United States General Accounting Office 135001

GAO

Testimony

For Release
on Delivery
Expected at
10:30 a.m.
Wednesday
February 10, 1988

Issues Related to Repeal of the Glass-Steagall Act

Statement of
Charles A. Bowsher
Comptroller General
of the United States

Before the
Subcommittee on Telecommunications and Finance
Committee on Energy and Commerce
United States House of Representatives

GAO/T-GGD-88-9

ISSUES RELATED TO REPEAL
OF THE GLASS-STEAGALL ACT

SUMMARY OF STATEMENT BY
CHARLES A. BOWSHER
COMPTROLLER GENERAL
OF THE UNITED STATES

In response to a request from the Honorable Edward J. Markey, Chairman of the Subcommittee on Telecommunications and Finance, GAO agreed to provide answers to a number of questions dealing with possible repeal of the Glass-Steagall Act and to provide its perspective on the ramifications of eliminating or extending the moratorium on expansion of banking powers contained in the Competitive Equality Banking Act (CEBA) of 1987.

In summary:

1) Our over-riding concern in any action affecting Glass-Steagall is the safety and soundness of the banking system and the protection of consumer interests.

2) GAO recognizes that the financial services industry and the products it offers have changed significantly in the 55 years since the passage of Glass-Steagall, a fact which requires modernization of the regulatory framework that oversees the relationship between the commercial banking and securities industries.

3) GAO therefore recommends that if Glass-Steagall is repealed, such repeal be phased-in over a period of time necessary to assure putting in place a renewed regulatory framework to oversee the relationships between the commercial banking and securities industries. The three major elements of this framework include:

-- Requiring firms engaging in both banking and securities activities to maintain capital reserves adequate to cushion against losses that might result from expanded activities in either area.

-- Assuring that insured deposits be protected from the risks of expanded securities activities by insulating banks from the operations of their securities affiliates through the mechanism of the holding company, which should be subject to comprehensive oversight by the Federal Reserve.

-- Providing adequate resources and expertise to assure that federal regulators are able to keep pace with growing problems in the banking sector, the proliferation of new products, and the explosion of activity in the nation's security markets. This is especially critical inasmuch as regulators' responsibilities for the safety and soundness of the banking system would become even more challenging if banking powers are expanded as a result of a relaxation of Glass-Steagall prohibitions.

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear today to discuss the issue of repeal of the Glass-Steagall Act and the choices that Congress faces regarding the soon-to-expire moratorium on expansion of banking activities. Over the past few years we have done a great deal of work that has a bearing on the issue and, at your request, have prepared a report on the subject which is being released today.

It is worth recalling the motivation that prompted the passage of the Glass-Steagall Act in 1933: a determination that depositors would never again face the risks that stemmed from the near collapse of the U.S. commercial banking system as the Great Depression deepened in the early 1930s. The original intent of the Glass-Steagall laws remains just as valid today as it did then.

The financial landscape has changed in many ways since 1933. With the passage of the Glass-Steagall laws, banking and securities activities were completely separated, financial activities were highly localized, and a new regulatory structure for dealing with the divided industries was created. Today, securities firms are offering many bank-like products, and banks have begun to engage in a wide variety of securities activities. As a result of changes in the electronic, communications, and regulatory environments the business of deposit taking and lending can now be done on a nationwide and international basis.

The preferences of depositors and borrowers for the products of these two industries have changed dramatically.

But, the ad hoc integration that has occurred between these two industries in recent times is potentially dangerous because it has not allowed for the systematic consideration of the legal and regulatory structure needed to better reflect the realities of today's financial marketplace.

Coming to grips with the question of Glass-Steagall repeal represents an critical opportunity to directly confront those dangers and modernize our regulatory approaches.

If the Glass-Steagall laws are repealed or relaxed we believe it is crucial that certain steps be taken to (1) preserve the safety and soundness of the banking system, (2) protect consumer interests, and (3) minimize the chances that unforeseen events will have a destabilizing effect. These steps center around assuring adequate capitalization, stipulating the bank holding company organizational structure, and providing necessary regulatory oversight.

Assuring Adequate Capital

It is essential to require that firms engaging in both banking and securities activities have and maintain a level of capital sufficient to cushion against losses that might result from the expanded activities. Just as allowing poorly capitalized and insolvent thrifts to continue operating bankrupted the Federal Savings and Loan Insurance Corporation, allowing poorly capitalized banking firms to enter the securities business and vice-versa would be equally dangerous.

Require the Bank Holding Company Structure, Restrict the Safety Net, and Preserve Liquidity

It is also essential that insured deposits be protected from the risks of expanded activities. Our work on the effectiveness of various insulation structures indicates that no corporate structure is fail-safe. But the bank holding company structure provides the greatest degree of legal, economic, and psychological insulation of insured deposits from other currently permissible activities. Thus, we believe it appropriate to require that the bank holding company structure be used to organize the association of banking and securities activities. The holding company should be subject to comprehensive oversight by the Federal Reserve and affiliated banking and securities firms should be overseen by their respective regulators.

Placing increased reliance on the holding company structure raises several related issues that need to be resolved. First, how far do we wish Federal Reserve lender-of-last-resort services to reach? Second, in times of crises, how will the liquidity needs of securities firms be met?

We believe it would be inappropriate to extend lender of last resort services to the nonbank parts of the holding company, and believe it essential that the activities of the securities affiliate pose no material threat to the bank. Therefore, holding companies must maintain levels of capital sufficient to act as a source of strength to their commercial banking unit.

The liquidity needs of banks and securities firms must be met, particularly in times of crisis. The events of last October 19th and 20th in the equity markets made clear the important role of banks in supplying liquidity to securities firms during market emergencies. To preserve traditional lending arrangements between banks and securities firms, we believe that banks should be permitted to lend to their securities affiliates, within limits, on an arms-length basis. However, 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.

<u>Increase Regulatory Resources</u>

Ultimately, the degree of comfort that one has with repeal of Glass-Steagall depends on one's faith in the regulators' abilities to effectively oversee the newly allowed activities, preserve bank safety and soundness, and protect consumer interests.

One of the reasons for passage of the Glass-Steagall laws was to prevent many of the consumer abuses that were occurring at that time. Nevertheless, in recent years the regulators' oversight priority has been with safety and soundness considerations. Insufficient emphasis has been placed on oversight 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.

In the area of safety and soundness oversight, we have concerns about the regulators' ability to keep pace with the growing problems in the banking sector, the proliferation of new products and the explosion of activity on our nation's securities markets. Resource levels and expertise have not kept up with developments in these markets. And, if banking powers are expanded, the regulators' responsibilities for preserving safety and soundness will become even more challenging. We believe it essential that steps be taken, concurrent with any relaxation of Glass-Steagall prohibitions, to increase both the resources of the regulatory agencies as well as their expertise.

Obtaining the needed regulatory resources will take time and there are uncertainties about the ability of so-called firewalls and other regulations to fully preserve safety and soundness and protect consumer interests. For these reasons, we believe a phased approach to Glass-Steagall modernization should be adopted. This would involve bank holding companies undertaking only a subset of securities activities or limiting securities activities to a certain percentage of the holding company's total business. In time, as more experience is gained and regulatory resources are put in place, the limits on activities could be relaxed and, if no problems occur, fully phased out.

- - - - - - - - -

In the final analysis, we believe the debate surrounding the repeal of Glass-Steagall provides Congress with an opportunity to build a modern regulatory framework that will serve our nation's needs. In its time, Glass-Steagall was a major part of a concerted effort to reassure a skeptical public that the commercial banking system could be restored to health and made sound. It was also designed to assure that abuses in the securities industry would no longer be tolerated, and that the federal government has not only a role, but an obligation, to oversee the financial services industry to protect the public interest.

The emergence of a new financial services industry undreamed of only a decade or two ago, requires the renewal and repair of old regulations. The stock market crash of last October highlighted the need for new approaches to deal with newly-linked markets in equities and derivative products. Similarly, the emergence of "nonbank banks" and the breaking down of Glass-Steagall barriers underscore the need for a critical appraisal of the relationship between commercial banking and the securities industry.

If we delay too long, we run the risk of perpetuating inequities. And, with a further breaking down of Glass-Steagall barriers, we also may create a situation in which banks and their depositors become once again exposed to financial panics like those of another era.

We cannot afford to miss this chance to assure a framework of regulation and oversight that will serve this nation and its citizens for decades to come.

This concludes my prepared remarks. We would be pleased to answer questions.