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Using "Firewalls" in a Post Glass-Steagall Banking Environment

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USE OF FIREWALLS IN A POST-GLASS-STEAGALL BANKING ENVIRONMENT

SUMMARY OF STATEMENT BY
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In response to a request from the Honorable Edward J. Markey, Chairman of the Subcommittee on Telecommunications and Finance, GAO is commenting today on the use of so-called "firewalls" to protect bank safety and soundness and prevent conflict of interest abuses if the Glass-Steagall Act is repealed or relaxed.

In summary:

GAO's ultimate interest is to determine what ground rules will best allow banks and consumers to reap the presumed benefits of Glass-Steagall repeal and, at the same time assure the safe and sound operation of the banking system and consumer protection.

GAO views firewalls as a set of legal and regulatory measures that separate nonbanking activities from banking activities carried out within the same organization and has reported that three types of separation are required to insulate banks:

-- legal separation, so that the bank is not legally liable for the debts of its affiliates;

-- economic separation, so that the bank is prohibited from excessively aiding an affiliate; and

-- psychological or market-perception separation, so that the public does not perceive the bank and affiliate as one.

GAO believes, however, that no insulation strategy should by itself be viewed as fail-safe, and cautions that attempts to create such firewalls must be weighed against the likelihood of reducing the presumed benefits of Glass-Steagall repeal.

GAO views firewalls as useful in combination with other methods of protecting bank safety and soundness and consumers and has recommended that if Glass-Steagall is repealed or relaxed:

-- the bank holding company structure be required, because it provides the most insulation.

-- the holding company be required to maintain adequate capital and act as a source of strength to its banks.

-- regulatory resources and expertise must be increased to assure compliance with laws and regulation.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to provide our views on the use of so-called "firewalls" to protect bank safety and soundness, prevent conflict of interest problems, and protect consumer interests. In April 1987, we issued our report entitled *Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities*, which dealt with the strengths and weaknesses of various corporate structures in protecting bank safety and soundness. In January of this year, we issued to your subcommittee another report entitled *Bank Powers: Issues Related to Repeal of the Glass-Steagall Act*. This report contained recommendations on how to protect bank safety and soundness if a decision is made to repeal the Glass-Steagall laws. These two reports are the principal basis for our testimony today.

Increases in the number, height and thickness of firewalls have been proposed by some as a means of protecting banking organizations from risks incurred by affiliated securities firms in an expanded powers environment. The recently passed Senate legislation (S. 1886) contains a number of firewall provisions. These include restrictions on corporate structure, interaffiliate transactions, director interlocks for larger banks, and sharing of confidential information, as well as other measures designed to prevent conflict of interest problems. S. 1886 also contains other "non-firewall" mechanisms to promote bank safety and soundness.

Our ultimate interest is to determine what ground rules will best allow banks and consumers to reap the benefits that are presumed to flow from repeal of Glass-Steagall laws and, at the same time assure the safe and sound operation of the banking system and consumer protection. Firewalls are one of a number of means offering the potential to achieve this. However, we believe total reliance on firewalls would be inappropriate because, (1) no set of firewalls should be viewed as completely fail-safe, (2) the benefits of repeal might be lost, (3) there may be dangers in constructing barriers that inhibit the flow of liquidity during periods of financial turmoil and, (4) there may be other mechanisms that may prove superior in accomplishing the desired result.

In my testimony today, I would like to first describe what we mean by firewalls and then offer some general views on their usefulness as a means of protecting bank safety and soundness.

CORPORATE STRUCTURES AND FIREWALLS

Firewalls are a set of legal and regulatory measures governing structural and operational relationships that organizationally separate nonbanking activities from banking activities carried out within the same organization. These laws and regulations are intended to legally, economically, and psychologically insulate or protect banks from risks incurred by nonbanking parts of the organization. They are also designed to prevent problems arising from conflicts of interest between the banking and nonbanking

components of the organization. From the federal government's perspective, these firewalls should be designed to protect its ability to fulfill its deposit insurance responsibilities, limit the reach of the Federal Reserve's lender of last resort function, and promote the safe and sound operation of the banking system.

Legal separation involves steps to assure that the bank itself cannot be held legally liable for the debts or losses of one of its affiliated or subsidiary organizations. Factors important to achieving such separation include, separate incorporation; adequate capitalization; separation of day-to-day business and formal management structures of each organization, including boards of directors, bookkeeping functions, and other operations.

Economic separation consists of structures designed to prevent the unrestricted flow of bank funds to nonbank affiliates, such as adequate and separate funding of the nonbanking unit with prohibitions on commingling of nonbank assets with bank assets. Any services or loans obtained by the affiliate from the bank must be at rates comparable to those charged nonaffiliated parties. In addition, the bank must be prevented from unduly transferring assets to, or purchasing bad assets from, an ailing affiliate. Federal Reserve Act sections 23A and 23B limit the extent to which, and specify the terms under which, banks may engage in transactions with their affiliates.

Psychological separation or insulation protects against depositor perceptions that the bank and its affiliated or subsidiary organizations are one entity. The greatest danger arising from failure to achieve psychological or market perception separation is that problems in an affiliate could be perceived by depositors as the bank's as well, leading to a run on the bank. Ways to mitigate against this possibility include using separate names and logos for the bank and affiliate, locating the bank and its affiliates in separate locations, conducting marketing activities separately, refraining from selling each other's products, developing and maintaining separate customer lists, and providing full and appropriate disclosure of the noninsured status of affiliate products.

USEFULNESS OF FIREWALLS

While firewalls are no doubt needed to protect bank safety and soundness in a modernized regulatory environment, I would like to make three main points about their usefulness:

-- No insulation strategy designed to provide legal, economic, and psychological separation is completely fail-safe.

-- Attempts to increase the number, height, or thickness of firewalls must be weighed against the likelihood of diminishing the benefits that repeal of Glass-Steagall laws is presumed to produce; and

-- Firewalls should be used in combination with other legal and regulatory mechanisms designed to foster incentives on the part of bank management to operate in a safe and sound manner.

How Protective Are Firewalls?

We indicated in our recent report on issues associated with Glass-Steagall repeal that no set of insulation techniques is likely to be fail-safe in protecting a bank from the risks of expanded activities. We did, however, note that among the various corporate structures we reviewed, the bank holding company structure offered the greatest degree of insulation. The holding company is organized in such a way that it would be much more difficult for creditors of a failed affiliate to successfully pursue a claim on a bank's assets than it would be in a bank subsidiary or bank department form of organization. Furthermore, the restrictions on interaffiliate transactions within a holding company are more rigorous than those that apply to other organizational forms of banking.

But adopting the holding company structure will not completely eliminate the possibility of misperceptions on the part of the public of how the affairs of nonbank affiliates might affect the banking affiliate. We described this potential market perception problem in our 1987 report. We cited several examples in which all of the corporate formalities were followed and Federal Reserve examiners had found no violations of restrictions

designed to achieve economic insulation. But market perception risks existed because these banks and their affiliates had common or similar names and logos, and used the same facilities. In other cases, smaller bank holding companies did not maintain separate boards of directors and used bank employees to conduct nonbank affiliate business. Of the 12 holding company nonbanking subsidiaries in our sample, all but one told us they were coordinating sales or marketing activities with the affiliated bank.

In addition to these market perception risks there can never be absolute assurance that when an affiliate is deeply troubled a bank will not come to the affiliate's rescue, either to protect the bank's good name or for other reasons. While bank rescues of failing or troubled affiliates or subsidiaries have not been common place, they have been sufficiently numerous over the past 10 years to raise doubts about the complete effectiveness of even legal or regulatory prohibitions on such activities. The most notable recent example is the Continental Illinois Bank's rescue of its First Options subsidiary.

Tradeoff Between Use of Firewalls and Achieving Benefits from Associating With Other Activities

Moreover, it might be disadvantageous to attempt to achieve absolute insulation because this could eliminate the benefits that are presumed to flow from combining banking and securities activities. Outright prohibitions on such activities as cross

marketing of products, use of banking facilities by affiliated organizations, tied-in product offerings, cross marketing and the sharing of common names, logos, and facilities would no doubt reduce the potential for adverse market perception and conflict of interest problems. However, one of the principal purposes of modernizing Glass-Steagall laws has been to capture the benefits that are presumed to flow to both banks and their customers from the joint operation of the banking and securities business. It is argued that cross marketing and a sharing of facilities will reduce the costs of producing banking services which could then flow to customers in the form of reduced costs or improved access to services.

In our report on Glass-Steagall issues, we did not render a judgement on the appropriate way in which to reconcile the tradeoff between concerns over potential conflicts of interest and market perception problems and capturing the benefits that would flow from corporate synergies and reduced costs of production. One approach to the tradeoff would be to impose full disclosure requirements on the relationship between the bank and the affiliate, and their products. Adequate oversight of compliance with those requirements should be part of this approach.

Another tradeoff occurs in the area of interaffiliate extensions of credit. We are concerned about total prohibitions on extensions of credit in any manner, such as those contained in S. 1886, by a bank to its securities affiliate. We recognize the

clear potential for conflict of interest problems that exists in such transactions as well as their potential adverse effect on bank safety and soundness if allowed to occur without limitation. And, there is a clear cut need for prohibitions on interaffiliate dealings such as those contained in S. 1886 on bank purchases of securities being underwritten by the securities affiliate and on bank loans to purchasers of those securities during and immediately following underwriting periods.

Commercial banks have traditionally maintained lending relationships with securities firms. During the market crash of October 1987, commercial banks were important suppliers of liquidity to market participants, augmented by general support from the Federal Reserve. If a total prohibition is placed on this type of lending between a bank and its affiliated securities firm, we are not sure that the liquidity needs of market participants could be as well met in the event that the October events are repeated. Whether the holding company would have sufficient strength to meet its securities subsidiary's funding needs or whether banks would be willing to extend loans to competing holding company securities subsidiaries is a matter of conjecture. We recognize that the current 23A and 23B limitations on interaffiliate lending might prevent the bank from meeting its securities affiliate's total funding needs in a market crisis. But such limitations at least allow some room for flexibility in such a situation.

One reason advanced for the total prohibition on interaffiliate extensions of credit is that the current 23A and 23B restrictions are subject to creative interpretation and are difficult and cumbersome to oversee. In our view, any concern over the regulators' ability to enforce the 23A and 23B restrictions should be addressed by additional oversight and increased penalties for violations of restrictions.

Firewalls in Context

Our report on Glass-Steagall issues contains a number of recommendations on how to preserve bank safety and soundness and protect consumer interests in a world of expanded powers. Except for our views that the bank holding company structure provided the best means of organizing banking and securities activities, and that the 23A and 23B restrictions on interaffiliate transactions were preferable to outright prohibitions on such transactions, we did not have any specific recommendations on firewalls.

Firewalls, such as those contained in S. 1886 are very important. But they must be employed in combination with other methods of protecting safety and soundness, such as adequate capital, requirements on the holding company that provide its management with incentives to operate in a safe and sound manner, and increased oversight and supervision. I would like to briefly discuss these other elements of our recommended approach.

Capital Adequacy: We recommended that if Glass-Steagall laws are repealed, undercapitalized holding companies should be prohibited from engaging in expanded activities. The dismal experience of the thrift industry has made it clear that both undercapitalized and insolvent institutions have incentives to make decisions that threaten safety and soundness. Well-capitalized institutions, on the other hand, have every incentive to preserve and increase the wealth of their stockholders. In our view, requiring the maintenance of adequate capital levels, and promptly dealing with institutions that become undercapitalized or insolvent would provide appropriate incentives for holding companies to operate in a safe and sound manner. We note in this regard that S. 1886 prohibits a bank holding company from buying a securities firm if in doing so the holding company would fall below its minimum capital requirements. However, the bill is not explicit about the steps to be taken if, after acquiring a securities firm, the holding company falls below its minimum capital level.

Holding Company Incentives: We also recommended that the holding company be required to act as a source of strength for the banking entity. Since one important reason for permitting banks to enter the securities business is to strengthen banking profits, the profits derived from the securities business should be available through the holding company to support weakened banking institutions. Alternatively, the holding company could be held liable for the losses incurred by FDIC in liquidating failed bank subsidiaries. These requirements would provide a powerful set of incentives for holding company management to

assure that the banking and other subsidiaries operate in a safe and sound manner. While it has been Federal Reserve policy to view the holding company as a source of strength for its bank subsidiaries, we indicated in our January report that such a policy should be made a legislative requirement. S. 1886 explicitly gives the Federal Reserve discretion to disapprove additional holding company investment in a securities subsidiary, if the holding company's capital falls below that necessary to fulfill its obligation to serve as a source of strength to its subsidiary banks. However, S. 1886 does not require that bank holding company capital be used to augment the strength of bank subsidiaries with capital deficiencies or other problems.

Oversight and Supervision: Finally, it is essential that those contemplating actions or activities that would constitute unsafe and unsound practices be aware that such activities will likely result in timely detection and severe penalties. We do not believe that the current oversight capabilities of the regulators create this sort of climate. In our January report, we questioned whether the regulators have the capability to adequately carry out all their oversight responsibilities in today's environment. And, we have serious reservations about their present ability to do so in an environment of expanded powers. Accordingly, we recommended that expansion of bank powers be conditioned on acquiring adequate resources to oversee the new activities.

We are pleased to note that S. 1886 as passed by the Senate adopts a phased approach to repeal of Glass-Steagall laws and also requires that the regulators develop a plan for overseeing compliance with the bill's firewall provisions and for responding to consumer complaints.

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Mr. Chairman, this concludes my prepared statement. We would be pleased to respond to questions.