United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives

May 1990

INTERNATIONAL FINANCE

Update on U.S. Commercial Banks' Securities Activities in London

141543

GAO

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

National Security and
International Affairs Division

B-229444

May 7, 1990

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

At your request, we have updated our September 1988 report[1] to evaluate the performance of U.S. commercial bank-owned securities subsidiaries in London and determine if significant changes had occurred in the last year. You expressed concern that conditions in U.S. banks' foreign securities operations had worsened. This report focuses on the performance of nine banks in the areas of bank earnings, capital adequacy, and management, including internal controls.

Results in Brief

While bank-specific problems are less severe than when we assessed their performance in our previous report, London financial markets continue to be a difficult environment in which to operate, with changes occurring in many foreign and domestic institutions. Several U.S. commercial banks continued to suffer losses on London-based securities trading and, in some cases, were forced to infuse capital from the U.S. parent to the U.K. subsidiary in order to continue to meet U.K. capital requirements. Some banks, however, have earned profits in London. Banks have altered their strategies in London and discontinued many operations that were not profitable. Improvements continue to be made in management oversight of securities subsidiaries and internal controls governing the operation of these subsidiaries.

Background

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] U.S. banks in London may conduct business in derivative products, such as interest rate and currency

[1] International Finance: U.S. Commercial Banks' Securities Activities in London (GAO/NSIAD-88-238, Sept. 8, 1988)

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

swaps,[3] financial futures and options,[4] U.S. Treasury and foreign government bonds, foreign exchange, precious metals, and Eurocurrency deposits.

The earlier report noted that during 1986 and 1987, London's financial markets were characterized by soaring trading volumes, strong competition, and uncertainty about changes resulting from the October 1986 deregulation of the U.K.'s financial markets, an event commonly known as the "Big Bang." Financial firms faced increased difficulties in the aftermath of the October 1987 stock market crash and the ensuing increase in investor caution. The losses that these firms faced were attributable in part to pre-crash U.K. equity volumes that never came back to the higher levels, too many market makers[5] and too few investors, and an overcapacity of traders in the Gilts (British government bonds) at a time when the government was decreasing the supply.[6]

U.S. banks suffered the largest losses in Eurodebt[7] operations and London-based equities' underwriting and trading. In many cases, U.S. banks also misestimated costs and effects of cultural differences. Our earlier report pointed out that weaknesses in management oversight and internal control systems contributed to these losses, but that improvements were beginning to occur.

Bank Earnings in London

While the banks' earnings in London are generally still considered poor or unsatisfactory by bank examination standards, over half the banks we examined either experienced reduced losses or earned a small profit in 1988. However, the cost of learning the equities business has been very expensive even for strong institutions. In no case, however, were the losses severe enough to compromise security and safety of the parent institution, although capital infusions from U.S. parent banks were needed in many cases (see the section below on bank capital).

[3]Interest rate swaps typically exchange floating-rate payments for fixed-rate payments. Currency swaps are agreements to deliver one currency against another currency at certain intervals.

[4]An option is a contractual right to buy or sell a specified amount of a financial instrument at a fixed price before or at a designated future date.

[5]Firms that stand ready to buy or sell specified securities at publicly announced prices.

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

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

As a result of losses, banks are revising their strategies in an effort to make the securities area profitable. To cut costs and improve earnings, a majority of the banks we reviewed have reduced or cut out completely some aspect of their securities activities. Two U.S. banks have totally eliminated their debt operations while remaining in equities. One has eliminated its equities operations while retaining its debt underwriting operations. Other banks have discontinued some activities, either in debt or equity. It appears that banks are moving away from the idea of being a "financial supermarket" and now have the objective of developing a specialty or finding a niche.

In some cases, however, the banks believe they have cut costs as much as they can, and an improvement in future profits now depends on the banks' ability to generate revenue. One bank, for example, is striving to expand its customer base and its distribution and trading capacities. Another bank's policy is to underwrite an issue if it is considered to be a strategic step toward strengthening a client relationship.

The majority of banks are involved in other activities, such as foreign exchange trading, which is very profitable now. They are also engaging in nontraditional activities[8] to further diversify and generate more revenue.

Bank Capital

Although the size of the losses in the recent year is less than in 1986 and 1987, capital infusions from the U.S. parent continue to be needed in many cases. Six of the nine banks for which we obtained information had to infuse capital into their London operations to bring capital up to meet minimum U.K. standards and thus to permit continued operations. In all cases, these capital infusions were approved by U.S. regulators and, as noted above, did not threaten the safety and soundness of any worldwide banking organization.

Management Oversight and Internal Controls

Perhaps the most noticeable change over the last year has been in the banks' management and internal controls. During the 1986-87 period, many banks had management or internal control weaknesses. They had 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. In the last year, however, nearly all the banks for which

[8] Examples of such activities include dealing in options and swaps.

we obtained information showed progress in this area. The majority of banks we reviewed are rated as satisfactory in bank examination reports, indicating that noticeable improvement has been made in the area of internal controls.

Over the past year significant staff cutbacks and increased management efforts to improve the banks' performance have occurred. Almost all banks reviewed have reduced their staffs, some by a small amount (e.g., from 37 down to 29) and others by a large amount (e.g., from 1,000 down to 350). Many banks have also changed key managers and, consequently, have changed the securities strategy and operations.

Environment

During the last year, numerous foreign and domestic institutions reduced or even eliminated their securities activities in response to continued poor performance. The performance of U.S. commercial banks is similar to that of others, according to many analysts. While comparable data are less available for firms other than the bank subsidiaries, it is generally believed that losses were common among British banks, U.S. investment banks, and other firms, operating both as market makers or brokers.[9] In fact, to help guard against some of the losses, several investment banks are trying to get into a few of the more traditional commercial banking activities, especially the now profitable foreign exchange trading.

The London financial market environment has remained a difficult one in which to operate, however. Today, U.S. commercial banks with London securities operations are still being forced to deal with a changing regulatory structure, continued competitive pressures to develop capabilities in foreign exchange and interest rate products, and reduced investor interest in equities and equity-related products. Persistent European skepticism about the true soundness of the U.S. banks also hurts in attracting talented foreign staff in Europe.

Agency Comments

The Office of the Comptroller of the Currency provided written comments (see app. I) and the Board of Governors of the Federal Reserve System and the New York State Banking Department provided oral comments. Each agency expressed overall agreement with our findings, and their comments have been incorporated into this report where appropriate.

[9] Firms that trade solely on behalf of investors.

Objectives, Scope, and Methodology

This review focuses on the securities activities of nine U.S. commercial banks in the London market that were analyzed in the 1988 report, to determine if significant changes had occurred over the last year. The activities include the underwriting and trading of corporate debt and equities in both the U.K. and Euromarkets.[10] We reviewed available bank examination reports at the Federal Reserve Board, the Office of the Comptroller of the Currency, and the New York State Banking Department for 1988 and 1989. We also reviewed internal agency memoranda and conducted interviews with bank examiners and regulators. Other relevant reports, studies, and publicly available information were analyzed as well.

All nine banks discussed in this report were included in the sample of banks in our 1988 report. There were not enough examinations conducted of U.S. commercial bank securities operations in other markets, such as Tokyo, Hong Kong, or Frankfurt, to permit extending the scope of our analysis beyond London.

The small number of banks in our sample is attributable to (1) the short time frame since our last review, and (2) the different approach the Federal Reserve System and the Office of the Comptroller of the Currency take in supervising banks. The Federal Reserve System examines banks along legal entity lines and therefore evaluates the total operation of a U.K.-incorporated subsidiary during a given bank exam. However, not all banks are reviewed every year. The Office of the Comptroller of the Currency follows a functional approach by targeting particular activities bankwide for examination. Again, not all banks are reviewed every year, and even if a bank is reviewed, the securities underwriting and trading function may not be examined for that particular year.

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 between May and October 1989.

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,

[10]A Euromarket is one in which a financial instrument is issued and sold outside of the country of the currency in which the instrument is denominated.

congressional committees, and other interested parties. If you or your staff have any questions, I can be reached on (202) 275-4812. Other major contributors to this report are listed in appendix II.

Sincerely,

Allan I. Mendelowitz

Allan I. Mendelowitz, Director
Trade, Energy, and Finance Issues

Comments From the Office of the Comptroller of the Currency

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

March 30, 1990

Mr. Frank C. Conahan
Assistant Comptroller General
United States General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Conahan:

We have received and reviewed your draft report titled "International Finance: Update on U.S. Commercial Banks' Securities Activities in London." The report is intended to update an earlier report made to the Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives.

The draft report focuses on the performance of U.S. commercial bank-owned securities subsidiaries in London in 1988 and 1989. We believe that the report is a fair description of U.S. commercial bank Euro-securities activities conducted in London following the "Big Bang." Suggestions that we had for clarifying certain points made in the report have been provided to your project manager.

Thank you for the opportunity to comment on the report.

Sincerely,

Judith A. Walter

Judith A. Walter
Senior Deputy Comptroller for Administration

Major Contributors to This Report

National Security and International Affairs Division, Washington, D.C.

James McDermott, Assistant Director
Debra Crowe, Project Manager
Michael Jenkins, Evaluator

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.

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

Official Business
Penalty for Private Use $300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100