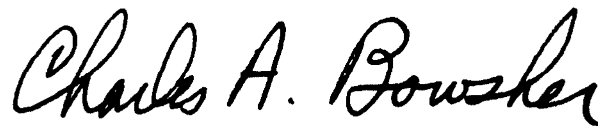
Some of the steps that we have outlined, such as capital rules and use of the holding company structure as a precondition for engaging in expanded activities, can be taken immediately through their incorporation into legislation. Other steps, such as increases in regulatory oversight resources and capabilities, will take longer.

If Congress is not prepared to relax Glass-Steagall prohibitions before March 1, 1988, it must decide whether to extend the current moratorium on expanded bank powers or let it expire. We indicated earlier that we consider neither outright extension nor expiration of the moratorium as particularly satisfying alternatives. But we also recognize that the time before March 1 is running short.

In view of this dilemma, Congress may wish to consider another alternative—an approach that would initiate some of the regulatory reforms we believe must be made commensurate with the repeal of Glass-Steagall accompanied by a phased expiration of the moratorium. This approach is somewhat similar to a phased approach to repeal of Glass-Steagall. It differs in that none of the Glass-Steagall prohibitions would be removed and only those activities that skirt Glass-Steagall and other restrictions would resume, unless constrained explicitly. A phase-out of certain prohibited activities under the moratorium, accompanied by the institution of certain regulatory reforms, would assure a more systematic approach to providing the regulatory changes and their oversight that are needed for the integration of commercial and investment banking activities.

Due to the time constraints imposed by your request, we did not obtain agency comments on this report. As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. At that time, we will send copies to other interested parties and make copies available to other parties upon request.

Sincerely yours,



Charles A. Bowsher
Comptroller General
of the United States

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Abbreviations

BHC	Bank Holding Company
CHIPS	Clearinghouse Interbank Payments System
CEBA	Competitive Equality Banking Act of 1987
FDIC	Federal Deposit Insurance Corporation
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission
S&L	Savings and Loan Association

Safety and Soundness After Repeal of Glass-Steagall

1. How can we ensure that the safety and soundness of the nation's banks will be preserved in a more fully deregulated (in Glass-Steagall terms) environment?

The nation could potentially obtain substantial benefits from repeal of the Glass-Steagall laws (see our answer to question 2). However, we recognize at the outset that all of the consequences of repealing Glass-Steagall restrictions cannot be completely foreseen. No system that Congress might establish can foreclose the opportunities for individual banks to misuse their existing or new powers and to fail. We need to ensure, therefore, that the failure of individual banks can be prevented from destabilizing the financial system.

Paradoxically, therefore, as the range of activities open to these firms is deregulated, an even greater need remains for laws and regulations that give appropriate attention to safety and soundness and for an adequately funded system of oversight and enforcement that has the flexibility to deal both with expected and unexpected problems. Otherwise, deregulation will bring with it the possibility of weakening rather than improving the financial sector.

In our opinion, public policy needs to be clarified or established, by or under the direction of Congress, in a number of areas in order to have reasonable assurance of a successful association between the banking and securities businesses.

Primary among these is the decision as to the type of organizational structure necessary to adequately protect the deposit system. That is, should new activities be permitted within the bank, by a subsidiary of the bank, or only through an affiliate in a holding company? This choice, in turn, requires a decision about whether to extend or limit the federal financial safety net consisting of deposit insurance; lender of last resort assistance; and the system of examination, supervision, and regulation. Related issues that need to be addressed include (1) maintenance of adequate capital and prompt resolution of failing institutions and (2) provision of adequate liquidity to securities firms associated with banks.

The Safety Net

The federal safety net includes deposit insurance; lender of last resort assistance; and the system of examination, supervision, and regulation. Major safety issues associated with repeal or relaxation of Glass-Steagall laws remain unresolved. Questions persist as to whether or not

safety net protection should be risk-responsive[1] and, if a holding company structure is chosen, whether the net should encompass only the insured bank(s) in a holding company or the holding company itself and all affiliates. These questions themselves raise the issue of oversight of the holding company. Under functional regulation, the bank regulators oversee banking activities and the Securities and Exchange Commission (SEC) and the industry's self-regulatory organizations supervise securities activities. Presently, the Federal Reserve oversees bank holding companies.

The experience of First Options Corporation, an "operating subsidiary" of Continental Illinois National Bank, illustrates the safety net dilemma. First Options suffered heavy losses during the stock market crash of October 1987, and it turned to its parent bank for recapitalization. The Office of the Comptroller of the Currency's (OCC) limitations on the size of permissible loans to one borrower did not allow Continental Illinois National Bank to meet its subsidiary's capital needs, although the bank did extend funds over one night.

According to the Federal Reserve, any commercial bank, under current procedures and with appropriate collateral, can obtain funds from the discount window to lend to a troubled subsidiary up to legal limits in a crisis. Allowing a bank to lend to its subsidiary, however, could result in extending the federal safety net to the nonbank subsidiary. Thus, steps are necessary to preclude extending the safety net to securities firms that are bank subsidiaries.

The failure of First Options, which serves 45 percent of the 1,200 traders on the Chicago Board Options Exchange, would have seriously exacerbated the stock market crisis. In any event, the holding company, Continental Illinois Corporation, was able to provide the necessary loan from uninsured funds.

nsulation

If it is decided that the safety net should not be extended to all subsidiaries, affiliates, or parent companies, the issue of insulation arises. Insulation is the set of legal, regulatory, and structural barriers separating different activities conducted by a given firm or organization. Insulation has been proposed as a way for banks to participate in new activities without endangering their insured deposits or calling on Federal Reserve

[1] Deposit Insurance; Analyses of Reform Proposals (GAO/GGD-86-32, 32A, 32B, Sept. 30, 1986).

support.[2] With repeal of Glass-Steagall, insulation will be necessary to ensure that any associated nonbank unit (for example, the holding company) cannot invade bank resources, and that deposit insurance and lender of last resort assistance do not extend to the nonbank unit.

In examining the efficacy of various insulation strategies, we found that no system of insulation should be expected, at all times and under all circumstances, to protect the bank from failure and its creditors and insurers from losses.[3] We also found that the extent of protection increases as the nonbank activities are organizationally removed from the bank. That is, the holding company affiliate structure provides a greater degree of insulation than does the bank subsidiary, which, in turn, provides greater protection than if the bank itself performs nonbank activities. At the same time, a positive correlation appears to exist between the degree of insulation afforded the bank and the resulting cost and diminution of benefits to the bank.

Recommendation

Because some risks to the safety and soundness of the banking system of repealing Glass-Steagall cannot be assessed in advance, we believe it prudent to err, if at all, on the side of caution. Therefore, should Glass-Steagall be repealed, we recommend that extended activities be organized in a holding company rather than in the bank. The holding company organizational form provides the bank and the deposit insurance fund with the highest degree of insulation from potential risks.

Regulatory Oversight

As indicated by recent thrift experience, product-line deregulation may be costly to the nation if not accompanied by an efficient system of

[2] Bank Powers: Insulating Banks From the Potential Risks of Expanded Activities (GAO/GGD-87-35, Apr. 1987).

[3] The degree of insulation achieved could, however, be substantially increased if the penalties for violating Sections 23A and B were raised so high as to become an effective deterrent to violation.

examination, supervision, and regulation.[4] Insolvent firms may choose to grow rapidly and engage in risky activities that would return them to solvency if successful, but impose costs on the insurance funds if unsuccessful. Experience during the 1970s and 1980s has shown that innovators can find legal loopholes in seemingly comprehensive laws and regulations. It has also shown that the innovators are often ahead of the regulators.

If banking is to become associated with the securities business, domestically as well as overseas, and vice versa, and appropriate laws and regulations are written, those who might abuse the new powers need to know that regulators of the bank, securities affiliate, and holding company will detect improper or illegal actions and enforce the laws and regulations. This implies that when moving to repeal Glass-Steagall, Congress should have a reasonable assurance that regulators achieve the level of industry oversight necessary to effectively do their job.

Examination resources of the federal regulators are already strained, and the expertise of the examination workforce needs strengthening.

- The regulatory agencies began falling behind their desired examination frequency schedule during the mid 1980s. The growth in the number of insured banks that were experiencing problems affected regulators' ability to devote resources to oversight of the industry.[5] Many of the thrift industry's problems as well as those of its deposit insurer have been attributed to oversight shortcomings.

Banks are subject to many regulations that are not immediately and directly related to safety and soundness, especially in the area of consumer protection. While regulators are also responsible for monitoring

[4]Thrift Industry Restructuring and the Net Worth Certificate Program (GAO/GGD-85-79, Sept. 1985).

Thrift Industry Problems: Potential Demands on the FSLIC Insurance Fund (GAO/GGD-86-48BR, Feb. 1986a).

Thrift Industry: Net Worth and Income Capital Certificates (GAO/GGD-86-100FS, June 1986d).

Thrift Industry: Cost to FSLIC of Delaying Action on Insolvent Savings Institutions (GAO/GGD-86-122BR, Sept. 1986f).

Thrift Industry: Forbearance for Troubled Institutions 1982-1986 (GAO/GGD-87-78BR, May 1987c).

Thrift Industry: The Management Consignment Program (GAO/GGD-87-115BR, Sept. 1987d).

[5]Ten FDIC insured banks were closed in 1980, 42 in 1982, 79 in 1984, 138 in 1986, and 184 in 1987. In addition, 7 banks were granted financial assistance in 1986 and 19 were assisted in 1987.

compliance with these regulations, priority has been given to the more explicit safety and soundness issues. Our past work on Bank Secrecy Act compliance as well as work currently underway on conflicts of interest reveals, for example, that the emphasis given in examinations to compliance with some of these regulations is unsatisfactory. Finally, our work at the Securities and Exchange Commission reveals that its resources have not increased in the past 7 years despite staggering growth in market activity. Only very recently has the Commission requested increased resources. We have, on several occasions, expressed concerns about the SEC's ability to effectively oversee securities market activities at its current staffing levels.

- Our current work on off-balance sheet activities indicates that the bewildering array of new products and services is testing the regulatory agencies' oversight expertise. Understanding the new and continuously evolving products in domestic and international securities and lending markets is acknowledged by regulators as a challenge.
- Financial decisions are being executed faster than ever due to advances in computer and communications technology. Regulators must be able to detect problems and act more quickly than ever before.

Permitting securities powers in bank subsidiaries—and to a lesser extent in holding companies—could exacerbate existing oversight problems. Achieving a satisfactory degree of oversight will probably require increased resources for regulatory supervision and examination, as well as more training for existing and new personnel.

Recommendation

Should extended powers be granted, we recommend that resources be increased for the banking and securities industry regulators in order to preserve safety and soundness and protect consumer interests. Regulatory resources are currently funded from a variety of sources, including examination fees, insurance premiums (and interest thereon), funds available to the Federal Reserve System, and appropriated funds. The necessary increases in resources could be obtained by raising fees and premiums for banks that have securities affiliates, and/or by instituting a new fee for examinations of holding companies engaged in both banking and securities activities.

Adequate Capital and Prompt Resolution of Failing Banks

Past GAO work has revealed the serious extent of the exposure to loss by the Federal Savings and Loan Insurance Corporation (FSLIC) from allowing insolvent thrifts to continue to operate.[6] Insured insolvent firms may gamble at the public's expense, particularly when the prices charged for insurance do not reflect risk. The gambler may then retain any profit, but, if the thrift fails, the losses accrue to the insurance fund, healthy firms in the industry, and, ultimately, taxpayers.

Banks or bank holding companies that are solvent but undercapitalized also have incentives to make decisions that could threaten the insured bank and, ultimately, the federal deposit insurance fund. Our work has shown that solvent thrifts with capital (measured under Generally Accepted Accounting Principles [GAAP]) below 3 percent of assets tend to undertake more risky activities than do their well-capitalized peers. (Both now pay the same rates for insurance.) Some weakened institutions make big mistakes, fail, and impose heavy costs on their insurer.

Additional powers would provide bank holding companies and/or banks opportunities to engage in risky activities through securities affiliates or bank subsidiaries. We believe that it is important to deal promptly with any bank when, or before, it becomes insolvent. A failed bank should be sold and capitalized where this can be done quickly. Where no buyers can be readily found, the firm may need to be recapitalized with public funds and then sold. As receiver for failed banks, the Federal Deposit Insurance Corporation (FDIC) now has several options for handling these banks, including the paying off of insured depositors and assumption of all assets to liquidate, arrangement of the purchase of bank assets and assumption of liabilities by another banking entity, and operation of the bank as a bridge bank in preparation for a sale. However, these actions may impose costs and inconvenience on bank customers. At the same time, it is difficult under existing laws and regulations to take control of a bank away from its owners while it still has positive value. An acceptable option to quickly resolve, but not close, a bank in danger of failing needs to be found. Ideally, resolution should occur while existing stockholders and creditors, rather than the insurance fund, can bear the losses in order to promote the market discipline necessary to keep institutions operating safely and profitably.

[6] Thrift Industry Forbearance for Troubled Institutions 1982-1986 (GAO/GGD-87-78BR, May 1987).

Recommendation

Should Glass-Steagall be repealed, we recommend that legislation or regulation prohibit undercapitalized holding company parents from engaging in extended activities.

Holding Company Support for the Bank

An issue related to the above discussion on capitalization and closure at public expense is the extent to which a holding company should be required to support a subsidiary bank. We believe that since an important reason for permitting the banking industry to enter the securities business is to strengthen banking, profits from the securities business should be applied to a weakened bank. (At the extreme, a holding company might be required to sell a nonbank subsidiary to support a bank.) Although the Federal Reserve has argued that bank holding companies have this obligation, the requirement is not specified in legislation, nor has it been enforced by the courts.

Recommendation

Should Glass-Steagall be repealed, we recommend that legislation or regulation require the holding company to act as a source of strength to its bank components.

The Provision of Liquidity

Practitioners and academics recognize that any firm, although solvent, may at some time experience a shortage of liquid funds (cash) necessary to pay its bills. Raising funds through asset liquidations in an emergency situation can be costly to the firm and prejudice its viability. For this reason, the provision of liquidity to temporarily troubled firms provides a useful societal function.

Firms experiencing liquidity problems have traditionally turned to their commercial banks for loans during crises. A firm's commercial bank is better placed than the Federal Reserve or other financial firms to lend to an illiquid customer due to its immediate access to confidential data necessary to judge the long-term viability of the customer. The commercial banks can, therefore, be described as lenders-of-next-to-last-resort to commercial and nondepository financial firms. This is an important social function in our economy.

For example, some securities firms suffered heavy losses during the October 1987 stock market crash and needed infusions of capital. Illiquidity developed among a number of securities firms on October 20, the day after the crash. Many firms, including New York stock exchange specialists, turned to their commercial banks for loans to meet these

unusual demands. To ensure that legitimate loan requests would be met, the Federal Reserve pumped liquidity into the banking system and encouraged the major New York banks to lend to their clients in the securities industry. These Federal Reserve actions were instrumental in preventing a collapse of the financial system, and most participants survived the crash.

Many commercial banks, particularly the large ones, regularly make loans to securities firms. Data derived from the quarterly call reports submitted to the federal bank regulators show that $18.4 billion in loans to securities dealers and others for purchasing or carrying securities were outstanding at the end of December 1986. Of the loans outstanding, $10.9 billion were on the books of the 33 banks with assets of $10 billion or more.

However, these bank loans were not evenly spread across the securities industry. Of 1,286 securities firms holding over 99 percent of both the industry's bank loans and total assets, we found that 41 percent (528) of the securities firms relied on bank loans for their credit needs. Of these firms, more than 13 percent (67 firms) had bank loans equal to or greater than 50 percent of their total assets. Over one-fifth (117 firms) had bank loans between 25 and 50 percent of their assets, and over one-quarter (141 firms) had bank loans between 10 and 25 percent of their assets. Finally, over one-third (203 firms) had bank loans less than 10 percent of their assets.

Clearly, many securities firms rely heavily on bank loans in their normal course of business. As demonstrated by the events of October 1987, the reliance on bank loans may become particularly important during a crisis. If the Glass-Steagall Act is repealed, preserving the role of commercial banks as suppliers of regular and emergency credit to securities firms, with insulation in place, needs to be addressed.

Some observers have expressed concern that allowing commercial banks and securities firms to become affiliated will enable the securities firms to have access to funds whose costs are subsidized through the deposit insurance system.[7] Such access could give an unfair advantage to bank affiliated securities firms over others, and also could raise insulation and conflict of interest issues. Consequently, debate is ongoing regarding

[7] The ability of a bank to lend to any affiliate is limited (assuming a 6 percent capital to assets ratio) to 0.6 percent of assets. This restriction limits the extent of the subsidy that could be provided to a securities affiliate.

the best way to insulate a securities firm from an associated bank. Two principal alternatives have been proposed in the debate. One proposal is to strengthen Sections 23A and 23B of the Federal Reserve Act, ensuring that all financial transactions, including intraday extensions of credit, are conducted on an arm's-length basis. The other proposal would require that banks be prohibited (not just limited under sec. 23A and 23B) from lending to securities affiliates. (See question 11.) This latter proposal could have the effect of undermining the banks' normal role as suppliers of credit to the securities industry.

As discussed above, securities firms already borrow from commercial banks. Denying securities firms the opportunity to borrow from their regular, but affiliated, bank could be a serious disadvantage, especially in a crisis. A securities firm affiliated with a bank would be forced to request a competing bank to provide the liquidity necessary for survival. The prohibition of lending between banks and their securities affiliates would undoubtedly enhance insulation, but would do so at the cost of a potentially serious restriction of liquidity to the securities industry.

Recommendation

We recommend that if Glass-Steagall is repealed, legislation or regulation stipulate that banks be allowed to lend to their securities affiliates, but that all such transactions be conducted on an arm's-length basis.

Benefits of Repealing Glass-Steagall

2. In what ways will our national economy and the interests of our citizens be served if banks, their subsidiaries or affiliates are allowed to participate broadly in securities activities?

Proponents argue that repealing the Glass-Steagall Act will provide substantial economic and social benefits. The list of potential benefits that proponents cite is impressive:

- There would be greater competition, which is, in itself, desirable. Prices charged to businesses and households would be reduced by bidding away any excess profits that might exist, and new and better services would be provided.
- Consumers would benefit from the increased availability of existing and perhaps new financial services. Other existing services might be provided at reduced prices. Consumers might also experience greater convenience in being able to "one-stop-shop." For example, a survey cited by proponents indicated that consumers would value the opportunity to purchase mutual funds from their bank instead of from, or in addition to, the current, more remote mutual fund distribution system.[1] A Federal Reserve study has also shown that a substantial number of consumers would like to be able to obtain all of their financial services from one location—their bank.[2]
- Businesses would benefit from improved access to the capital markets. Large firms might pay lower prices for underwriting services as a result of enhanced competition at the national level from the largest commercial banks. Smaller firms would, for the first time, have direct access to the capital markets if regional and community banks offered services previously not available from the highly concentrated set of national underwriters. Results obtained from a 1987 survey of about 700 of 1,700 large U.S. corporations with sales over $250 million conducted in 1987 by Greenwich Associates found that firms relying on both banks and the commercial paper markets and those with lower credit ratings particularly oppose the retention of Glass-Steagall.[3]
- Smaller firms located away from the New York City home of most investment banks would receive better access to the capital markets if

[1]Statement by Charles Piston, American Bankers Association, before the House of Representatives, Committee on Banking, Finance and Urban Affairs, December 3, 1987, p. 7.

[2]Veronica Bennett, "Consumer Demand for Product Deregulation," Federal Reserve Bank of Atlanta, Economic Review, May 1984, pp. 28-37.

[3]Greenwich Associates, Greenwich Associates Large Corporation Banking 1987 Report to Executives.

their needs could be serviced by the larger regional bank holding companies. This development would improve the regional allocation/distribution of investment funds.

- State and local governments would likely pay lower interest rates on issues of municipal revenue bonds. According to a 1979 review by Professor William Silber of 12 academic studies, underwriting spreads are lower for general obligation bonds, which can currently be underwritten by banks, than for revenue bonds, which most insured banks cannot issue.[4], [5] Some of the reduced issuing costs might be passed on to users of local government services as lower prices; some might be used to reduce state and local tax rates; and some savings might be used to provide more services.
- The ability to engage in a more diversified set of activities would allow banks to be more efficient. That is, they might earn higher returns for their current level of risk exposure, or reduce their risk exposure at their current rate of return (or a little of both). Even activities that are individually risky could benefit a bank when included to an appropriate degree as part of a portfolio of activities whose returns are cyclically offsetting.[6] These outcomes may help counter losses in the domestic commercial banking industry that have been attributed to securitization and globalization in the capital markets.
- If the bank holding company is strengthened by diversification, it may have less need to plunder, in a variety of ways, its bank's capital and profits.
- A stronger banking industry would emerge, reducing both failures and the exposure of the FDIC, as well as the likelihood that the taxpayer would ultimately have to provide funds to meet any underfunded federal insurance guarantees.
- Increased access to the financial markets and lower costs of capital would encourage investment in the national economy, employment, economic growth, and prosperity.

In our opinion, while the potential benefits are conceptually real, they should not be overanticipated. In particular, the potential benefits of

[4] A spread is the difference between the price paid to the issuer and that charged to retail customers by the underwriter.

[5] Professor Silber's study has been criticized for exaggerating the benefits found in the studies surveyed. See C.O. Bierwag, George G. Kaufman, and Paul H. Leonard, "Interest-Rate Effects of Commercial Bank Underwriting of Municipal Revenue Bonds: Additional Evidence."Journal of Banking and Finance, vol.8 issue 1, March 1984, pp. 35-50.

[6] Data have been presented in several academic studies to show that investment banking activities may offset cyclical fluctuations in banking. See, for example, Robert Litan, What Should Banks Do? The Brookings Institution, 1987.

expanded powers to commercial banks should not be exaggerated because of the following considerations.

- While rates of return on equity have historically been higher on average in the investment banking industry than in the commercial banking industry, they are also more volatile. Although recent investment banking profit rates have been high, table II.1 shows that the gross volume of profits in investment banking is small relative to total profits in commercial banking.[7] Therefore, dividing the profits that banks may be able to capture by entry into the securities industry among participating commercial banks might not increase bank profitability substantially. Moreover, returns to investment banking have been declining recently and, according to some analysts, may continue declining through 1992.[8]

In a deregulated environment more securities underwriting might be accomplished so that the pool of securities industry profits would not necessarily remain fixed but could grow. However, competition may also reduce profit margins. Therefore, there could be either more or less profits to be shared between investment and commercial banks than those listed in table II.1.

[7]Total net income before taxes in the banking industry was 2.75 times larger than the comparable figure for securities firms.

[8]The Investment Banking Industry: Strategic Analysis/Financial Forecast, Sanford C. Bernstein and Company, Inc., October 1987.

Table II.1: Relative Sizes of the Securities and Commercial Banking Industries

Amount of Total Industry Characteristics Accounted for by the Top 8, Top 25, and All Firms in the Two Industries at Year-End 1986 (All Values Are in Billions of 1986 Dollars)

	Assets[a]	Equity Capital[b]	Gross Revenues[c]	Pre Tax Net Income[d]
Top 8				
Commercial Banks	$619.4	$30.8	$61.0	$5.0
Securities Firms	$272.9	$11.2	$26.0	$2.9
Top 25				
Commercial Banks	$971.6	$49.9	$93.7	$8.1
Securities Firms	$414.6	$17.1	$39.0	$4.4
All Firms				
Commercial Banks[e]	$2,941	$182.5	$277.9	$22.8
Securities Firms[f]	$524.8	$32.0	$64.9	$8.3

Source: SEC Monthly Statistical Review, FDIC reports of income and condition.
[a]Assets of the top 8 and top 25 firms (measured by asset size), and of all firms.

[b]Equity capital of the top 8 and top 25 firms (measured by value of capital), and of all firms.

[c]Gross revenues of the top 8 and top 25 firms (measured by revenue values), and of all firms.

[d]Pre-tax income of top 8 and top 25 firms (measured by total pre-tax income), and of all firms.

[e]There were 14,198 FDIC insured commercial banks included in our sample as of year-end 1986.

[f]There were 9,328 broker-dealers registered with the SEC in 1986.

- Investment banking appears to be more concentrated at the national level than commercial banking. However, given moderately free entry in both industries (except that commercial banks cannot enter investment banking), excess profits may not be as substantial as is sometimes implied for those firms that operate in the national money markets. (We examine this issue further in app. V.) Regional pockets of monopoly power may, however, exist in both the commercial banking and investment banking industries. These pockets could be reduced by reciprocally enhanced competition between both industries, especially if new firms enter the industries.

The argument that allowing banks in a bank holding company to undertake securities activities will substantially strengthen the commercial banking industry, needs to be eyed somewhat critically. Attempts to insulate the insured bank from the risks undertaken by other elements in the holding company would separate the profits of such activities from the bank. These profits will belong to the holding company, not to the bank. Benefits to the bank itself would derive only when

- The bank holding company acts as a source of strength to the bank by making capital infusions.

- The bank's costs of production are reduced by the synergies of the joint production of a wider range of services (economies of scope as well as scale).
- The bank's revenues are enhanced by attracting additional banking business as a result of consumers' profitable "one-stop" shopping. Success can result from the cross-marketing of products and from nonabusive tie-ins, which may both reduce costs and raise revenues.

In sum, banks may benefit from expanded powers, but the potential benefits of the new activities should not be exaggerated. And, two very difficult trade-offs need to be resolved that directly affect the extent to which these benefits may materialize.

- The more the new activities and their management are integrated with the bank, the more any profits will benefit the banking industry itself. However, separation is recommended by those who want to insulate the bank from any downside risks of loss and ultimate failure. In other words, the first trade-off exists between safety and potential profitability. Conceptually, greater bank insulation (and protection for the FDIC) occurs incrementally at the expense of reduced potential profitability. No analytical basis exists for deciding where the dividing line should be placed along the spectrum of safety and soundness and profitability possibilities.
- The more joint marketing arrangements that are permitted to the banks in organizing the new activities, the more profitable they are likely to be. But some fear that commercial banks may use their powers to take advantage of, and overcharge, their customers. Here, a second trade-off exists. The more protection required, the less profitable the new activities may be for commercial banks and also for their holding companies. (See questions 7 through 11.) Moreover, increased competition would reduce the incidence of abuse. The choice along the trade-off spectrum cannot be resolved through analysis. It will be largely a matter of judgment.

Finally, it should be pointed out that the potential benefits banks may receive from repeal of the Glass-Steagall Act are not the most compelling rationale for changing the law. The issue to focus on is whether the users of commercial bank and investment bank services—both businesses and households— will benefit from repeal. The data we have reviewed indicate that households and businesses are likely to benefit from lower prices and enhanced services, as long as the safeguards we suggest elsewhere in this report are put in place.

International Competitiveness

3. In what ways will product-line deregulation or financial services restructuring enhance the international competitiveness of the U.S. Capital markets?

The Glass-Steagall restrictions are one factor causing U.S. banks to undertake securities activities abroad. Thus, business that would have been conducted in the United States, is being carried out abroad. These restrictions are, therefore, prejudicing the competitiveness of the U.S. capital markets. A similar loss of business occurred in the 1970s when Regulation Q forced financing arrangements to relocate from the United States to the Eurodollar markets.

If banks are allowed to underwrite securities in the United States, we anticipate that some business will reenter this country. This process would enhance the competitiveness of the U.S. capital markets.

Foreign Securities Operations of U.S. Commercial Banks

4. What problems have arisen as a result of the relatively free hand the U.S. commercial banks and bank holding companies have had in the international arena with regard to securities activities? Have there been any failures or financial difficulties encountered by these banks, their affiliates or subsidiaries? How have the foreign operations of these banks enhanced the competitiveness or asset base of the domestic bank or the holding company?

We have not conducted comprehensive audit work directly related to these questions. However, based on work related to the overseas activities of U.S. banks, we are providing some general comments. While our comments focus on the activities of U.S. banking institutions in London, we believe that they reflect common issues. U.S. banks overseas engage in a wide range of securities-related businesses. In London, for example, U.S. banking institutions are involved in underwriting debt and equity, Eurocommercial paper, merchant banking, trading securities, market-making, and options.

In London, U.S. firms are organized in a complicated subsidiary structure, owing to U.S. and U.K. financial regulations and tax laws. While not permitted in the United States because of Glass-Steagall and Bank Holding Company Act restrictions, U.S. banks are permitted to conduct investment banking activities overseas. Typically, each function is separately incorporated, resulting in a complicated corporate structure; in one instance a U.S. bank has 113 U.K. subsidiaries. Each of the six U.S. banks we contacted operate a commercial bank in London as a branch of the parent U.S. bank and an investment bank subsidiary. The investment bank subsidiaries are typically a separately incorporated U.K. subsidiary. In one case, however, the investment bank is operated as a U.S. Edge Act corporation. Such complex arrangements make it more difficult both to manage and to regulate these organizations.

International operations permissible for U.S. banking institutions overseas are set forth in "Regulation K" (Reg K).[1] Because of the absence of limits on the underwriting of debt securities, some major U.S. money center banking institutions have become significant players in the Eurobond and Eurocommercial paper markets in London. A U.S. money

[1] Regulation K was issued by the Board of Governors of the Federal Reserve System under the authority of the Federal Reserve Act, the Bank Holding Company Act of 1956, the International Banking Act of 1978, the Bank Export Services Act, and the three International Lending Supervision Acts. Permissible activities may be conducted by an Edge Corporation, Agreement Corporation, bank holding company, or member bank. Foreign branches of U.S. banks are also able to "establish or invest in a wholly-owned subsidiary" which is engaged in activities that are permitted member banks.

center bank, for example, is the number one underwriter of Eurocommercial paper. The recent contraction in the Eurobond market due to both competitive pressures and internal market problems has, however, caused a decline in demand for such instruments. In addition, U.S. banking institutions have seen decreased demand for their specialty, U.S. dollar denominated bonds, due to the falling value of the dollar.

Nevertheless, U.S. banking institutions, especially since recent deregulation in London's financial markets, have expanded. Because European governments, such as the U.K. and France, are privatizing large portions of government-owned industries, equity underwriting has become an even more attractive product offering.

As much as U.S. banking institutions would like to become even more active in overseas equity markets, they are prevented from doing so by the provisions of Reg K. Reg K limits equity underwriting to $2 million per issue per subsidiary.[2] According to a Federal Reserve official, the intent of Reg K was to limit issues to $2 million. However, some banking institutions have interpreted Reg K as permitting up to $15 million per issue or 5 percent of the institution's capital and surplus. According to bank officials, two methods are used to partially circumvent the equity underwriting limits of Reg K. The first is a consortium approach, whereby the bank owns up to the maximum 5 percent in a consortium of financial firms that act to distribute equity underwritings and assume the associated underwriting risk. In the other method of circumvention, a bank merely spreads a placement, up to $2 million per subsidiary, around its international subsidiaries to a maximum of $15 million per issue. The Federal Reserve takes issue with such interpretations and is currently conducting discussions with a major U.S. banking institution that has sought to exceed equity underwriting limits by taking a 5 percent interest in a consortium of insurance companies that underwrite large equity issues.

Reg K is not alone in fostering the creation of subsidiaries overseas. In London, some U.S. banking institutions have set up a variety of subsidiaries to house different functional activities, such as issuing debt and equities, in order to comply with British regulatory requirements. The U.K.'s Self Regulatory Organizations prefer to regulate by function, which tends to encourage the establishment of separate subsidiaries.

[2]It also may not exceed 20 percent of the capital and surplus or voting shares of an issuer unless the underwriter is covered by binding commitments from subunderwriters or other purchasers.

Tax and administrative concerns also play a role in the creation of additional subsidiaries. It should be noted that a substantial number of these entities are "paper" organizations.

One major U.S. money center banking entity has taken this proliferation to the extreme. Such cases present regulatory authorities with the challenge of untangling complex corporate structures, understanding their operations, and tracking any transfers of funds among them and the U.S. parent. This situation is further complicated by the development of increasingly more complex financial instruments.

We have several observations in regard to this regulation in the context of the Glass-Steagall question. First, Reg K permits foreign branches of U.S. banks to directly and indirectly engage in securities activities. This would appear not to be in accord with our views that securities-related activities should be housed in affiliates of the bank holding company in order to insulate banks and protect depositors. A Federal Reserve official told us that the existing Reg K was probably intended to help U.S. banks be competitive overseas by being less restrictive of their operations.

The Federal Reserve is required to review Reg K every 5 years. If the current limits on bank powers remain in force, the limits on equity underwriting will probably be a major topic of discussion at the next review. In 1984, when the last review took place, many U.S. banks requested that the limits on equity underwriting be expanded. The Federal Reserve responded that the area of overseas equity underwriting was too new and untested to permit such an expansion at that time. Changes in Reg K will depend, to a certain extent, on whether the Glass-Steagall restrictions on domestic equity underwriting are repealed. It should also be noted that the extent to which U.S. banking could make use of expanded underwriting limits would depend on the laws and regulations of the countries in which they operate. In the U. K. for example, British underwriting limits based on capital exposure may override expanded Reg K limits.

Difficulties Encountered in the London Markets

In the course of our work related to federal oversight of the foreign operations of U.S. banks, we looked at a nonrandom group of federal banking institution examination reports for eight money center banks with a major presence in the London markets. The federal bank examiners targeted these institutions for review because of their size. These reports reviewed the London operations of these banking institutions

over the 1985 to 1987 time frame. We reviewed these examination reports to get a picture of the overall scope of the London operations and types of specific problems that the banks encountered, rather than to assess banks' securities operations systematically.

We found that some of the investment banking affiliates of U.S. banks in London that we examined did experience significant internal control and managerial problems, resulting in the affiliates receiving less than satisfactory performance ratings from the federal bank regulators.

Examiners cited internal control weaknesses in six of the eight banking institutions we reviewed. They included (1) the lack or inadequate nature of written procedures establishing general accounting policies, separation of duties, and accounting for off-balance sheet items; (2) internal audit functions that were deficient in identifying and tracking operations; and (3) the absence of limits on trading or, if established, the fact that the violations of the limits were not routinely reported to management. (One of the London-based banking entities experienced a multimillion dollar loss in 1987 resulting from unauthorized positions.) Examiners cited management weaknesses in several banking entities. High personnel turnover in the rapidly expanding London markets appears to have contributed to the management problems found in some of these firms. In one firm, annual turnover (including management) averaged 31 percent.

According to these examiner reports, a significant conflict of interest episode occurred in one bank's London-based entity. Thirty-one employees purchased approximately 500,000 shares in the July 1986 public equity offering of one of its clients. These shares were subsequently sold during the first few days of trading for a sizable profit. The institutions had apparently not established a written conflict of interest policy to deal with this type of situation. Although federal banking regulators examined this episode and said this action was legal, they also said it was highly questionable from an ethical standpoint.

The press reports that the securities subsidiary of one large multinational bank holding company lost $50 million in its Dublin office during the stock market crash through the violation of internal trading procedures. This loss, however, is very small (approximately one-half of 1 percent) in relation to the bank's capital. Another U.S. bank holding company is also reported to be experiencing managerial difficulties with its European securities activities. Senior staff of the Federal Reserve Board told us that it is not clear if managerial problems experienced in

the securities activities of U.S. banking entities in London are "teething pains" or if they will persist.

Internal control and managerial weaknesses noted in the London operations appear to have been exacerbated by the unexpected, stiff competition found in the London capital markets. According to the examination reports we reviewed, competition in London has been higher than anticipated and resulted in lower than projected profitability for some institutions.[3] Internal control and management weaknesses noted resulted in additional pressures on earnings. Two of the investment banking institutions we reviewed required substantial capital injections in 1987 because of the difficult market conditions in London. According to the examination reports, one of these injections was directly attributable to "Black Monday," the events of October 19, 1987, while the other injection was required because of continuing losses experienced in 1987.

It should be noted, however, that the problems experienced have not, to date, appeared to be serious enough to jeopardize these banks' operations in the United States.

[3]U.S. banks often say that it is easiest to engage in such securities activities by acquiring British firms. Citicorp, Chase, Security Pacific, and others have followed this strategy.

Competitive Consequences of Glass-Steagall Repeal

5. What are the likely competitive consequences of product deregulation/structural reform? In particular, will there be a differential impact on small versus large banks? Will there be increased market concentration in the banking industry as a result? Explain whether such concentration is undesirable. Is the securities industry as presently constituted undesirably concentrated? Are there barriers to entry into the securities business such that competition is affected? What will be the impact on concentration in the securities industry? Should there be limitations placed on the kinds of affiliations, by asset size, for example, between commercial banks and securities firms?

The repeal of the Glass-Steagall laws should increase competition in both the banking and securities industry. For example, banks desiring to participate in new activities can be expected to strive for market share in new service areas, such as mutual fund sponsorship and underwriting. Similarly, securities firms entering the banking industry might be expected to enhance competition, particularly in local markets. The success of these efforts depends upon the price and quality of services offered by the bank and/or its affiliates and the reactions by existing securities firms. The competitive consequences could benefit consumers and might also result in reduced margins between income and expenses for the competing firms.[1] This is, of course, typical of the process by which competitive markets achieve efficiency.

As competition intensifies, any differences in the tax and regulatory treatments applied to banks and securities firms become more important. For example, bank-affiliated firms may be able to attract capital more easily if the market perceives that securities firms affiliated with bank holding companies are more likely to fall within the federal safety net than are other firms. On the other hand, restrictive regulatory requirements, such as higher capital requirements for bank holding company subsidiaries than for unaffiliated firms, could inhibit the ability of bank-affiliated firms to compete.

Small Versus Large Banks

Although critics of Glass-Steagall repeal have expressed concerns that deregulation will prejudice small banks to the benefit of large institutions, the evidence is not compelling. Indeed, small in-state banks in Maine and Georgia have thrived following approval for out-of-state

[1] There are data that indicate that investment bankers in the currently concentrated securities markets underprice newly issued shares. Competition from commercial banks should reduce this underpricing and so provide additional capital to the companies issuing stock.

banks to enter those markets. In Georgia, the numbers of small banks have increased, and they have grown more rapidly than their bigger competitors.

Even where small firms prosper, however, consolidation can occur and is likely to continue in the banking industry. Contributing to this trend are changes in the technological and economic environment and in interstate banking. Allowing banks to offer securities products and vice versa is unlikely to reverse the trend. It may even accelerate the process, although we would expect the influence from this source to be marginal.

Some consolidation in the total number of banking firms in the national economy need not be a problem. The United States has more banks absolutely and among the highest number of banks per capita among industrialized countries. A somewhat reduced number of banks operating through interstate branching in more parts of the country, with entry to the industry open to anyone who can meet the capital and personnel requirements, should enhance, rather than reduce, competition in many markets.

The largest banks might be the first to take advantage of repeal of Glass-Steagall. They are in the best position to provide investment banking for major corporations or, for example, to launch a nationwide marketing campaign for a sponsored mutual fund. Larger banks would also best be able to take advantage of the fact that nonbank affiliates of a holding company are not constrained by the interstate and intrastate branching restrictions that are applicable to commercial banks. As a result, the holding company could operate a nationwide securities affiliate.

However, these large banks typically have lower capital to asset ratios than the smaller banks. Therefore, if additional capital is required before permission is given to engage in additional activities, the largest banks may not be the first to use the new powers. In these circumstances, the next tier of banks—the regional banks—might continue their recent gains relative to the money center banks and first begin to use the new powers. The third tier of banks—community banks—could also benefit by selling mutual funds and by underwriting securities for smaller corporations, municipal revenue bonds, and asset-backed obligations (such as collateralized mortgage obligations and credit-card and automobile receivables).

Banks in even smaller size categories could also benefit from repeal of the Glass-Steagall Act. While they might be too small to underwrite securities issues themselves, they could join other banks in a syndicate arrangement. Alternatively, they could sell products underwritten by the larger banks on a commission or franchise basis similar to travelers checks or credit cards.

In the case of the very smallest banks, however, requiring that securities activities be conducted in a separate affiliate of a bank holding company might prevent these banks from undertaking them. The legal and administrative costs of establishing a bank holding company in order to establish affiliates with separate locations and personnel may well be an unreasonable burden.

Finally, while some small commercial banks may choose to enter the securities industry, many may choose not to do so. Some may prefer to continue specializing in their present activity, such as consumer banking, which demands specific knowledge of local markets. This strategy may allow them to earn a higher rate of return than that earned by the multiproduct regional and money center banks. The repeal of the Glass-Steagall Act would not foreclose this opportunity for small banks. In the same way that specialized shopping boutiques remain profitable side-by-side with retail department stores and discount centers, specialized local banks may continue to find a profitable niche in the banking industry.

Concentration in the Securities Industry

In the securities industry, as in banking, there are many small firms and a much smaller number of large ones. However, concentration of assets, revenues, and underwriting income in the top few firms is significantly greater in the securities industry than in banking. As is shown in table V.1, of the 9,328 securities firms registered with the SEC in 1986, the eight largest (measured by assets) held 52 percent of industry assets. The eight largest commercial banks held 21 percent of commercial bank assets. The eight most highly capitalized securities firms held 36 percent of industry capital as compared to 17 percent for the banks with the greatest values of capital. The eight securities firms with the highest revenues received 40 percent of industry revenues. The eight highest-earning commercial banks earned 22 percent of industry revenues. The top eight securities firms (in terms of pre-tax income) received 35 percent of industry revenues. The equivalent percentage for commercial banks was 22 percent. A similar degree of concentration was found among the top 25 firms in each industry.

Table V.1: Concentration in Securities and Commercial Banking Industries
(Percentages of Certain Industry Totals Accounted for by the Top 8 and the Top 25 Securities Firms and Banks in 1986)

	Assets[a]	Capital[b]	Revenues[c]	Pre-Tax Income[d]
Top 8				
Securities firms[e]	52	36	40	35
Commercial banks[f]	21	17	22	22
Top 25				
Securities firms	79	55	60	53
Commercial banks	33	27	34	35

Sources: FDIC Reports of Commercial Bank Income and Condition and letter to Senator Proxmire from SEC.

[a]Percentage of industry assets held by the top 8 or 25 firms (measured by asset size) in the industry.

[b]Percentage of industry capital held by the top 8 or 25 firms measured by capital.

[c]Percentage of industry gross revenues earned by the highest earning 8 and 25 firms.

[d]Percentage of industry pre-tax income earned by the highest-earning 8 or 25 firms.

[e]There were 9,328 broker-dealers registered with the SEC at the end of 1986.

[f]There were 14,198 FDIC-insured commercial banks at the end of 1986.

Data from several other sources, most notably the House Committee on Government Operations, suggest that certain segments of the investment banking industry are highly concentrated—those parts where commercial banks cannot currently compete. For example, 10 securities firms accounted for about 90 percent of the underwriting of corporate debt and stock securities offered for sale to the public in 1985.[2] Indicative of an undesirable degree of concentration, at least in some market segments, two factors suggest that a few dominant firms may have been earning monopoly profits: (1) a large share of industry revenues accrue to a small number of (dominant) firms and (2) the securities industry has much higher rates of return on equity than are available in other industries. Despite these factors, the SEC and many industry observers suggest that most securities markets have become more competitive in the last few years since fixed commissions were abolished and shelf registrations were introduced.

Barriers to Entry

The highly concentrated, pyramid structure of investment banking stretches back well into the previous century in the United States. Two

[2]In these statistics (supplied by the SEC to the House Subcommittee on Commerce, Consumer, and Monetary Affairs, and published in "Structure and Regulation of Financial Firms and Holding Companies," hearings before a House Subcommittee of the Committee on Government Operations, House of Representatives, parts 1, 2, 3, (1986) p. 600 and p. 604) the lead underwriter is given full credit for the entire issue.

principal reasons may account for much of this concentration: (1) the need to command large sources of capital and (2) the importance of reputation in attracting new business.[3] Reputation in the securities industry is derived from successful past experience. These two characteristics make it difficult for newcomers to enter the investment banking industry.

Larger, well-managed commercial banks are likely to be among the firms that have the best chances of having the capital, reputation, and experience necessary to successfully enter the investment banking business. Thus, exclusion from major parts of the securities industry contributes to its concentration.

Commercial Bank Entry

Although some observers question how banks will adapt to the more volatile corporate securities markets, many banks have long-standing business relationships with large corporations and already compete effectively in many aspects of the securities business. For example, banks already participate fully in the U.S. government securities market, a highly competitive, worldwide market with by far the largest volume of transactions of any securities market.[4] If commercial banks can successfully enter investment banking, concentration should be reduced in that industry. For example, concentration is currently lower in those segments (such as municipal general obligation bonds and Eurodollar securities) where commercial banks are currently permitted to compete.

Limitations on Affiliations

Concerns have been raised that mergers between the largest commercial banks and securities firms could lead to financial conglomerates with excessive antisocial power. Those who judge that the enforcement of the current antitrust laws is insufficient to prevent this undesirable outcome will probably want to legislate against affiliations between the largest commercial banks and the largest securities firms.

However, if such size restrictions are adopted, Congress may also want to consider allowing exceptions in cases where a large bank or securities

[3]See Samuel L. Hayes, III, A. Michael Spence and David Van Praag Marks, Competition in the Investment Banking Industry, Harvard University Press, Cambridge, Mass., 1983.

[4]A general indicator of the expected ability of banks to compete may be the primary dealer system. As of December 1, 1987, 14 of the 40 primary dealers recognized by the Federal Reserve System are U.S. banks or firms affiliated with U.S. banks.

firm gets into financial difficulty and no smaller firm has the financial resources to take it over.

Acquisition of Banks by Securities Firms

6. On the other side of the coin, should securities firms be permitted to engage more broadly in traditional banking activities? Are there any particular banking activities that it would be in the nation's interest for securities firms to participate in? What effect would this have on competition within the banking industry?

The 1930s banking legislation effectively prohibited securities firms from owning or being affiliated with banks for many years. Beginning about 1980, however, a loophole in the legislation began to be exploited that allowed any firm, including securities firms and nonfinancial commercial firms, to establish "nonbank banks." These entities may either offer insured demand deposits or make commercial loans, but not do both. (A "bank" was then defined by the Bank Holding Company Act as an entity that did both.) Thus, the nonbank bank was not restricted by legislation, such as the Bank Holding Company Act and the Federal Reserve Act, applicable to banks. This loophole was closed to new banks and restricted for existing nonbank banks by the Competitive Equality Banking Act of 1987.

Banking Activities

We believe, based on our work on nonbank banks, that nonbank holding companies' reasons for wanting to establish nonbank banks could indicate the reasons for a securities firm to acquire a bank.[1]

We asked 21 holding companies why they wanted to establish a nonbank bank.[2] The reasons included

(1) accepting insured deposits to finance new and existing activities. In some cases, such activities were previously funded from more expensive sources such as commercial paper sales.

(2) improving the company's image with the consumer (by replacing a finance office with a bank office).

(3) creating new products. (This was cited particularly by nonbanking firms in regard to offering insured products.)

(4) obtaining access to the Federal Reserve's systems of check clearing and wire transfers. (This was also cited by nonbank holding companies.)

[1] Financial Services: Information on Nonbank Banks, (GAO/GGD-86-46 FS, Mar. 21, 1986).

[2] The 21 holding companies were judgmentally chosen. Of those, 14 were bank holding companies and 7 were nonbank holding companies that had filed applications to open nonbank banks.

(5) attracting a larger portion of the existing customer business.

Benefits to the Nation of Extending the Powers of Securities Firms

Under the appropriate safeguards, the nation could theoretically expect to benefit from the greater degree of competition in banking that additional banks, established by securities firms, would offer. While banking is less concentrated at the national level than the securities industry, more, rather than less, competition is generally presumed to be beneficial. Moreover, some banks may still have a degree of monopoly power in local markets where competition is hampered by laws restricting interstate banking and within-state branching. In theory, greater competition would reduce prices and enhance services for the financial service consumer.

Risks

Critics of a repeal of Glass-Steagall express concerns, however, that allowing securities firms (or commercial firms in general) to own banks will carry unacceptable risks. Risks that critics sometimes allude to include

- increased failure rate as the new entrants to banking make mistakes and lose their capital.
- reduced bank profit margins due to competition and failures among the least efficient existing banks.
- increased vulnerability of Fed Wire and the Clearinghouse Interbank Payments System (CHIPS) large dollar wire transfer system to losses made on behalf of nonbank units in the holding company, and
- conglomeration of some firms to the extent that these larger firms represent an unacceptable concentration of financial and commercial resources.

It should be noted that the loss of the least efficient banks can benefit the nation as long as their failures do not destabilize the system.

Failures

Concerns about additional bank failures resulting from securities firms getting into banking and inefficient banks failing because of more competition may be overstated. In our economy, we expect that inefficient firms will cease operations as competition makes an industry more efficient. Most banks already operate in a competitive environment and, if supervision is adequately funded, regulatory officials should be able to deal with problems in particular institutions as they develop. If failing banks are dealt with quickly before their losses mount (as discussed in

Table VI.1: Activities Permitted to Bank Holding Companies by the Bank Holding Company Act

Activities
Conducting securities brokerage and margin lending activities. Offering securities brokerage services and unrelated investment advice within the same entity.
Underwriting and dealing in obligations of the United States, general obligations of States and their political subdivisions, and certain money market instruments such as bankers' acceptances and certificates of deposit.
Providing advice concerning foreign exchange operations, policies, and procedures and arranging for the execution of foreign exchange transactions.
Acting as futures commission merchant for futures contracts covering bullion, foreign exchange, U.S. government securities, negotiable U.S. money market instruments, and certain other money market instruments (futures commission merchant activities also cover the provision of options on certain futures contracts).
Providing futures advisory services on a fee basis as a futures commission merchant or a commodity trading advisor.
Buying and selling gold and silver bullion and silver coin; dealing in exchange and silver futures and arbitraging gold and silver internationally.
Operating an Article XII New York Investment Company.
Executing unsolicited purchases and sales of securities as an agent solely on the order and for the account of customers.
Brokering options on securities issued or guaranteed by the U.S. government and its agencies and on money market instruments; brokering options in foreign currency on exchanges regulated by the SEC.
Executing and clearing options on bullion and foreign exchange on commodity exchanges regulated by the CFTC.
Executing and clearing futures contracts on a municipal bond index.
Executing and clearing futures contracts on stock indexes and options on such futures contracts.

Because many securities firms are already combined with commercial firms, allowing securities firms to own banks could break down the existing barriers between banking and commerce. We observe, therefore, that continuing to separate commercial banking from commerce is likely to become more difficult in a deregulated environment where commercial banking and securities firms are allowed to associate.

However, separation of banking and commerce would continue to be required under the Bank Holding Company Act even if the Glass-Steagall restrictions were lifted. In that event, securities firms would be required to divest their commercial activities in order to acquire or become affiliated with a commercial bank. This option has the merit of allowing a securities firm a choice in whether it wants to be involved in commercial banking and to subject itself to the burdens of that choice. However, a divestiture would impose a heavy burden on those securities firms already affiliated with commercial enterprises. The burden might be so great as to deny, in reality, many securities firms access to commercial banking activity.

daylight (intra-day) extensions of credit.[3] Opinion is divided as to whether these laws should be extended to all subsidiaries of banks and to intra-day granting of bank credit. Additional protection for the payments systems could be served by outright prohibition of certain transactions between a bank and its subsidiaries or holding company affiliates, as well as by requiring that overdrafts be collateralized. (See question 11.) While such actions may protect the payment system from certain types of risk (as noted in response to question 1), potential problems with respect to the liquidity of financial markets strike us as being of more overriding importance.

Banking and Commerce

At present, both commercial banks and their holding companies can engage in a variety of financial service activities that are regarded as closely related to banking. (See table VI.1.) While the separation between banking and commerce is maintained for the most part, securities firms are less constrained in their commercial activities and affiliations. Many securities firms are already affiliated with commercial firms. For example, one investment bank and securities brokerage firm with a retail distribution network is a subsidiary of a large commercial holding company which also operates a retail distribution network, a nonbank bank, life insurance and property casualty insurance companies, and a savings and loan holding company. Another large commercial firm is involved in both insurance and securities activities.

[3]The Competitive Equality Banking Act of 1987 (sec. 101) placed a full collateralization requirement on all overdrafts between a grandfathered nonbank affiliate and the affiliated bank.

Consumer Issues - Tie-Ins, Conflicts of Interest, and Joint Marketing

7. How can we prevent tie-ins and other coercive forms of merchandising for banks' or securities firms' deregulated products? Is there any structural way by which we can eliminate such concerns or must we constantly monitor or supervise them? What sorts of regulatory resources will such monitoring require?

8. How should the bank and its affiliates or subsidiaries be structured so as to restrict the flow of confidential information? Similarly, if securities firms enter the banking business, what structural modification would be required to restrict the flow of confidential information? What are the risks of failing properly to restrict such flow?

9. To what extent should joint marketing of services be permitted?

These three questions involve a common concern: the structure of product and/or service relationships between a bank and its nonbank affiliates and/or its subsidiaries. The basic issue is how to obtain the benefits—both for the banking industry and to consumers—from the expansion of powers of banking organizations while minimizing abuses. The problems we are asked to discuss—coercive tie-ins and improper use of confidential information—are examples of abuse that can exist for customers in the provision of financial services.

Tie-Ins

Joint marketing involves a range of activities including common advertising strategies, common marketing efforts, and product tie-ins. Tie-ins exist when a business entity seeks to link the sale of a product or service with the purchase of another product or service of that entity. All other things being equal, joint marketing, or cross-selling of products or services, permits lower costs of production.

When competition is present, lower cost (efficient) production benefits consumers in the form of reduced prices and/or improved services. For example, home buyers using a holding company's real estate brokerage subsidiary may be offered discounts on home appliances sold by its retail store affiliate. Similarly, purchasers of automobiles, from time to time, may be offered reduced loan rates when financing through an affiliated finance company. In a deregulated environment, consumers might pay reduced fees for checking accounts if they also purchase mutual fund shares from an affiliate company.

Such tie-ins are not coercive or abusive when consumers can choose where they shop. In short, tie-ins can be attractive to consumers as well

The difficulties facing securities firms that want to acquire a bank could be mitigated in several ways. For example, a distinction could be made between financial firms (such as insurance companies) that would be permitted to be affiliated with banking and nonfinancial firms (such as retailers or manufacturing enterprises) that would not. Alternatively, firms that are predominantly nonbanking could be exempted from the restrictive bank holding company laws.

market perception separation issue arises if, in the instance of a joint marketing effort, the public is led to believe that the bank and securities units are not separate corporate entities.

For our study, we judgmentally selected 23 organizational entities conducting various nontraditional activities. These entities were subsidiaries or affiliates of 19 banks or bank holding companies. Our results, while not projectable to all banks, do provide some insights into the operations of some major participants in nontraditional activities. Of the 12 holding company nonbank subsidiaries examined in our sample, all but one stated that they coordinated sales or marketing activities with the affiliated bank.

The Benefits of Information Sharing

The use of information within a banking organization also involves similar considerations. One of banks' historical roles has been the acquisition of credit information about their customers — both depositors and borrowers. Changes in technology and in the economic environment have substantially reduced the costs of acquiring, storing, processing, and transmitting information. As a result, banking organizations could more easily use information for more than one purpose.

The ability for greater use of information can benefit both the provider and the user of financial services by reducing the total costs of providing such services. For example, a bank might enclose advertisements for products of its securities affiliate in monthly bank statements for selected account holders, thereby reducing marketing expenses of the securities affiliate. When competition exists, part of this cost reduction will pass to the customer in the form of lower prices and/or improved services.

Banks claim that Glass-Steagall restrictions have inhibited their ability to take advantage of new technologies in information processing. They point out that the new technology is allowing other nonbank players in the financial markets to offer a wider range of products and services than banks can lawfully provide.

The Abuse of Confidential Information

Although there are benefits from the flow of information within a banking organization, abuse of information can prejudice the customer or be used in an unwarranted way to benefit bank directors, officers, or employees. Examples could include insider trading by bank employees or misuse of confidential information. For example, confidential data

as beneficial to the affiliated companies providing the products or services. Consequently, attempts to prevent all tie-ins could restrict bank and nonbank activity, thus preventing customers from benefitting from the expansion of powers of banking organizations.

In some circumstances, however, tie-ins can coerce consumers. While the Bank Holding Company Act prohibits banks from providing credit or other services conditional on the purchase of additional services, expanded powers may increase opportunities to violate the laws.

Thus, trade-offs exist between protecting consumers from abuse and allowing them the opportunity to benefit from synergies. These trade-offs must be considered when determining the degree of joint marketing to allow. On the one hand, the more joint marketing allowed, the lower production costs will be and the more banks and their customers may benefit when all goes well and the securities activities are profitable. On the other hand, joint marketing makes it harder for the public to discern any distinction between bank and securities activities.[1] Correspondingly, when things go wrong, customers may discover that their investments are not insured, and the bank (and ultimately the FDIC) may not be insulated from losses that the affiliate incurs.[2]

In our study of ways to insulate a banking organization, we distinguished three kinds of separation: economic, legal, and market perception.[3] To achieve insulation in marketing, it is not sufficient to conduct activities in separately capitalized, legally independent subsidiaries or affiliates. It is necessary that the public perceive a distinction between the bank and its subsidiaries and affiliates. The greater the degree of joint marketing of bank and securities services, the harder it is for customers to perceive a distinction between the bank and its affiliates. The

[1]In its recent amendments to regulations governing the securities activities of insured nonmember banks and their affiliate, FDIC deleted its proposed requirement for separate entrances and different common names or logos. Instead, it modified disclosure requirements and limited disclosure to certain conditions, such as when a bank and its affiliate or subsidiary share the same or similar name or logo. The final regulation provides that the bank's subsidiary or affiliate must disclose to its customers and prospective customers that securities recommended, offered or sold by or through the bank's securities subsidiary and/or affiliate are not FDIC-insured deposits; that such securities are not guaranteed by, nor are obligations of, the bank; and that the subsidiary and/or affiliate and the bank are separate organizations. (12 C.F.R. Part 337: Final Rule.)

[2]Under the principle of estoppel, the creditors of an affiliate generally have no claim on the assets of the bank. However, if they can justifiably claim that the affiliate or the holding company misled them so that they thought they were dealing with the bank rather than with an affiliate, the bank could therefore be held liable.

[3]Bank Powers: Insulating Banks From the Risks of Expanded Activities (GAO/GGD-87-35, Apr. 1987).

First, a competitive market in any industry open to conflict of interest gives customers, often the potential losers in such conflicts, the opportunity to take care of their own interests. If customers have been abused or anticipate a loss from conflict of interest abuse, they can take their business elsewhere in addition to pursuing legal remedies that may be available to them. Some proponents of Glass-Steagall repeal note that competition could be enhanced by repeal, and that additional competition would also serve to protect the consumer.

A second control over conflicts of interest, internal policies of the bank, provides guidance to those employees finding themselves in conflict of interest situations on how they may effectively and fairly handle such situations. In a competitive environment, the bank's reputation for fairness and fiduciary integrity in handling its customers' affairs is crucial to its success as an ongoing business. In this situation, it behooves the bank to institute internal policies that protect both the consumer and the bank's reputation. In its efforts to protect its reputation, the holding company should avoid incentives for employees to exploit conflict of interest opportunities. One way to do this is to carefully design the employee compensation system within the holding company. For example, if the bank and its securities affiliate are separate profit centers with completely separate compensation plans, including bonuses, there will be less incentive for abuse.

A third control, laws and regulations, protects against conflict of interest abuses. These laws and regulations need to assure several points:

- A basic legal framework that makes abuses illegal.
- A regulatory system that requires regulated institutions to have policies and procedures for identifying and controlling conflict of interest situations and that checks compliance with policies and procedures.
- A system that ensures equitable resolution of individual problems.

As indicated in our prior work on bank insulation, an institutional environment in which the bank is insulated from its affiliates in the holding company can reinforce the protection provided by the legal framework and its enforcement.

The Legal Framework

For example, a number of laws already protect consumers from abuse. Under antitrust laws, tie-in arrangements are illegal in all businesses when a "not insubstantial" amount of interstate commerce is involved and when enough economic power over the tied-in product could affect

obtained in connection with a bank loan by the bank to a particular company might be used to advise clients of the bank's securities affiliate about the desirability of buying or selling that company's stock.

Conflicts of Interest

At the request of the Chairman of the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations, we are studying situations in which conflicts of interest can arise in banking and how to prevent or control abuses.[4] The focus is on abuses that are not for personal gain. We held discussions with industry participants, regulators, and knowledgeable academic experts. We visited 18 bank holding companies and reviewed bank and holding company examination reports for many of them. The sample was nonrandom; we selected both nationally and state chartered banks and their holding companies that we anticipated would use extended powers. We also asked those interviewed whether a relaxation of Glass-Steagall restrictions would increase conflict of interest incidence and abuse.

Once we have completed the work we will have more detailed observations on this issue. However, we would like to offer the following general information.

Conflicts of interests occur as a normal aspect of business, including banking. They become abusive and a societal problem when they are not resolved in an efficient and equitable manner. An example is a bank violation of fiduciary responsibilities.

Bankers, academic experts, and federal regulators with whom we met generally acknowledged a number of situations in banking that could lead to conflict of interest abuses. They also noted that relaxing Glass-Steagall restrictions would increase the number of such situations. No one with whom we spoke said that abuse of confidential information was currently a major problem, however.

Controlling Conflicts of Interest

In our review of the literature, we identified three forces that work to control coercive tie-ins and misuse of confidential information: (1) competition, (2) internal policies, and (3) legal restrictions.

[4]There is no universal agreement on the definition of a conflict of interest. As used in this discussion it refers to a situation when one person or business serving two or more interests can favor one interest, possibly illegally, at the expense of others.

Separation of Officers, Directors, and Premises

10. Is it necessary to have complete separation of officers, Directors, and premises?

In our previous work we have not directly addressed this issue. We, therefore, are not in a position to provide an answer to your question. However, we will discuss some of the important issues, current practices in banks and bank holding companies, and efforts by the FDIC to establish applicable regulations.

It seems to us that there are two primary concerns implicit in your question. First, is it necessary to have complete separation, both physical and organizational, in order to avoid potential conflicts of interest and to alleviate consumer confusion? Second, particularly for smaller banks, do the benefits to be obtained from complete separation offset the substantial increase in costs that such separation would require?

We have pointed out, in response to your earlier questions, that insulating commercial banking from securities activities is one way to approach concerns about risks and conflicts of interest inherent in relaxing Glass-Steagall restrictions. We also emphasized that trade-offs must be considered in designing an insulation strategy. The more complete the insulation, the more likely it is that some of the benefits associated with product deregulation will not be realized.

An important part of determining an insulation strategy is deciding rather precisely the degree of separation of officers, directors, and premises that will be required. Decisions must also be made regarding the degree of separateness of corporate names and logos. As we noted regarding insulation in our responses to questions 7, 8, and 9, three perspectives are important: economic separation, legal separation, and market perception separation. The issues are complicated, and there is considerable room for judgment concerning the best approach to appropriate insulation. For example, there is no way to determine with certainty at what point overlaps between directors or officials of separately incorporated banks and affiliated or subsidiary securities firms run an unacceptable risk of defeating the purposes of legal separation. Similarly, there is no way to know whether the use of a common name or logo will lead market participants to assume there is little separation, even though there may be separate officers, directors, and premises and even though full disclosure of these facts might be required.

competition. Also, the Bank Holding Company Act, as amended in 1970, states in Section 106 (b)(1) that "A bank shall not in any manner extend credit, lease or sell property of any kind, or furnish any service, or fix or vary the consideration of any of the foregoing on the condition or requirement -(A) that the customer shall obtain some additional credit, property or services from a bank, holding of such bank, or from any other subsidiary of such bank holding company..." The act also specifies remedies for consumers harmed by illegal bank tie-ins.

creditors of this failed subsidiary who might argue that they had been misled to believe they were dealing with the bank rather than the subsidiary. The courts would have to determine the validity of the creditors' residual claims on the assets of the bank. Unambiguous disclosure by the bank and by the subsidiary would reduce the likelihood of such claims being validated.

Other banks face similar risks. For example, a futures commission merchant operation followed essentially the same corporate principles as the above case—also using the bank's name and a common entrance. In another case, we found that a moderate-sized bank organized an investment advisory subsidiary which, while incorporated, used bank supervisors, staff, office space, and the bank's initials in its name. In each of these cases, consumers' confusion about which organization they were dealing with—the bank or the subsidiary—could potentially justify an "estoppel" claim.

Our sample also included nonbank subsidiaries of bank holding companies that used a variety of insulation techniques. One, a discount brokerage, had the above insulation characteristics as well as a separate name and premises. However, it participated in cross-selling products, used the bank's marketing services, and relied on the bank's customer base. In another case, an affiliate of a bank used the same logo to start its name as did the bank, was in the main bank building, and used a common entrance. We also visited two small credit life insurance companies that were bank holding company subsidiaries. Both operations resembled bank departments—the insurance policies were typically sold in the bank by bank employees to bank customers. Such factors can weaken market perception separation.

FDIC Actions

FDIC has recently addressed the issue of separate premises as part of its deliberations on nonmember bank securities activities. In 1982 it determined that the Glass-Steagall Act did not prohibit insured nonmember banks from being affiliated with securities companies or from establishing or acquiring a securities subsidiary. In 1984 it issued regulations (12 C.F.R. 337) governing insured nonmember transactions with securities companies. They permitted state-chartered nonmember banks to engage

Current Practices

Banking organizations show a wide range of responses to these organizational issues. At the present time there are no restrictions in the Bank Holding Company Act regarding common officers or directors of banks, bank holding companies, and affiliated nonbanking enterprises, nor does the Federal Reserve System impose such restrictions in its administration of the act.[1] Furthermore, except for Glass-Steagall Act restrictions, there is no prohibition against officers of commercial corporations serving as directors of commercial banks and of securities firms. The principle of restricting membership on boards of directors to reduce or eliminate potential conflicts of interest and enhance legal separation is, however, recognized in federal laws applicable to mutual funds. The Investment Company Act presently limits the number of directors, officers, or employees from a single bank that can serve on the board of a registered investment company.

In the course of our work on insulation issues, we judgmentally selected 23 organizational entities that were conducting various nontraditional activities; they were located in 19 banks or bank holding companies.[2] The organizations selected included some of the country's largest bank holding companies as well as both large and small national and state banks.

We found a range of practices with respect to separation of officers, directors, premises, and other relationships. We found one large multinational bank holding company that organized a discount brokerage operation as a subsidiary of the bank. It was legally separate and had a separate board, meetings, books, and staff. Its assets were segregated, and it adhered to funds-flow restrictions. It disclosed to customers that it was a fully-owned subsidiary and a separate corporation. It did not suggest the bank was responsible for the subsidiary's obligations. The bank was vulnerable to some market perception risk, however, because the subsidiary had a name similar to the bank's, shared common entrances, engaged in cross-selling, and used the bank's marketing services.

This bank, therefore, may become exposed to contingent liability risk should its subsidiary fail, resulting from potential "estoppel" claims by

[1] FDIC's regulations for state nonmember banks engaging in securities activities through a bank "bona fide" subsidiary require that the subsidiary (1) have a majority of directors that are neither officers nor directors of the bank and (2) have no common officers with the bank. (12 C.F.R. 337)

[2] Bank Powers: Insulating Banks From the Risks of Expanded Activities (GAO/GGD 87-35, Apr. 1987).

allowing greater affiliation of banking and securities activities and may be more restrictive than needed to protect the public from abuses and the deposit insurance fund from losses. Modifications that would permit a certain percentage of officers or directors to serve both units and/or exempt banks under a certain size should be considered, but due consideration needs to be given to achieving adequate insulation. If complete separation is not required, however, stringent disclosure requirements need to be in place and enforced to reduce the possibility of customer confusion.

in a full range of securities activities through a bank "bona fide" subsidiary or affiliate, provided the activities were authorized under state law.[3]

In taking the above actions, the FDIC sought to protect bank safety and soundness by establishing a number of conditions.[4] The conditions forbade common officers with the bank and required that there be a majority of directors that were neither officers nor directors of the bank. They also (1) prohibited the use by an insured nonmember bank of a name or logo common to that used by its securities subsidiary or affiliate if that subsidiary or affiliate engaged in securities activities prohibited to the bank by the Glass-Steagall Act and (2) required that an insured nonmember bank be physically separate and distinct in its operations from the operations of the subsidiary or affiliate; no common entrance with the bank except for a common outer lobby or common corridor was allowed.

FDIC received petitions to reconsider the prohibition against common names and the requirement for physical separation and postponed the compliance deadline several times. After reconsideration, FDIC deleted the requirements that the securities entity have a separate entrance from the bank and also that the securities entity and the bank could not share a common name or logo. Instead, FDIC requires that the securities entity must use physically separate offices or office space, which are clearly distinguished from the bank's. (FDIC plans to assess during bank examinations whether the physical arrangement is such as to preclude customer confusion.) FDIC noted it would rely on disclosure rather than the requirement for different names and logos to prevent customer confusion.

Observations

Prohibitions against common officers and directors would enhance economic, legal, and market perception of insulation and reduce the opportunity for conflicts of interests. Similar restrictions on the use of common premises and on corporate names and logos would contribute to the same objective. However, such outright prohibitions would restrict opportunities for banking organizations and the public to benefit from

[3]Section 103 of CEBA made sections 20 and 32 of the Glass-Steagall Act applicable to nonmember banks from March 6, 1987, to March 1, 1988. Affiliations and interlocks established prior to March 5, 1987, can continue for 2 years.

[4]The FDIC took this action to insure legal separateness and to prevent possible confusion on the part of the public, which could give rise to claims against the insurance fund or FDIC as receiver of a failed bank.

extend credit to their affiliates. Under Section 23A, loans or extensions of credit to the affiliate, purchases of investment securities of the affiliate, or the transfer of assets between the bank and the affiliate are limited for transactions involving any one affiliate to 10 percent of the bank's capital stock and surplus and to 20 percent of the bank's capital stock and surplus for all affiliates combined. Also, a bank and its subsidiaries may not purchase low-quality assets from an affiliate and any covered transactions between a bank and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices. Furthermore, any loan or extension of credit to, or guarantee on behalf of, an affiliate granted by a bank or its subsidiary must be secured by collateral having a market value of 100 percent or greater than the loan, extension of credit, or guarantee.

Section 23B (enacted as sec. 102(a) of CEBA) places additional limitations on specified transactions, specifically calling for arm's length transactions and listing more covered transactions.[3] Under both Sections 23A and 23B, any bank transaction with a third person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate.

Other legislation relating to transactions among affiliates cited in the Comptroller of the Currency's December 1987 testimony before the Senate Committee on Banking, Housing, and Urban Affairs includes the following:

- The National Bank Act limit on extensions of credit to a single borrower to 15 percent of capital and surplus (up to 25 percent if secured by readily marketable collateral).
- The Federal Reserve Act restrictions on extensions of credit by a member bank to its executive officers, directors, and principal shareholders and those of a parent bank holding company, and bank holding company subsidiary, or company controlled by such persons. Credit must be given on an arm's length basis and other restrictions apply. The Bank Holding Company Amendments Act established similar requirements for such officials of correspondent banks.

[3] A member bank and its subsidiaries may engage in the transactions "only (a) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or (b) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies." (sec. 23B [(a)(1)].)

Interaffiliate Transactions

11. How should current laws that restrict transactions among affiliates be amended in order to provide the enhanced protection that product deregulation may necessitate?

GAO has reported that economic separation is one of three key factors of insulation.[1] Economic separation provides that a bank and its affiliates be adequately and separately funded with no comingling of assets, that any services or loans obtained from the bank be obtained at rates comparable to those charged nonaffiliated parties, and that the bank be prevented from unduly transferring assets to or purchasing bad assets from an ailing affiliate. Economic separation restrictions are generally addressed through flow of funds restraints and specific restrictions on the payment of dividends.

If securities powers are to be granted to bank subsidiaries and/or affiliates, a careful examination of all of this legislation is in order, as is generally recognized. A number of acts contain provisions relevant to the issue of transactions among affiliates and the protection (or insulation) of the insured bank. These include the Federal Deposit Insurance Act, the Competitive Equality Banking Act of 1987 (CEBA), the Bank Holding Company Act, the National Bank Act, and the Federal Reserve Act. The extent and nature of the amendments that may be needed depend on whether securities activities will be permitted in bank holding company affiliates only or bank subsidiaries as well. The nature of any changes will also depend upon the balances to be struck between the benefits of insulation and the benefits of closer relationships and between minimum risks to the insured bank and maximum opportunity for profit (or loss). If banks are to be permitted to affiliate with securities firms, the Investment Company Act and other securities laws will need to be reviewed as well.

Flow of Funds Restrictions

Present legislation, generally speaking, restricts certain transactions of an insured bank and its subsidiaries with an affiliate and limits these "covered transactions" and unrestricted transactions to arm's length pricing. The basic law governing funds flow within a bank holding company is found in Sections 23A and 23B of the Federal Reserve Act.[2] Section 23A limits the extent to which all member banks may grant loans or

[1] Bank Powers: Insulating Banks From the Potential Risks of Expanded Activities (GAO/GGD-87-35, Apr. 14, 1987).

[2] Section 18(J) of the Federal Deposit Insurance Act extends Sections 23A and B to nonmember insured banks.

Presently, payments made by the bank on behalf of a third party are considered extensions of credit with respect to Sections 23A and 23B if outstanding overnight. The Federal Reserve has not taken a formal position as to whether outstanding transactions during the day (daylight overdrafts) are, or are not, covered by Sections 23A and 23B, according to a Federal Reserve Board staff attorney.

Many proposing that bank powers be expanded argue that laws governing funds flows within a holding company should be tightened. Maximum insulation of the insured bank with respect to funds flow would be achieved by prohibiting the bank from making loans, extending credit to, purchasing assets from, or investing in a securities affiliate. This prohibition is included in legislation currently proposed by the Chairman of the Senate Committee on Banking, Housing and Urban Affairs. The House Committee on Government Operations recommended in its September 1987 report that:

"interaffiliate lending by insured depository institutions is not essential to the basic purposes of capital mobility and financial industry competitiveness for which financial services holding companies would be established. The financial services holding company structure provides a convenient and efficient mechanism for the corporation to obtain substantial amounts of financing at low cost from uninsured sources and to allocate this funding to its subsidiaries as needed, without employing its insured depository subsidiaries as a conduit for such credit" (p. 47).

An alternative to complete prohibition of transactions between banks and their affiliates would be to strengthen Sections 23A and 23B. It would also be necessary to increase the regulatory resources available for detection of abuses and for enforcement. Furthermore, penalties for violations could be increased. This approach recognizes that banks are a primary source of liquidity for securities firms on a routine basis and especially during a financial crisis. We have discussed this option at greater length in our response to question 1 (app. I).

Dividend Restrictions and Capital Support Requirements

Banking law provisions contain dividend payment restrictions generally consisting of notifying and receiving approval from state and federal regulators under certain circumstances. A national bank must obtain approval from the Comptroller of the Currency and a state member bank must receive approval from the Federal Reserve before paying, in any calendar year, dividends exceeding the total of that year's net profits combined with retained net profits of the preceding 2 years.

- The Federal Reserve Act prohibitions against a member bank purchasing securities or other property from, or selling them to, its directors unless certain provisions are met.

The importance and limitations of funds flow controls are illustrated by the failure of Hamilton National Bank. In the mid-1970s, severe problems developed in the holding company's mortgage banking affiliate, which specialized in real estate development loans with its operation funded through bank lines of credit and the sale of holding company commercial paper. When the parent holding company was unable to roll over its commercial paper, it forced Hamilton National Bank to buy a large amount of low quality mortgages from the severely distressed mortgage banking affiliate of the holding company. These purchases far exceeded the amount permitted by law (sec. 23A of the Federal Reserve Act) and resulted in the subsequent failure of the bank.

This episode needs to be put in perspective, however. It happened a decade and a half ago, and the experience has not been frequently repeated. Moreover, while it caused a bank to fail, it did not threaten the overall financial system. Nevertheless, it should not be dismissed as irrelevant. The violations noted most often by the regulators in our conflict of interest inquiry concerned violations of Section 23A.

Loans to Affiliates

Presently, Sections 23A and 23B of the Federal Reserve Act apply only to a bank's transactions with its affiliates, not with its subsidiaries. There is a clause, however, that allows restrictions to be placed on bank subsidiaries if it is determined that the subsidiary's activities could threaten the bank. The application to subsidiaries is now made on a case-by-case basis.

The Federal Reserve Board is also considering extending funds flow restrictions to subsidiaries and has requested comments on its November 1987 proposals concerning real estate investment and development activities in a holding company framework. Included is a proposal that nonbank subsidiaries of banks engaged in real estate should be considered "affiliates" under Sections 23A and 23B. The Board has questioned whether a bank is adequately insulated from the risks of such activities conducted by a nonbank subsidiary of a bank. It has also sought comment on a proposal that would prohibit nonbank subsidiaries of holding company banks from conducting real estate investment and development activities.

Request Letter

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LAWRENCE R. SIDMAN
CHIEF COUNSEL AND STAFF DIRECTOR

October 13, 1987

The Honorable Charles A. Bowsher
Comptroller General of the United States
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

As part of the Subcommittee on Telecommunications and Finance's examination of the nature and appropriate degree of intersection between commercial and investment banking and the regulatory and supervisory issues implicated by such intersection, I would like to request the General Accounting Office to prepare for the Subcommittee a report addressing certain questions that I regard as central to a proper understanding of the above issues. My goal in requesting this report is to obtain for my Subcommittee the benefit of a considered analysis of these issues so that we may develop a fuller understanding of the implications of any structural changes that Congress should consider making in the relationship between commercial and investment banking.

I am aware of an April 1987 study issued by the GAO that focuses on how to insulate banks from the risks attendant to product deregulation. Our request seeks to build upon that earlier study. It is important that we come to grips with these issues well in advance of the March 1 expiration of the moratorium on expanded bank powers. I request, therefore, that the General Accounting Office report be submitted to the Subcommittee on or before December 1 of this year.

To assist you in beginning the process of preparing this report, I would like to set forth for you some of the questions to which we would like the General Accounting Office to respond. Our staff would be pleased to work with your staff in order further to refine these questions and to develop others. Solely for purposes of this discussion, the following questions presuppose modifications to the existing barriers between commercial and investment banking. Neither I nor the Subcommittee has reached any definitive conclusions as to whether any such changes should in fact be made. Our initial questions are as follows:

1. How can we ensure that the safety and soundness of the nation's banks will be preserved in a more fully deregulated (in Glass-Steagall terms) environment?

Although states frequently have similar requirements, requirements are not uniform for all banks nationwide.

Another issue related to transactions is the extent to which a bank holding company can be required to infuse capital or otherwise support a failing or weak subsidiary bank. While the Federal Reserve policy is that the bank holding company should serve as a source of strength, it has not been able to effectively implement this policy and efforts to do so have been challenged. The House Government Operations Committee report proposes that the bank holding company be made liable for all insurance fund losses should the bank fail.[4] The Committee said this would be a further constructive managerial incentive to encourage continuing holding company oversight of the insured depository and its subsidiaries. The Committee said this would also discourage potential abuse of an insured subsidiary.

Recommendations

We have two recommendations regarding interaffiliate transactions. First, we believe that some transactions between affiliates should be allowed, but only on arm's length basis, in order to adequately satisfy the liquidity need of securities firms that are affiliated with banks. If necessary, Sections 23A and 23B should be strengthened and such additional regulatory resources as may be necessary for supervision and enforcement should be provided. Congress may also consider increasing the penalties for infractions of Sections 23A and 23B.

Second, the bank holding company should be required to act as a source of strength to the bank. Moreover, if the holding company avoids that responsibility, Congress should consider making the holding company financially liable for any losses incurred by the insurance fund.

[4] Modernization of the Financial Services Industry: A Plan for Capital Mobility Within a Framework of Safe and Sound Banking. Sixteenth report by the Committee on Government Operations (House Report 100-324, Sept. 30, 1987).

The Honorable Cha-les A. Bowsher
October 13, 1987
Page 3

11. How should current laws that restrict transactions among affiliates be amended in order to provide the enhanced protection that product deregulation may necessitate?

This list is not intended to restrict but rather to guide the General Accounting Office's analysis of these very complex issues.

Sincerely,

Ed Markey

Edward J. Markey
Chairman

The Honorable Cha. es A. Bowsher
October 13, 1987
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2. In what ways will our national economy and the interests of our citizens be served if banks, their subsidiaries or affiliates are allowed to participate broadly in securities activities?

3. In what ways will product-line deregulation or financial services sector restructuring enhance the international competitiveness of the U.S. capital markets?

4. What problems have arisen as a result of the relatively free hand that U.S. commercial banks and bank holding companies have had in the international arena with regard to securities activities? Have there been any failures or financial difficulties encountered by these banks, their affiliates or subsidiaries? How have the foreign operations of these banks enhanced the competitiveness or asset base of the domestic bank and of the holding company?

5. What are the likely competitive consequences of product deregulation/structural reform? In particular, will there be a differential impact on small versus large banks? Will there be increased market concentration in the banking industry as a result? Explain whether such concentration is undesirable. Is the securities industry as presently constituted undesirably concentrated? Are there barriers to entry into the securities business such that competition is affected? What will be the impact on concentration in the securities industry? Should there be limitations placed on the kinds of affiliations, by asset size, for example, between commercial banks and securities firms?

6. On the other side of the coin, should securities firms be permitted to engage more broadly in traditional banking activities? Are there any particular banking activities that it would be in the nation's interest for securities firms to participate in? What effect would this have on competition within the banking industry?

7. How can we prevent tie-ins and other coercive forms of merchandising for banks' or securities firms' deregulated products? Is there any structural way by which we can eliminate such concerns or must we constantly monitor or supervise them? What sorts of regulatory resources will such monitoring require?

8. How should the bank and its affiliates or subsidiaries be structured so as to restrict the flow of confidential information? Similarly, if securities firms enter the banking business, what structural modification would be required to restrict the flow of confidential information? What are the risks of failing properly to restrict such flow?

9. To what extent should joint marketing of services be permitted?

10. Is it necessary to have complete separation of officers, directors and premises?

Testimony:
"Views on the Federal Rescue of the Continental Illinois National Bank and Trust Co.," (Dec. 14, 1984)

Federal Financial Institutions Examination Council Has Made Limited Progress Toward Accomplishing Its Mission (GAO/GGD-84-4, Feb. 3, 1984)

Financial Institution Regulatory Agencies Can Make Better Use of Consumer Complaint Information (GAO/GGD-83-31, Aug. 25, 1983)

Credit Insurance Disclosure Provisions of the Truth in Lending Act Consistently Enforced Except When Decisions Appealed (GAO/GGD-83-3, Oct. 25, 1982)

Bank Merger Process Should Be Modernized and Simplified (GAO/GGD-82-53, Aug. 16, 1982)

Information About Depository Institutions' Ancillary Activities is not Adequate for Policy Purposes (GAO/GGD-82-57, June 1, 1982)

Issues to Be Considered While Debating Interstate Bank Branching (GAO/GGD-82-36, Apr. 9, 1982)

The Securities Industry and Its Regulation

U.S. Government Securities: An Examination of Views Expressed About Access to Brokers' Services (GAO/GGD-88-8, Dec. 18, 1987)

Securities Regulation: Budget and Workload Statistics, FY 1979-1988 (GAO/GGD-87-94FS, June 6, 1987)

Testimony:
"Perspective on the Securities and Exchange Commission's Budget," (T-GGD-87-16, May 13, 1987)

Testimony:
"Insider Trading in the Securities Markets," (GGD-87-2 Dec. 11, 1986)

Securities Regulation: Securities and Exchange Commission Oversight of Self-Regulation (GAO/GGD-86-83, Sept. 30, 1986)

SEC Enforcement Program: Information on Productivity Statements and Cases Closed Without Action (GAO/GGD-86-106BR, Aug. 26, 1986)

Related GAO Products

Commercial Banking Supervision and Regulation

Financial Audit: Federal Deposit Insurance Corporation's 1986 and 1985 Financial Statements (GAO/AFMD-87-58, Aug. 12, 1987)

Banking Services: Changes in Fees and Deposit Account Interest Rates Since Deregulation (GAO/GGD-87-70, July 13, 1987)

Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities (GAO/GGD-87-35, Apr. 14, 1987)

Deposit Insurance: Analysis of Reform Proposals (GAO/GGD-86-32, 32A, 32B, Sept. 30, 1986)

Bank Secrecy Act: Financial Institution Regulators' Compliance Examinations (GAO/GGD-86-94, Aug. 1, 1986)

Financial Audit: Federal Deposit Insurance Corporation's Financial Statements for 1985 and 1984 (GAO/AFMD-86-67, July 30, 1986)

Bank Secrecy Act: Treasury Can Improve Implementation of the Act (GAO/GGD-86-95, June 11, 1986)

Commercial Banking: The Relationship Between Profitability and Capital Ratios (GAO/GGD-86-88BR, June 9, 1986)

Bank Regulation: Information on Independent Public Accountant Audits of Financial Institutions (GAO/GGD-86-44FS, Apr. 21, 1986)

Financial Services: Information on Nonbank Banks (GAO/GGD-86-46FS, Mar. 21, 1986)

Difficulties in Evaluating the Effectiveness of the Community Reinvestment Act of 1977 (GAO/OCE-86-1, Nov. 4, 1985)

Information on the Extent of Fully Insured Brokered Deposits in FDIC-insured Institutions (GAO/GGD-86-15FS and FS-S, Oct. 29, 1985, and Dec. 6, 1985)

Examination of the Federal Deposit Insurance Corporation's Financial Statements for the Years Ended December 31, 1984 and 1983 (GAO/AFMD-85-58, May 29, 1985)

response to question 1), the failure of some additional banks due to increased competition need not place a great burden on the deposit insurance system.

The Payments System

The large dollar wire transfer systems facilitate the flow of very large payments through the financial system. In the second quarter of 1987, the average daily payments volume in each of the two major wire transfer networks was approximately $600 billion. The two systems are Fed Wire, operated by the Federal Reserve, and CHIPS, a private clearinghouse. Although the operation of the two systems is quite different, potential problems could arise in both cases because payments can be sent at anytime during the day and they do not have to be covered and cleared through the Federal Reserve Banks until the end of the day. In the case of Fed wire, this means that a bank's reserve account could, for several hours during a day, have a negative balance. These negative balances are called "daylight overdrafts," and in effect, are very short-term, interest-free loans. CHIPS operates differently, but negative imbalances between net credit and net debit accounts are also called daylight overdrafts. On a typical day, daylight overdrafts on the two wire transfer systems total about $80 billion.

Allowing securities firms access to the large dollar wire transfer systems through bank affiliates may increase risks in two ways. First, the Federal Reserve guarantees payments made on Fed Wire. Consequently, the Federal Reserve carries the risks of public loss. At the same time, of course, the guarantee also protects the stability of the Fed Wire system as a whole. If a problem occurs, the Federal Reserve would seek to recover its losses from the bank making the faulty payment, hence the problem is similar to an ordinary credit risk problem for the bank. The Federal Reserve has introduced, and is currently experimenting with, tightening daylight overdraft caps to limit the extent of its exposure.

Second, large dollar payments made through CHIPS are not currently guaranteed. Therefore, a systemic crisis could arise (as computer simulations have shown) if a large participant were to fail and bring down other firms to which it owed intra-day funds. Thus, a major default through Fed Wire would affect the Federal Reserve and cause it to lose money. However, through CHIPS, such a default could affect the financial system.

Sections 23A and 23B of the Federal Reserve Act do not now clearly apply to transactions between banks and their subsidiaries or to

U.S. Treasury Securities: The Market's Structure, Risks and Regulation (GGD-86-80BR, Aug. 20, 1986)

Securities Regulation: SEC Enforcement Efforts in 1978 and 1985 (GAO/GGD-86-97FS, July 16, 1986)

Securities Regulation: Background and Selected Statistics on the SEC's Full Disclosure Program (GGD-86-87FS, July 10, 1986)

Securities and Futures: How the Markets Developed and How They Are Regulated (GAO/GGD-86-26, May 15, 1986)

Functional Regulation: An Analysis of Two Types of Pooled Investment Funds (GAO/GGD-86-63, May 12, 1986)

Testimony:
"Audit Standards and Procedures Relevant to Audits of Financial Institutions Involved in Significant Government Securities Repurchase Agreements," April 17, 1985

Statistics on SEC's Enforcement Program (GAO/GGD-85-28, Mar. 25, 1985)

Survey of Investor Protection and the Regulation of Financial Intermediaries (GAO/GGD-83-30, July 13, 1983)

Commodity Futures Regulation: Current Status and Unresolved Problems (GAO/CED-82-100, July 15, 1982)

Statistical Data on Securities and Exchange Commission's Allocation of Staffing and Other Budgetary Resources for Fiscal 1977 to 1981 (GAO/AFMD-82-73, June 18, 1982)

International Banking and Financial Services Activity

Country Differences in Accounting for Takeover Costs (GAO/NSIAD-88-56BR, Dec. 28, 1987)

Legislative and Administrative Obstacles to Write Down and Swapping of Less Developed Country Debt (T-NSIAD-87-29, Apr. 2, 1987)

International Banking: The Framework Underlying Country Risk in International Lending (GAO/NSIAD-86-183FS, Sept. 4, 1986)

International Banking: U.S. Banking Supervision and International Supervisory Principles (GAO/NSIAD-86-93, July 25, 1986)

Implementation of the Yen/Dollar Agreement (GAO/NSIAD-86-107, June 3, 1986)

International Coordination of Bank Supervision: The Record to Date (GAO/NSIAD-86-40, Feb. 6, 1986)

Supervisory Examinations of International Banking Facilities Need To Be Improved (GAO/GGD-84-65, Sept. 9, 1984)

International Banking Facilities Have Improved the Competitive Position of Banks in the United States (GAO/NSIAD-84-128, Aug. 7, 1984)

Statutory Requirements for Examining International Banking Institutions Need Attention (GAO/GGD-84-39, July 11, 1984)

Floating Exchange Rates in an Interdependent World: No Simple Solution to the Problems (GAO/NSIAD-84-68, 68A, Apr. 20, 1984)

Bank Examination for Country Risk and International Lending (GAO/ID-82-52, Sept. 9, 1982)

Thrift Industry

Thrift Industry: The Management Consignment Program (GAO/GGD-87-115BR, Sept. 10, 1987)

Financial Audit: Federal Savings and Loan Insurance Corporation's 1986 and 1985 Financial Statements (GAO/AFMD-87-41, May 27, 1987)

Thrift Industry: Forbearance for Troubled Institutions 1982-1986 (GAO/GGD-87-78BR, May 6, 1987)

Thrift Industry: The Treasury/Federal Home Loan Bank Board Plan for FSLIC Recapitalization (GAO/GGD-87-46 BR, Mar. 3, 1987)

Testimony:
"The Federal Savings and Loan Insurance Corporation —Financial Condition and Recapitalization Issues," (T-AFMD-87-4, Mar. 3, 1987)

Thrift Industry: Cost to FSLIC of Delaying Action on Insolvent Savings Institutions (GAO/GGD-86-122BR, Sept. 9, 1986)

Financial Audit: Federal Savings and Loan Insurance Corporation's 1985 and 1984 Financial Statements (GAO/AFMD-86-65, July 7, 1986)

Thrift Industry: Net Worth and Income Capital Certificates (GAO/GGD-86-100FS, June 23, 1986)

Thrift Industry Problems: Potential Demands on the FSLIC Insurance Fund (GAO/GGD-86-48BR, Feb. 12, 1986)

Thrift Industry Restructuring and the Net Worth Certificate Program (GAO/GGD-85-79, Sept. 24, 1985)

Formal Supervisory Process for Savings and Loan Associations Should Be Strengthened (GAO/GGD-81-91, Sept. 17, 1981)

Other Products Concerning the Financial Services Industry, Securities Markets, and Risks

Financial Condition of American Agriculture as of December 31, 1986 (GAO/RCED-88-26BR, Oct. 20, 1987)

Testimony:
"Regulation of the Financial Guarantee Industry," (T-GGD-88-2, Oct. 14, 1987)

Guaranteed Student Loans: Analysis of Premiums Charged by Guaranty Agencies (HRD-88-16BR, Oct. 7, 1987)

Insurer Failures: Property Casualty Insolvencies and State Guaranty Funds (GAO/GGD-87-100, July 28, 1987)

Farm Finance: Secondary Markets for Agricultural Real Estate Loans (GAO/RCED-87-149BR, July 7, 1987)

Financial Services: Developments in the Financial Guarantee Industry (GAO/GGD-87-84, June 25, 1987)

Debt Restructuring Activities During the 1984-85 Farm Credit Crisis (GAO/RCED-86-148BR, May 5, 1986)

Tax Policy: Financial Cycles in the Property/Casualty Industry (GAO/GGD-86-56FS, Apr. 9, 1986)

Cost and Benefits of Financing with Tax Exempt Bonds (GAO/RCED 86-2, Feb. 10, 1986)

Federal Accounting and Auditing Standards Affecting the Private Sector (GAO/GGD-86-48BR, Sept. 30, 1985)

The Federal National Mortgage Association in a Changing Economic Environment (GAO/RCED-85-102, 102A, Apr. 15, 1985, and July 17, 1985)

Secondary Market Activities of the Student Loan Marketing Association (GAO/HRD-84-51, May 18, 1984)

Guidelines for Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34, Mar. 29, 1984)

International Insurance Trade—U.S. Market Open (GAO/ID-82-39, Aug. 23, 1982)

Glossary

Bank Holding Company
A company that owns or controls one or more banks. Control is usually evidenced by ownership of 25% or more of a bank's voting stock, but also may be evidenced by control over the election of a majority of the directors or by other forms of control. The Federal Reserve Board determines which activities closely related to banking may be engaged in by bank holding companies, either directly or through nonbank subsidiaries. Examples of nonbanking activities that the Board has approved are owning finance companies and engaging in mortgage banking.

Clearinghouse Interbank Payments System (CHIPS)
An automated clearing system used primarily for international payments. This system is owned and operated by the New York Clearinghouse banks. It engages Fedwire for settlement.

Daylight Overdraft
A daylight overdraft occurs when an institution has sent funds over Fedwire in excess of the balance in its reserve or clearing account or it has sent more funds over a private wire network than it has received.

Discount Window
Figurative expression for Federal Reserve facility for extending credit to eligible institutions, particularly commercial banks.

Estoppel
In general, the creditors of an affiliate have no claim on the assets of an affiliated bank. However, under the legal principle of estoppel, a creditors may successfully claim that the affiliate or the holding company misled them into believing that they were dealing with the bank. The bank could then be held liable to the creditors.

Eurobonds
Debt instruments of governments or corporations which are issued and sold outside of the country of the currency in which the bonds are denominated.

Eurodollar Market
A market for dollars held in deposit outside the United States, for example, in Europe.

Euro Commercial Paper
Short term debt instruments issued outside of the country in which the securities are denominated.

Fedwire

The Federal Reserve funds transfer system, Fedwire, is used for transferring reserve account balances of depository institutions and government securities.

Fiduciary

A person acting alone or jointly with others primarily for the benefit of another in all matters connected with its actions. The principal function of a fiduciary is the management of property for others, such as by the trust department of a bank.

Functional Regulation

A means of organizing the federal regulation of financial institutions so that the regulation would be by functional activity, such as sales of securities to the public, rather than by industry classification. Thus, regardless of whether the financial institution providing the product or service is a banker, bank holding company affiliate, securities firm, or insurance company, functional regulation would subject similar financial products and services to similar regulatory treatment by a single federal agency. As applied to securities activities, it would ensure that public investors are protected by the securities laws enforced by the SEC regardless of the entity with which these investors choose to deal with respect to their securities transactions. It would also ensure that differences in regulatory treatment would not give competitive advantages to similar products offered by different types of firms. The concept of functional regulation may be applied only to new powers (such as allowing banks to underwrite corporate securities and sell mutual funds) or to existing powers (such as activities of banks in government securities market).

Lender of Last Resort

As the nation's central bank, the Federal Reserve has the authority and financial resources to act as "lender of last resort" by extending credit to depository institutions or to other entities in unusual circumstances involving a national or regional emergency, where failure to obtain credit would have a severe adverse impact on the economy.

Member Bank

A depository institution that is a member of the Federal Reserve System. All national banks are required to be System members and state-chartered commercial banks and mutual savings banks may elect to become members.

Nonbank Banks

Limited purpose financial institutions chartered by the Office of the Comptroller of the Currency or by state authorities. Because these institutions do not offer both demand deposits and commercial loans, they fell outside of the narrow definition of "bank" found in the Bank Holding Company Act of 1956. This definition of a bank was changed in the Competitive Equality Banking Act of 1987.

Nonmember Bank

A state-chartered commercial bank that is not a member of the Federal Reserve System. Nonmember banks are subject to reserve requirements set by the Federal Reserve and they also have access to the Federal Reserve discount window on the same terms as member banks.

Securitization

A process whereby a group of mortgages or other loans are pooled and used as the basis for debt securities sold to the public. The holders of the securities receive their principal and interest payments from the repayments made on the original pools of loans. Securitization allows financial institutions to control risks by selling off loans and it also provides opportunities for fee income from underwriting commissions and loan servicing. The Glass-Steagall Act restricts the ability of commercial banks to underwrite such securities and to sell them directly to the public.

Self-Regulatory Organizations

Nongovernment organizations that have statutory responsibility to regulate their own members under the oversight of the Securities and Exchange Commission. An example is the New York Stock Exchange.

Thrift Holding Company

Any company that directly or indirectly owns or controls a thrift institution with federal deposit insurance. As is the case with the bank holding company, tests for ownership and control include ownership of 25 percent or more of voting stock and control over selection of a majority of the directors.

Unitary Thrift Holding Company

A thrift holding company that owns only one insured thrift institution.

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