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Report to the Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, House of Representatives

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INTERNATIONAL FINANCE

U.S. Commercial Banks' Securities Activities in London

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Comptroller General
of the United States

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September 8, 1988

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

Dear Mr. Chairman:

At your request, we reviewed how U.S. commercial banks performed their securities underwriting and trading activities in the London markets[1] during 1986 and 1987 to assess how they might handle such activities within the United States if the Glass-Steagall Act of 1933 were revised or repealed.

The Glass-Steagall Act's prohibition against the underwriting and trading of corporate debt and equity securities by commercial banks applies to business conducted within the United States. According to the Federal Reserve's Regulation K,[2] banks may underwrite and trade securities outside the United States, within certain limits. These activities may be undertaken by subsidiaries of the bank holding company or by subsidiaries of the bank itself, but not by branches, which are permitted to underwrite only local government securities.

U.S. commercial banks conduct the greatest concentration of their overseas underwriting and trading activities in London. Approximately 50 U.S. commercial banks operate in London, and 18 of them engage in at least a minimal amount of underwriting and trading.

The range and type of such activities varies among these 18 banks. Most are large banks; 16 are considered money-center or super-regional banks.

Bank examination reports from the Federal Reserve, the New York State Banking Department, and the Office of the Comptroller of the Currency indicate that most of the London securities subsidiaries of U.S. banks

[1] The London markets include the United Kingdom market and the Euromarkets operating out of London. Euromarket securities activities include Eurodebt and Euroequity underwriting and trading. In the Euromarket, securities are denominated in a currency other than that of the country in which the security was issued.

[2] Regulation K sets forth regulations for U.S. banking institutions operating abroad and foreign banking organizations operating in the United States.

recorded losses or were marginally profitable in 1986 and 1987. The financial difficulties that banks had in 1986 and 1987 were exacerbated by the October 1987 stock market crash.

In several cases, the losses suffered by the London securities subsidiaries were large enough to require capital infusions from the U.S. parent in order to permit continued operations and to bring capital up to minimum United Kingdom standards. Furthermore, many subsidiaries had management or internal control weaknesses, according to the examination reports.

It is important to note, however, that the losses and internal control problems of U.S. banks in London did not threaten the worldwide operations of any of these banking institutions; in every case, these losses were a relatively minor percentage of the consolidated worldwide capital of each of these banking institutions.

Generally, banks registered the largest losses in their Eurodebt[3] operations, because this was the area of underwriting and trading in which U.S. bank subsidiaries were most heavily involved at a time of declining demand in the Eurobond markets. In addition, those U.S. banks with equity market-making and trading subsidiaries also experienced losses. Falling revenues were not able to cover overhead structures originally designed to meet higher anticipated levels of business.

These problems are attributable to both deficiencies in internal bank management and control of London activities as well as to the turbulence in the London capital markets from 1986 to the present. A number of U.S. commercial banks committed substantial resources to building their securities subsidiaries in London without the necessary controls and staff in place to effectively handle unfamiliar financial transactions in a highly competitive environment.

Most significant among the management and internal control problems cited by bank examiners were (1) lack of a sufficient Eurodebt distribution network or customer base, (2) high overhead expenses and staff problems, (3) absence of trading limits or exceeding established limits, (4) inadequate credit and market risk evaluation, (5) overburdened accounting and computer systems, and (6) nonexistent or inadequate

[3]Eurodebt operations for these banks have generally been U.S. dollar bonds issued in London (i.e., Eurobonds).

written procedures for accounting, credit evaluation, and separation of duties.[4]

The environment in the London capital markets during this period was a major factor in many of the problems that were observed.

During 1986 and 1987, U.S. banks found themselves managing securities activities as relative newcomers in perhaps the most competitive financial markets in the world at one of their most difficult times in recent history. One official described the experience of U.S. commercial banks in the London markets as "learning to sail in a hurricane."

London's markets were characterized by soaring trading volumes following deregulation of the U.K. market[5] which overwhelmed accounting and computer systems, strong competition in both the U.K. and Euromarkets which hurt profitability among both established firms and new entrants, uncertainty about changes in U.K. regulation resulting from the Financial Services Act of 1986, contraction in the Eurobond sector, the virtual collapse of the perpetual floating rate note market,[6] the stock market crash of October 1987 and the ensuing increase in investor caution.

The difficulties of any institution operating in these markets were considerable, and U.S. commercial banks were not the only financial firms with problems in their London operations.

It is important to note that foreign and U.S. investment banks as well as foreign commercial banks were also hard hit during 1986 and 1987.

Although it is impossible to know with certainty which problems were attributable to internal (management) or external (market conditions) factors, we believe that some valuable lessons can be learned and applied in the United States, particularly if Glass-Steagall were to be repealed or substantially revised.

[4]These problems are not necessarily listed in order of importance.

[5]In October 1986, the U.K. deregulated its financial markets, an event commonly known as the "Big Bang."

[6]Perpetual floating rate notes are debt securities without maturity dates used by many commercial banks in Europe to raise permanent capital. Because they lack maturity dates, their value depends to a large degree upon the presence of liquid secondary markets where these notes can be sold.

The performance of U.S. banks in London highlights the need for strong internal controls within banks and adequate capitalization in order to lower the risk presented by these activities to each banking institution's consolidated operations. In our January 1988 report on the Glass-Steagall Act,[7] we recommended that, if the Act is repealed, steps be taken to preserve the safety and soundness of the banking system, protect consumer interests, and minimize the chances that unforeseen events would have a destabilizing effect. This earlier report recommended that banks be required to use the bank holding company form of operation as one component of ensuring adequate separation of banking and securities activities, internal controls, and protection against loss; some of the banks whose London operations we reviewed did use this form of operation.[8]

Adequate capitalization for bank holding companies is essential to cushion banks against potential losses from securities operations. Banks should also base the development of their securities business upon their ability to manage these operations. Finally, bank regulatory authorities need to closely monitor the development of these activities to ensure that they do not endanger the solvency of the banks themselves.

There is evidence that banks are seeking to improve their management and oversight of their London operations. According to officials of the Federal Reserve and the Office of the Comptroller of the Currency, U.S. commercial banks have demonstrated determination to strengthen their London operations by strategically re-evaluating their role in London, making dramatic management and staff changes, and increasing the oversight of London operations by senior bank management.

The London experience further demonstrates the need for strong and effective regulation of any additional securities powers for U.S. banks since ultimately, as we noted in our January 1988 report, 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 soundess and protection of consumer interests.

[7] Issues Related to the Repeal of the Glass/Steagall Act (GAO/GGD-88-37).

[8] In this report, the term subsidiary refers to both subsidiaries of the bank holding company and subsidiaries of the bank itself.

Agency Comments

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) and the New York State Banking Department (NYSBD) expressed overall agreement with our findings. (See Appendix IV). In general, these organizations emphasized that U.S. investment banks and foreign banks operating in London experienced difficulties similar to those of U.S. commercial banks.

The OCC disagreed with our conclusion that the London experience points to the need for strong regulation of any additional securities powers for U.S. banks in the United States. While we recognize, as the OCC does, that U.S. banks operated in a very difficult environment in London, this does not minimize the necessity to have strong supervision of banks' securities activities, particularly as the banks begin these operations. The FDIC and the NYSBD disagreed with a prior GAO recommendation, restated in this report, that banks be required to use the bank holding company structure in establishing securities subsidiaries. As stated in earlier reports, such as our report on the Glass-Steagall Act,[9] we believe the bank holding company structure provides the most legal, economic and psychological segregation of insured and non-insured activities. The FDIC also stated that adequate capitalization of bank holding companies is not as important as a policy of preventing the federal safety net from being extended beyond the insured bank. We believe that adequate capitalization is especially important as it would be the first line of defense against the risk of loss from securities activities.

Objectives, Scope, and Methodology

We focused our review on those securities activities of U.S. banks in London which are currently not permitted in the United States so that our findings would have the most relevance to the discussion of the repeal or revision of the Glass-Steagall Act. These activities include the underwriting and trading of corporate debt and equities in both the U.K. and Euromarkets. The London market was chosen because it is the one in which U.S. banks are most actively engaged in underwriting and trading.

We reviewed available bank examination reports at the Federal Reserve Board and the Office of the Comptroller of the Currency for the years 1986 and 1987 as our primary source for assessing the performance of 18 U.S. commercial banks in London. These reports were supplemented

[9] Issues Related to the Repeal of the Glass-Steagall Act (GAO/GGD-88-37).

with regulatory agency internal memoranda and discussions with bank examiners. We attempted to place U.S. bank performance into the perspective of the U.K. and Euromarkets by interviewing regulators, bankers, academic experts, securities analysts, and others and analyzing relevant reports, studies, and publicly available information. Our discussions with bank officials addressed general issues concerning U.S. bank operations in London rather than issues raised in bank examination reports on their particular institutions.

Given the timeframe in which this review was conducted, it was not possible for us to determine definitively the extent to which the problems of U.S. bank subsidiaries in London were caused by internal control problems or external market factors. In addition, our efforts to generalize about U.S. banks in London were limited because the nature of the data collected by bank regulators often prevented comparisons and because of (1) variations in the quality of bank management, (2) differences in each bank's level of activity in various financial instruments, and (3) the different methods the banks used to allocate profits and expenses. It was often not possible to disaggregate the profitability of individual sectors, such as underwriting and trading of debt and equity, due to the lack of appropriate data.

To avoid compromising the confidentiality of the information contained in bank examination reports, we have not included the names of banks and their associated performance.

We conducted our review in accordance with generally accepted government auditing standards.

As agreed with your office, we plan no further distribution of this report until 30 days after its issuance date unless you release its contents earlier. At that time, we will provide copies to executive agencies, congressional committees and other interested parties.

Sincerely yours,

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Contents

Abbreviations

U.K.	United Kingdom
FRN	Floating Rate Note
FRS	Federal Reserve System
NYSBD	New York State Banking Department
PFRN	Perpetual Floating Rate Note
SRO	Self Regulatory Organization

The Environment of the London Markets

The convergence of several key events in the U.K. and Euromarkets during 1986 and 1987 made those markets an increasingly difficult environment for financial firms. The difficulties presented by the already highly competitive Euromarkets were compounded by problems in the Eurobond market in 1987 and the deregulation of the U.K. domestic market in October 1986, which ushered in a period of relative chaos and intensified competition in both the U.K. and Euromarkets. Previous ways of conducting business no longer applied, while cut-throat competition squeezed profit margins. Finally, the stock market crash of October 1987 led to increased caution among investors, reducing demand for all but the most low-risk investment products.

The Eurobond Market

The Eurobond market encompasses the underwriting and distribution of debt securities to investors in one or several markets outside the issuer's home market by a syndicate of international securities firms and banks. Eurobonds are denominated in a currency other than that of the nation in which they are issued, such as U.S. dollar bonds issued in London. The Eurodollar bond market developed in the 1960s as a means for corporations to raise capital outside of the United States and outside U.S. regulation. Until recently, U.S. dollar-denominated bonds accounted for the largest share of the Eurobond market. The recent depreciation in the value of the U.S. dollar relative to other currencies, together with uncertainty concerning future movements in the value of the dollar, contributed to the expansion of the non-dollar currency sectors of the Eurobond market at the expense of U.S. dollar-denominated bonds. In large part due to the decline of the U.S. dollar relative to the Japanese yen, U.S. institutions lost their prominence in the Eurobond market to the Japanese.

Intense competition in the Eurobond markets has led firms to introduce debt product innovations, such as the perpetual floating rate note (PFRN). PFRNS are issued by a variety of financial firms, including a number of U.S. commercial banks. In December 1986, for a number of reasons, the $17 billion market for PFRNS virtually collapsed. The PFRN crisis sent a shock through the Eurobond market as it forced investors and financial firms to consider the potential dangers of innovative financial instruments. Several U.S. bank subsidiaries had large exposures in the PFRN market when demand fell.

A slowdown in the demand for Eurobond issues denominated in various European currencies began in early 1987 partly as the result of rising interest rates in Europe, while the falling value of the U.S. dollar made

U.S. dollar-denominated bonds less attractive. Further, the effects of the collapse of the U.S. domestic bond markets during April and May were experienced in London's Eurobond market, as prices fell. By August 1987, according to most London traders, bull markets in debt instruments were over.

The final blow to the Eurobond market in 1987 was the October stock market crash, which led to an increased cautiousness among investors. This further reduced the volume of activity in the Eurobond market, causing some firms to reevaluate their decision to participate in this market.

The Euroequity Market

The Euroequity market[1] is not nearly as well developed as the Eurobond market. The Euroequity market has not yet developed the automated clearance and settlement facilities which are available for Eurobonds, and this has tended to limit the flow of equity capital across national borders.

Earnings figures indicate that Euroequities had been a very profitable area for investment banks up to the time of the October 1987 stock market crash. U.S. commercial banks were at a distinct disadvantage because the Federal Reserve's Regulation K restricted them from more than minimal participation in the equities markets at a time when their competitors, investment banks, were able to partially offset their losses in Eurobonds with profits from equities activities. It should also be noted that these same restrictions minimized the potential losses to U.S. banks from equities operations.

Prior to the stock market crash, the U.K. equities market was booming while Eurobond trading was not yielding profits for many dealers. Following the stock market slide, investors in search of a safe haven turned to government securities. Although the decline in interest rates that quickly followed the stock market crash produced a rally in the government bond markets, the Eurobond market's weaker issues were unable to recover in the wake of events that had seriously affected their credibility and the market's perceived liquidity during 1987.

[1] Euroequity refers to common and preferred stock distributed to investors in one or several markets outside the issuer's domestic market.

Deregulation of the U.K. Market

The so-called Big Bang of October 27, 1986, dramatically deregulated the U.K. domestic financial markets by eliminating the practice of paying fixed commissions on purchases of stocks and bonds and removing the separation among the underwriting, sales and trading functions. As part of this deregulation, in March 1986, foreign firms were allowed to buy U.K. stockbrokers. In order to ensure adequate investor protection and regulatory supervision following Big Bang's overhaul of financial service activities, the Financial Services Act of 1986 was enacted to establish standards of conduct and an entirely new regulatory structure for the U.K. securities industry.

With the removal of restrictions on the conduct of securities business, the volume of traded securities dramaticallly increased and many players entered the U.K. domestic market to partake of this opportunity for new business. Despite this increased level of business, profit margins decreased substantially due to a competitive free-for-all among the many financial firms that had rushed to enter the U.K. market. As a result of this competition, commission rates for large trades in the U.K. domestic equity market fell 50 percent from their pre Big-Bang level. At the same time, spreads between buying and selling prices decreased in the trading of foreign equities on the London Stock Exchange, reducing profit opportunities for traders.

The rapid increase in trading volume after Big Bang also put severe pressure on the settlement and clearing processes of financial firms' back-office systems in London. At the end of July 1987, unsettled deals of the six major market-makers totaled more than $1 billion, the highest level ever recorded. Settlement problems were exacerbated by the confusion created by the high trading volumes during the October stock market crash.

Heightened competition in both the U.K. domestic market and Euromarkets resulted in a focus on capturing market share at any cost. Revenues reduced by severe competition were often unable to cover high overhead costs associated with maintaining an office in London. In what some have characterized as a "shake-out," many U.S. and foreign firms cut their London staff levels dramatically in order to minimize their losses.

The Securities Activities of U.S. Commercial Banks in London

Much of the discussion surrounding the possible repeal or revision of the Glass-Steagall Act of 1933[1] has focused on the Act's prohibition against commercial banks' underwriting and trading corporate debt and equity securities for their own accounts or affiliating with any corporations engaged principally in these activities. This prohibition applies to the domestic operations of U.S. commercial banks but not to their overseas business. The Federal Reserve's Regulation K permits U.S. commercial banks, within certain limits, to engage in these activities overseas to allow U.S. banks to remain competitive in foreign markets.

Structure of Activities

In London, U.S. commercial banks conduct a full-range of securities operations. Securities underwriting and trading activity takes place in separately capitalized subsidiaries.[2] Bank branches may conduct business in derivative products, such as interest rate and currency swaps, futures and, options.[3]

Regulation K, to a certain extent has shaped the development of U.S. banks' underwriting and trading activities in the U.K. and Euromarkets. For example, Regulation K permits U.S. banks to engage in debt underwriting and trading to a much greater extent than in equity underwriting and trading.[4] Thus, some U.S. banks have been able to become active participants in the Eurobond markets in London, while U.S. banks' participation in overseas equity markets has been relatively limited because of the provisions of Regulation K.

Corporate debt and equity underwriting and trading are but one aspect of the wide range of activities in which U.S. banks engage in London, which include asset securitization, gilt (U.K. government bonds) underwriting and trading, financial futures/options, investment portfolio management, foreign exchange trading, interest rate swaps, syndicated lending, trade finance, and global custody services.

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

[2] A U.S. bank may conduct these activities in subsidiaries of the bank itself or of the bank holding company.

[3] Under Section 25 of the Federal Reserve Act, foreign branches of U.S. banks are not permitted to engage or participate in corporate securities underwriting or trading.

[4] Regulation K limits equity underwriting to $2 million per underwriting issue per bank subsidiary. Several subsidiaries of a banking organization may each underwrite up to $2 million of the same issue as long as each subsidiary is separately capitalized and the management of each subsidiary makes an independent judgement to join the underwriting. The aggregate amount of any issue that may be underwritten by a consolidated banking organization is $15 million.

Regulation of Activities

Both U.S. and U.K. regulatory authorities supervise the securities activities of U.S. banks in London. The responsible U.S. supervisors are the Federal Reserve System (FRS) and the Office of the Comptroller of the Currency (OCC). The New York State Banking Department (NYSBD) also supervises banks[5] chartered in New York State and operating in London. U.K. regulators include the London Stock Exchange, the self-regulatory organizations(SROS)[6] and the Bank of England.

U.S. Regulation

Each U.S. regulatory authority is statutorily responsible for supervising different U.S. bank operations depending upon their type of charter and organizational form. In practice, however, their responsibilities overlap and they share information and resources.

The FRS is authorized to examine state-chartered Federal Reserve member banks and the bank holding companies of both state and federally chartered banks. The NYSBD has responsibility for banks that are chartered in New York, and it maintains an office in London. The OCC is authorized to examine federally chartered or national banks and their subsidiaries. The OCC also examines federally chartered bank holding company subsidiaries to monitor activities that may have an impact on the bank as a whole. Because this overlaps with FRS oversight responsibilities, the OCC and the FRS coordinate their examinations of these entities. The OCC and the NYSBD meet periodically to discuss general regulatory issues in London, but they do not conduct joint examinations since the OCC has no supervisory authority over state-chartered banks.

The informal system of joint examinations and information sharing between the FRS and the OCC is especially important to the FRS, since it does not maintain an office in London as the OCC does. The OCC's on-site presence in London gives bank examiners flexibility in visiting banks as needed. The FRS' lack of a London office results in less of a hands-on ability to monitor U.S. banks in London. The FRS has considered opening an office in London but has not done so.

[5]This includes London subsidiaries of those U.S. bank holding companies that control New York State chartered banks.

[6]SROs are practicioner-led bodies which fall under the jurisdiction of the Securities and Investments Board and are empowered to enforce standards of member conduct.

The FRS and the OCC differ in their overall approach to supervising banks in London. The FRS examines banks along legal entity lines[7] and therefore evaluates the total operations of a U.K.-incorporated subsidiary during a given bank examination. The OCC follows a functional approach by targeting particular activities bankwide for examination. For example, if the OCC examines accounting and computer systems for the consolidated bank, these activities might also be evaluated in London. As a result of this approach, the full range of securities activities are not thoroughly evaluated every year. The OCC believes the targeted approach makes the best use of its examination resources by basing targeting on a hierarchy of relative risk that each banking institution or situation poses to the banking system as a whole. It should be noted that, although formal bank examinations may target certain activities, internal memos from London bank examiners to OCC headquarters on individual bank performance in London cover a much wider range of the banks' activities in London.

U.K. Regulation

The role of U.K. regulators in supervising the securities activities of U.S. banks has been in a state of flux since Big Bang's deregulation of the U.K. market and the enactment of sweeping U.K. financial legislation in 1986. The Financial Services Act of 1986 introduced a system of closer supervision of London's financial market participants in reaction to numerous investor complaints. Under this legislation, SROs will supervise the securities activities of all financial firms operating in the United Kingdom, including U.S. banks. The London Stock Exchange will continue to supervise all U.S. bank subsidiaries as well as other U.S.-owned firms that are members of the Exchange to ensure that they meet minimal required capital levels and conduct their business in compliance with British laws and regulations. The Bank of England becomes involved in reviewing the securities activities of U.S. banks in London only if these operations fall under its jurisdiction and the Securities and Investment Board, which supervises SROs, agrees that the Bank of England should be the lead regulator.

[7] The FRS shares its examination responsibilities for New York State chartered banks on a yearly alternating basis with the NYSBD. Thus, the FRS examines these banks every other year.

U.S. Bank Performance in London

Most of the U.S. commercial bank subsidiaries recorded unprofitable or marginally profitable underwriting and trading activities during 1986 and 1987. Losses among a number of large money-center bank subsidiaries required capital infusions from the parent institutions in order to continue operations and to bring capital up to required U.K. minimum standards.

The October 1987 stock market crash did not have a major impact on most U.S. bank subsidiaries in London since their involvement in equity markets was relatively small because of Regulation K limitations. The crash, however, did affect those U.S. banks with equities market-making subsidiaries. Virtually all market-makers, including U.S. bank-owned, market-making subsidiaries, suffered losses as they had large inventories of stocks[1] going into the crash and therefore were vulnerable to a downturn in stock prices. Most firms found it difficult to break even during the volatile swings in the market, although they were able to recover some of their losses on their stock inventories through large spreads or differences between buying and selling prices.

U.S. bank subsidiaries' back-office systems were overwhelmed by the explosion in volume that followed Big Bang in October 1986. Accounting, settlement, credit evaluation, and computer systems could not keep pace with the volume and types of securities transactions as management felt pressure to produce profits in this new, chaotic environment. Severe competition squeezed profit margins as reduced revenues failed to cover large overhead operations put into place in anticipation of increased business. Meanwhile, as the dollar weakened against other currencies, the demand for Eurodollar bonds declined dramatically, eliminating one of the more important revenue sources of U.S. bank subsidiaries. In addition, the near collapse of the perpetual floating rate note market left several U.S. banks holding an inventory of greatly discounted value. Finally, the stock market crash resulted in investor cautiousness resulting in reduced trading volume which further eroded bank revenues in London.

In response to the problems experienced during this period, most U.S. banks had embarked on a strategic rethinking of their operations in London by the end of 1987. Many banks have subsequently reduced their staff levels and made senior management changes to bring greater expertise and control to their London operations.

[1] Regulation K limits a banking organization to holding, on a consolidated basis, only $15 million of the stock of one company, whether such stock is held in trading accounts or as long-term investments.

Significant Internal Control and Business Management Problems

Bank examiners cited several common problems in the London securities operations of U.S. banks: (1) lack of a sufficient Eurodebt distribution network or customer base, (2) high overhead expenses and staff problems, (3) absence of trading limits or exceeding established limits, (4) inadequate credit and market risk evaluation, (5) accounting and computer systems unequipped to handle the complexities of securities transactions and overburdened by the sudden surge in volume following Big Bang, and (6) nonexistent or inadequate written procedures for accounting, credit evaluation, and separation of duties. The relative importance of these problems cannot be measured with certainty since they are interconnected. Thus, these problems are not listed in order of importance.

Insufficient Eurodebt Distribution Network

U.S. commercial banks have had difficulty in establishing the customer bases so critical for success in the Eurodebt sector. To be able to underwrite large issues and to sell the bonds they purchase in the underwriting process, banks need to have in place a strong network of customers, such as central banks, corporation and investment managers, insurance companies, and pension and public funds. Without a strong London customer base to purchase portions of debt issues, U.S. banks were limited in the number and size of debt underwritings they could prudently manage. Because banks retained ownership of underwriting issues longer than they had planned, the risk of loss was increased in those cases where banks engaged in debt underwriting without a sufficient customer base. Some banks were left holding portions of their debt underwriting issues and absorbed losses when their holdings decreased in value.

High Overhead Expenses and Staff Problems

Prior to Big Bang, many U.S. bank subsidiaries were inexperienced in conducting securities activities in the U.K. market and Euromarkets, as U.S. banks were relatively new in these markets. To participate as members of the London Stock Exchange and to take advantage of the new business opportunities that were anticipated after Big Bang, a number of large U.S. commercial banks acquired British securities firms, several of which were considered among the best in London. Unfortunately, these banks found they had paid large premiums for staff accustomed to transacting business under the previous highly protected, fixed-commission system and unable to adapt quickly to the demands of the new system. This situation was compounded by difficulties in philosophical and operational compatibility between the more control-oriented commercial bankers and the relatively more independent investment bankers. U.S. banks were plagued by high turnover as these problems were combined with the banks' difficulties in matching the higher salaries of investment firms in an environment where a large number of firms were chasing a limited number of staff.

Trading Limit Problems

The lack of established trading limits or exceeding established limits appeared to be symptomatic of the chaotic environment which characterized both financial firms' internal operations and the London marketplace itself. As some firms struggled to break even, inexperienced traders engaged in aggressive trading strategies unchecked by management. Commercial bank managers with limited experience in securities trading managed traders hired from firms which had few internal controls. With so many other problems to manage in a rapidly changing financial environment, managers gave insufficient attention to the importance of ensuring adherence to trading limits.

Inadequate Credit and Market Risk Evaluation

Most U.S. bank subsidiaries in London were cited by bank examiners for inadequate evaluation of credit and market risk in their securities operations. As start-up operations in the equity securities sector, most U.S. bank subsidiaries are still developing their credit control processes. Although U.S. banks have had considerable experience in underwriting debt issues in London, credit evaluation for debt securities was cited by bank examiners as less than adequate in certain cases. These problems have resulted in markets made in stocks without sufficient analysis being performed as well as a number of large Eurodebt underwriting issues being processed without any credit approval.

Accounting and Computer System Problems

In most U.S. bank subsidiaries, back-office support was incapable of providing adequate accounting and computer systems. Sophisticated, integrated accounting systems are necessary for the proper operation of securities activities. However, the rapidly changing nature of the marketplace in London did not allow banks to be able to change their systems gradually. Difficulties in adapting bank accounting systems to securities activities were compounded by the London market's problems in upgrading its relatively unsophisticated U.K. clearing and processing system. Much of the difficulty that U.S. banks had in London with clearing systems was also tied to the less sophisticated and slower nature of clearing systems in other countries.

The absence of adequate accounting systems made it difficult for banks to know which products were profitable or unprofitable in London. The failure of some U.S. bank subsidiaries to mark-to-market[2] their securities portfolios translated into an inability to price transactions correctly, as the market value of their products were not known. A number of bank subsidiaries had accounting records with serious imbalances between securities received and securities to be delivered, which left them exposed to unknown possible losses. The problems in several U.S. bank subsidiaries were so severe that external auditors were unable to certify the statements of the subsidiaries until special auditing teams were brought in from headquarters to untangle the accounting transactions.

Inadequate Written Procedures

Written procedures for accounting, credit evaluation, and the separation of duties was often nonexistent or poorly conceived. The absence of such written procedures in some cases reflected poor planning, lack of direction, and the higher priority given to other aspects of the London operations.

[2]Marking-to-market refers to the recalculation of the value of a trading position in securities, using closing market prices.

Agency Comments

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

August 31, 1988

Mr. Frank C. Conahan
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

We have reviewed your draft report titled "International Finance: U.S. Commercial Banks' Securities Activities in London." Overall, we found that the draft report provides an accurate overview of U.S. commercial banks' performance in the London securities market during 1986 and 1987, especially after the October 1987 stock market crash. However, we disagree with the conclusion expressed on page 4. For the reasons listed below, we believe it is difficult to argue that the London experience points to the need for strong regulation of additional securities powers for U.S. banks in the U.S.

The draft correctly recognizes that the losses and internal control problems reflected by U.S. banks' securities subsidiaries in London did not threaten the worldwide operations or consolidated capital of the banking institutions. While those problems warrant regulatory concern and attention, it is important to put the problems into perspective. Many of these subsidiaries were acquired in late 1986. Operating losses and a difficult adjustment period are not unusual because of the marked differences between the generally conservative nature of the acquiring commercial banks and the entrepreneurial style of the acquired subsidiaries. Further, our work has shown that the profit motive is frequently secondary to maintaining a presence in London. The presence enables U.S. banks to participate in more lucrative EEC financial markets and win a share of fee and advisory business.

The draft states, "There is some evidence that banks are seeking to improve their management and oversight of their London operations." From our perspective, there is tangible evidence that the national banks are taking corrective action. Many of our banks recognized the need for strategic retrenchment prior to the October crash. We are seeing a reevaluation of markets and product lines, substantial management changes, and improvements in risk management controls and systems. For example, banks tell us that they continue to earn a significant amount of fee income from participation in other London markets, e.g. investment banking.

It is important to note that not all of the U.S. banks had major difficulties and/or suffered losses in London. Some of the smaller, more conservative regional banks have had reasonably well controlled and profitable securities operations from inception. It should also be noted that non-U.S. banks were equally unprofitable in London in the same time period and that nonbanks are not making money in the securities markets at the expense of banks. The London experience may have been caused by an oversaturation in the securities market.

Thank you for the opportunity to comment on the draft report. Attached for your consideration are some suggestions for technical clarification.

Sincerely,

Judith A. Walter

Judith A. Walter
Senior Deputy Comptroller for Administration

Attachment

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF DIRECTOR · DIVISION OF BANK SUPERVISION

August 15, 1988

Mr. Frank C. Conahan
Assistant Comptroller General
National Security and International
Affairs Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

Thank you for the opportunity to review and comment on your draft report titled, "How U.S. Banks Managed Their Securities Activities in London."

Now on page 4.

We have reviewed this report and generally agree with its findings (or otherwise have no basis for disputing them) with two notable exceptions. On page 3, the report alludes to an earlier GAO report that recommended that banks be required to use the bank holding company form of operation as one component of ensuring that separation of banking and securities activities, internal controls, and protection against loss are adequate. We maintain that the holding company organization is not the only means of helping to ensure this result and that, in general, banks should be permitted to choose the organizational form (holding company or direct subsidiary) that best suits their needs. We do not believe that the thousands of banks that are not in holding company structures or which are held by nonoperating shell companies should be forced to the expense and burden of forming operating holding companies in order to engage in securities activities. We believe securities activities can be conducted in bank subsidiaries provided the banks have excess capital and adequate safeguards are in place. We would be very interested in learning whether the GAO noted any demonstrable advantage to the holding company form of organization over the subsidiary form in reviewing the securities activities of U.S. banks in London.

Now on page 4.

On the same page 3, we also note the statement regarding the importance of adequate capitalization for bank holding companies to cushion banks against potential losses from securities operations. Of much greater importance, in our view, is clearly establishing the position that the federal safety net will not be extended beyond the insured bank. The government's primary focus with regard to protecting the safety and soundness of the banking system should be on the bank and not its owners or their nonbank subsidiaries. Obviously it is preferable to have soundly capitalized bank owners than poorly capitalized owners. However, capitalization is of lesser importance as long as the government is willing, and the public believes it is willing, to take the necessary steps to protect the bank from its owners. We believe "building the wall" around the bank is not only feasible but essential to the extent banks are to become engaged in new nonbanking activities.

Now on page 13.
Now on page 14.

Now on page 14.

On a technical level, the reference to $15 million in footnote 4 on page 14 presumably should be to $16 million. The reference at the bottom of page 15 to FRS authority to examine "state-chartered banks" is more accurately stated as "state-chartered member banks." State-chartered banks that are not members of the FRS are examined and supervised by the FDIC. In the first full sentence on page 16, the meaning of "bank holding company subsidiaries of national banks" is unclear.

We trust these comments are helpful.

Sincerely,

Paul G. Fritts
Director

STATE OF NEW YORK
BANKING DEPARTMENT
TWO RECTOR STREET
NEW YORK, N.Y. 10006

JILL M. CONSIDINE
SUPERINTENDENT OF BANKS

August 29, 1988

Mr. Allan I. Mendelowitz
Senior Associate Director
United States General Accounting Office
Room 4148
441 G Street, N.W.
Washington D.C. 20548

Dear Mr. Mendelowitz:

Re: Draft Report
International Finance

U.S. Commercial Banks' Securities Activities in London

Thank you for sending us the referenced draft report for review and comment.

In general, we have no objection to your comments regarding the financial difficulties experienced by U.S. banks operating in London during the 1986-1987 period. It is our understanding, however, that security firms and foreign banks operating in London experienced difficulties similar to those of the U.S. banks during that period. A reference to this comparison would be of interest.

Some specific comments follow:

Now on page 4.

P. 3 - "...earlier report recommended that banks should be required to use the bank holding company form of operation...".

Our position is that, subject to vigorous enforcement of adequate safeguards to assure safety and soundness, certain security operations may be conducted in a bank or a subsidiary of the bank.

P. 13 - The report indicates that "most banks have chosen to conduct underwriting and trading in subsidiaries of the bank holding company."

With the exception of one institution, New York State chartered banks conduct these activities through second-tier subsidiaries of the bank - merchant bank subsidiaries of Edge Corporations which are direct subsidiaries of the bank.

Now on page 14.

P. 15 - "The New York State Banking Department (NYSBD) also supervises some activities for banks chartered in New York State and operating in London."

We supervise all activities of banks chartered by New York State. We examine only selected activities or entities, the selection being on the basis of their importance to the bank.

"The NYSBD has responsibility for banks that are chartered in New York..." We are also involved in examination of bank holding companies and bank holding companies' non-banking subsidiaries. Therefore, if the securities operations in London were conducted by subsidiaries of bank holding companies (which control NYS chartered banks), we would be involved in their supervision and examination.

Now on page 15.

P. 18 - We note that we are discussing with the Securities and Investment Board a Memorandum of Understanding with a view toward sharing information and coordinating supervisory activities.

We appreciate the opportunity to offer our comments.

Very truly yours,

Edward P. Eustace
Deputy Superintendent of Banks
and Chief Examiner

Glossary

Asset Securitization	The conversion of traditional bank assets into negotiable securities which may then be purchased either by depository institutions or by non-bank investors.
Bank Holding Company	A company that owns or controls one or more banks.
Big Bang	The term used to describe the deregulation of the London securities markets in 1986, which included the removal of restrictions on foreign ownership of U.K. securities firms (Mar. 1986); unfixing of commission rates for trades on the London Stock Exchange and elimination of the segregation between broker and jobber functions (Oct. 27, 1986); and implementation of the Stock Exchange Automated Quotation (SEAQ) System, a new screen-based trading system (Oct.27, 1986).
Clearance and Settlement	The completion and settlement of securities transactions, including an agreement between parties as to terms and conditions.
Eurobond	A debt instrument of a government or corporation which is issued and sold outside of the country of the currency in which the bond is denominated.
Euroequity	Common and preferred stock distributed to investors in one or several markets outside the issuer's domestic market.
Financial Futures	Contracts for future delivery of a security.
Floating Rate Note	A medium-term security carrying a floating rate of interest which is reset at regular intervals, typically quarterly or semiannually.
Market-Making	The process by which a firm acts as a principal to trade equity securities from an inventory, constantly offering bid or asked prices at which they will either buy or sell the securities.

Option	The contractural right to buy or sell a specified amount of a financial instrument at a fixed price before or at a designated future date.
Perpetual Floating Notes	Debt securities without maturity dates used by many commercial banks in Europe to raise permanent capital. Because they lack maturity dates, their value depends to a large degree upon the presence of liquid secondary markets where holders can sell these notes.
Self-Regulatory Organizations	Practicioner-led bodies which are empowered to enforce standards of member conduct.

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