DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

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Dear Chairman Ruder:

I very much apologize for not being able to get together with you yesterday. As you can imagine, we are very involved at the moment in international negotiations which I fear have preoccupied my schedule. However, since you will be testifying this Thursday, I thought you should have an advance opportunity to review the testimony I will present tomorrow on behalf of the Administration. As you will see, we generally embrace the Proxmire-Garn bill.

I understand you may have some technical amendments to enhance the concept of functional regulation in S. 1886. I look forward to discussing these with you personally as we move forward to modernize the Glass-Steagall Act.

Sincerely,

George D. Gould

The Honorable
David Ruder
Chairman, Securities and
 Exchange Commission
450 Fifth Street
Washington, D. C.

Enclosure

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STATEMENT OF
THE HONORABLE GEORGE D. GOULD
UNDER SECRETARY FOR FINANCE
UNITED STATES DEPARTMENT OF THE TREASURY
BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ON
THE FINANCIAL MODERNIZATION ACT OF 1987, S. 1886

Mr. Chairman, Senator Garn, and Members of the Committee.

I welcome this opportunity to appear before you in support of S. 1886, the Financial Modernization Act of 1987. There is a still-urgent need to modernize our nation's financial services industry to better serve consumers and business. I also want to commend this Committee for its role in recapitalizing the Federal Savings and Loan Insurance Corporation (FSLIC). That important legislation was made possible by the willingness of the Congress and the Administration to strike a compromise for the good of the public.

It is my hope that this self-same spirit of compromise will set the tone for the important business we now have before us. If so, I am confident that this Committee will agree that S. 1886 provides the proper starting point for broader reform.

Mr. Chairman, the Administration applauds the bipartisan leadership that you and Senator Garn have demonstrated over the years, not only in cosponsoring this pro-competitive and pro-consumer legislation, but also in your repeated public assurances -- upholding the clear statement of Congressional intent in the Competitive Equality Banking Act -- that the moratoria on new products and services will not be extended beyond next March.

As we proceed, Mr. Chairman, we should be skeptical of the defenders of the status quo, who will argue that the recent volatility in the stock market precludes the need to update our antiquated and protectionist financial laws. It does not. Some observers will try to equate the risks involved with investing in the stock market -- a risk we acknowledge up front -- with the alleged riskiness of engaging in new activities by certain classes of financial institutions. They should not. Recent market events, however, have underscored the need for adhering to fundamentals, such as adequately and separately capitalized firms and vigilant supervision to maintain the integrity of the federal safety net. These same real world events should not be used as an excuse or stand in the way of reforming laws to promote both greater competition and consumer benefits.

My testimony today is divided into three parts: a brief overview of the changing world marketplace; the reasons why the Administration supports reform of the Glass-Steagall Act; and then specific comments on the Financial Modernization Act.

Mr. Chairman, you also have asked for our comments on the Financial Services Oversight Act (S. 1891) introduced by your colleagues, Senators Wirth and Graham. While the sponsors obviously have put a great deal of thought and effort into drafting the approach first outlined by New York Federal Reserve Bank President E. Gerald Corrigan, I will be unable to make any specific comments at this time because the Administration does not yet have a formal position on this new legislation. As soon as the Administration reaches a position on the Financial Services Oversight Act, I would be pleased to respond for the record.

The Changing World Marketplace

Like it or not, the financial services world is changing all around us. In the past several years, thousands of pages of Congressional testimony have recorded these changes.

Today's products were not available yesterday; tomorrow's services are not yet contemplated. Technological advances, enhanced access to information, and growing customer sophistication have combined to create a demand for new products and services deliverable on a local, national, and international scale. (For example, the Treasury STRIPS ("Separate Trading of Registered Interest and Principal of Securities") program has reduced the cost to the government of financing the public debt by facilitating competitive private market initiatives with a minimum of direct government involvement.) Near perfect substitutes for traditional banking products found their genesis in powerful economic forces (such as accelerating inflation) and in statutory restrictions dating back to a time few of us really remember. Many U.S. firms fund themselves just as efficiently overseas as they do in this country and even some government-sponsored entities (such as the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and the Federal Home Loan Bank System) have sold securities in foreign markets.

It was not all that long ago, for example, when the major problem facing all of our depository institutions was that of maintaining a stable source of funds throughout the interest rate cycle. You might remember that it was quite common in the 1970s to have periodic credit crunches brought on by inflationary binges and the "disintermediation" of funds during the high side of the interest rate cycle. Savers simply withdrew their savings from government regulated accounts at depository institutions in favor of new market rate accounts (most notably money market mutual funds) at other financial intermediaries that in large measure were driven by rapidly advancing computer and communication capabilities. After extended and contentious debate, this problem was ultimately resolved in favor of consumers when Congress authorized the phase-out of deposit interest rate controls. Rate decontrol, in conjunction with other innovations (such as money market deposit accounts and interest-bearing transaction accounts) on the liability side of the ledger have given bank managements the flexibility to fund their institutions effectively and efficiently throughout the interest rate cycle.

The public interest has not been served by the strait jacket that in many cases restrains our depository institutions on the asset side from competing head on with other providers of financial services. The most obvious and easily understood example and challenge to traditional commercial banking operations has been the tremendous growth in the commercial paper market as a close substitute for bank commercial and industrial (C&I) loans. Other less regulated financial intermediaries have moved swiftly into the commercial lending field. As the Chairman of the Board of Governors of the Federal Reserve System recently testified, the commercial paper market has more than doubled since 1980, rising from $31 billion to $78 billion as of mid-year 1987. What is even more astounding is the high degree of concentration found in these protected markets. According to Federal Reserve data, about 94 percent of all dealer-placed commercial paper outstanding as of October 1986 had been placed by five large nonbank dealers. Clearly, the public interest would be served by increased competition and safety is enhanced by diversification.

Perhaps the single most important trend today is that of the securitization of a wide range of bank assets. Securitization originated in the 1970s under government auspices as a way to bring new funding to the housing market. Since then, the growth of securitized mortgages has been nothing short of phenomenal. For example, recent Congressional testimony established that as recently as 1980 the volume of mortgage pass- through issuance amounted to about $23 billion; in 1986 that volume had increased by over eleven-fold to about $263 billion. Indeed, over half of all mortgages originated are now securitized in one way or another.

What has taken place in terms of mortgages is even now spreading to other types of assets -- with the potential to increase an institution's liquidity and enhance credit availability for consumers. Automobile loans, consumer loans, credit card receivables, mobile home loans, and commercial loans -- in addition to mortgages -- are now candidates for securitization. If banking organizations are prevented from competing in this emerging area, then their less-regulated competitors will simply move to establish direct funding relationships with the ultimate borrowers, circumventing the banks entirely.

As markets develop and improved risk management is required, both diversification and securitization of traditional bank assets will play an ever increasing role in prudent financial management. Some institutions, particularly smaller banks, may choose to act as originators, servicers, and distributors of new securitized assets, while other, larger institutions may wish to engage in the full securitization process, including packaging and underwriting of these bank portfolio derivatives. Such developments will increase liquidity and should increase the ability to manage the risks of portfolio lending; this trend will encourage safety and soundness over the long run and ought to be encouraged by Congress.

Moreover, states are continuing to respond to local market demands more quickly than the federal government. State initiatives have become an important source of some of the new products and consumer services offered by state-chartered commercial banking organizations. A Federal Deposit Insurance Corporation (FDIC) survey shows that as of April 8, 1987:

-- 11 states authorized direct investment in equities;

-- 13 states authorized underwriting of municipal revenue bonds; and

-- 12 states authorized full service brokerage, and 35 states permitted discount brokerage.

The experience of these states is noteworthy for the lack of problems to date. To the best of our knowledge, not a single incident has been documented where these activities of state-chartered institutions have raised safety and soundness concerns for either the state regulators or the FDIC.

Finally, if editorial opinion is any indication of public sentiment, then most Americans believe that our nation's banks are hamstrung by archaic laws. Dozens of newspapers across the country have called on Congress recently to modernize our financial system and permit our financial institutions to compete. These editorials have not only appeared in the larger cities of New York, Chicago, Detroit, Dallas, Cleveland, Los Angeles, and Washington, but have also surfaced in Oakland, San Antonio, Madison, San Jose, Norfolk, and elsewhere. One Pittsburgh paper, for example, contended that "the Glass-Steagall Act of 1933 is a fossil that is seriously hampering the efficiency of the entire financial services sector -- and, indirectly, the American economy."

Modernization is not an academic discussion lost on the public at large. To the contrary, the public has expressed its vital interest in both new products (as witnessed by the explosive growth of new transaction and savings accounts and creative mortgage instruments) and new providers who offer convenient access to innovative financial services. We simply cannot be satisfied with the status quo or we risk the stagnation of a sector of our economy that not only plays a critical financial intermediation role but also is necessary for our continued economic growth.

A First Step Toward Comprehensive Restructuring

The need to modernize our financial services industry has spawned a large number of reform proposals that are worthy of serious consideration. Some would shift from Congress to the regulators or the states the authority to decide which products and services banks and other financial institutions could provide to consumers. Others focus instead on the structure used by financial services firms to conduct new activities to better serve consumers.

These various reform proposals* -- including both the Financial Modernization Act of 1987 and the Financial Services Oversight Act -- share several common elements, although they differ in structure and the degree of change advocated. All seek to promote greater competition in the delivery of financial services. All seek benefits from this new competition for the end users -- consumers, business, and government. All contain safeguards to prevent unfair competition and conflicts of interest, and all provide for extensive supervisory oversight.

These proposals are timely and thought-provoking. They demonstrate clearly that the Congress has a wide range of alternatives before it. It is interesting to note that many of these proposals rely on the holding company structure proposed by the Administration in 1982 as the primary vehicle for expanding products and services through separately capitalized affiliates.

One of the most striking features in most of these reform proposals is the recommendation that the dated, artificial restrictions between commercial and investment banking ought to be reduced or even eliminated. This common thread is clearly

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FOOTNOTE:

See also, for example: S. 60, "Financial Services Competitive Enhancement Act of 1987," introduced by Senator Garn; H.R. 3209, "Consumer Services Bank Act of 1987," introduced by Representative La Falce; H.R. 3063, "Dual Banking System Enhancement and Financial Services Competitiveness Act," introduced by Representative Carper; and H.R. 3360, "Financial Services Holding Company Act of 1988," introduced by Representative Dreier. Other proposals have been advanced: "Financial Market Structure: A Longer View," by E. Gerald Corrigan, President, Federal Reserve Bank of New York (January 1987); Federal Deposit Insurance Corporation, "Mandate for Change: Restructuring the Banking Industry," (October 1987); and "Modernization of the Financial Services Industry: A Plan for Capital Mobility within a Framework of Safe and Sound Banking," Committee on Government Operations, U.S. House of Representatives (September 1987).

recognized in the Financial Modernization Act of 1987. Amending the Banking Act of 1933 -- the so-called Glass-Steagall Act -- is the proper first legislative step.

We are all aware of the reformation of financial markets around the world, as illustrated by the Big Bang in London last year, and extending to Canada, Japan, and this country as institutions struggle to follow and finance their customers wherever they may operate. The name of the game is customer service. For most American industries, satisfying the consumer has always been the bottom line, but banking organizations have not always been able to keep pace with the financial needs of their customers. As a reaction to the Great Depression, Congress imposed rules that tried to achieve stability at the expense of service. These rules may have been well intentioned -- they even restored financial confidence for a time -- but the Glass-Steagall prescription did nothing to cure the larger economic ills that forced the closing of over 7,000 banks. Rather, it was the creation of federal deposit insurance, the establishment of the Securities and Exchange Commission, and lessons learned by Federal Reserve experience that advanced financial stability. In retrospect all that some of these rules did was protect various segments of the financial industry from competition -- and they offered little incentive to better serve consumers.

As I mentioned earlier, new technology, the inflation of the 1970s, and new competition have changed the marketplace. Too often, our vision of better consumer service ignores such change and gets lost in the thicket of debate on whether or not to preserve one industry's domain over a certain kind of service. Too often, we end up debating the relevance of fifty year old laws for a time gone by, instead of focusing on current and future service to consumers.

I believe we need to change our focus -- toward consumer service and away from interest group protection. Yes, we must always be concerned with safety and soundness. But that concern need not mean that anti-competitive behavior must remain entrenched forever. We must recognize that the 1930s legislative framework is itself unsafe and unstable in the new world marketplace: it sacrifices fair competition -- particularly in products and services -- for the deceptive nostalgia of an era long since gone. The financial institutions that once may have benefitted from 1930s restrictions are now hindered by them -- with potentially dangerous consequences for the future if they are not permitted to keep pace with ever-changing business needs and consumer demands.

Our mutual focus must be on the needs of consumers -- and not on the self-serving pleas of special interests seeking government's help to thwart competition. For the ten reasons I will outline below, the Administration supports modernizing the Banking Act of 1933 to permit the affiliation of commercial and investment banking subject, of course, to the watchful eye of the proper supervisory agencies.

Glass-Steagall Reform

1. Competition is enhanced and concentration is avoided.

The Glass-Steagall Act is essentially protectionist legislation, and in the long run artificial economic barriers do more harm than good. Competition is a prerequisite not only for the advancement of economic well-being in our society but also for safety and soundness in the long run. We urge the Committee to focus on the public benefits to be gained from fair and open competition between commercial and investment banks.

Consider the following data about the degree of concentration in the investment banking industry:

- In 1986 five securities firms managed 69 percent of the dollar total of all underwritten public debt offerings, and five firms managed 95 percent of all public offerings in which the securities firm acted only as agent.

- In 1986 five securities firms managed 47 percent of the dollar total of all underwritten public offerings of common and preferred stock, and five firms managed 26 percent of equity offerings in which the firm acted only as agent.

- In 1986 five securities firms managed 41 percent of the dollar total of all underwritten municipal revenue bonds.

- In the first half of 1987 five securities firms managed 99.9 percent of the dollar total of all underwritten asset-backed securities.

- In 1985 the top five mutual fund complexes in each group managed 60 percent of taxable money market funds, 81 percent of U.S. Government or repo money market funds, 59 percent of tax exempt (non-money market) securities funds, 53 percent of U.S. Government (non-money market) securities funds, 54 percent of corporate equity funds, 46 percent of corporate debt funds, and 60 percent of foreign securities funds.

Similar facts about this highly concentrated industry were recently compiled in an excellent study by the House Government Operations Committee. I urge you to review that Committee's findings for yourselves.

2. Consumers benefit.

Businesses, municipalities, consumers and the economy as a whole would benefit substantially from enhanced competition between the commercial banking and the securities industries. There would be a greater variety of products, more convenience and lower costs. For example, in recent testimony before the Senate Banking Committee, associations of ultimate users, the National Governors Association and the National League of Cities, strongly supported allowing commercial banking organizations to underwrite municipal revenue bonds. The enhanced underwriting competition would decrease the costs of issuance, increase the market for these bonds, and provide significant savings to state and local governments. Indeed, a review by NYU Professor William Silber of 12 studies by nine different research teams concluded that increased competition from banks and bank holding companies would result in savings to state and local governments of between 6.7 and 13.3 basis points. While only a rough calculation, 10 basis points on approximately $108 billion of new issue revenue bonds in 1986 would have saved state and local governments $108 million in interest costs that year. This conclusion is consistent with estimates of a 5 to 10 basis point differential made by the Government Finance Officers Association, according to testimony of the National Governors Association.

Similarly, the National Association of Realtors, the Mortgage Bankers Association, and the National Association of Home Builders strongly supported commercial bank underwriting and dealing in mortgage-backed securities as a means of lowering the cost of housing finance. The trend toward securitization, they have testified, is indispensable to growth in the housing market, which depends on reliable availability of mortgage capital. Moreover, this trend has the additional salutary effect of increasing private sector participation in a market largely dominated by federal agencies.

Consumers of all income levels and types should benefit as well. More investment opportunities should be available to consumers as banking organizations of all sizes offer more -- and hopefully more efficient and beneficial -- products and services. Take discount brokerage, for example. My impression is that consumers have in fact benefitted from having depository institutions in this line of business, recent market events notwithstanding. The ability of banks to organize, sponsor and sell mutual funds is another example of how "ordinary" consumers in every community in this country could benefit by having more investment opportunities available. As we have seen, most mutual funds have fared well and remained stable during recent weeks. Similarly, business consumers stand to gain from lower borrowing costs if banking organizations can underwrite commercial paper more cheaply than by making traditional commercial loans. These are the kinds of new opportunities for consumers that Congress cannot afford to ignore.

Absolute prohibitions ought to be avoided when there are overriding public benefits to be gained and any abuses can be managed adequately by targeted regulation and supervision. Assuming proper disclosure and safeguards against tie-ins and conflicts of interest, Glass-Steagall reform clearly would be pro-consumer and pro-competitive.

3. Risk is diversified.

Reforming the Glass-Steagall Act would enable banking organizations to diversify their earnings, attract new capital, and better meet the needs of their customers. Thus, it would be consistent with good business practice. Underwriting and dealing in securities could substantially reduce risk to the bank for two reasons. First, studies have shown that securities underwriting is no more risky -- and probably less risky -- than commercial lending. Second, studies also have shown that when securities underwriting is combined with commercial lending, overall earnings variability is reduced because of the negative earnings correlation between the two activities. Furthermore, by attracting new capital and enhancing the value of the franchise and by stemming the erosion of assets, banks will be in a stronger position to meet the challenges of the future.

4. Basic safeguards already are in place today.

Numerous structural safeguards -- such as the Federal Deposit Insurance Corporation and the Securities and Exchange Commission -- have been instituted since the problems of the 1930s. Federal oversight of banking organizations has been greatly strengthened to promote safety and soundness. Moreover, many other safeguards to protect against risk, avoid conflict of interest abuses such as tie-ins, and promote fair competition already are in place.

For example, the FDIC requires nonmember banks to conduct securities underwriting activities (authorized by state law) only in *bona fide* subsidiaries designed to avoid safety and soundness problems and other concerns. Sections 23A and the new 23B of the Federal Reserve Act (Sec. 102 of the Competitive Equality Banking Act of 1987) impose restrictions on transactions and require arms-length transactions between insured depositories and their affiliates to promote fair competition, avoid conflicts of interest, and prevent undue risk. These existing requirements create a system of regulation that makes a complete separation unnecessary in today's modern world. A more complete listing of existing safeguards is attached as Appendix A.

Members should readily agree with us on the need to conduct these new activities in separately and adequately capitalized entities as a prerequisite for properly insulating the bank. We should be frank in recognizing the facts of today's marketplace: margins are often thin, volatility is an everyday occurrence, and capital hits can and should be expected from time to time.

Events of the past few weeks have underscored the need for sufficient capital to withstand market risk, a point I highlighted in a recent article. One of my major points is worth repeating for this Committee:

> "Capital enables firms to offer services at competitive fees and to absorb losses from risks inherent in volatile markets....American companies also need more capital to increase their margin for error -- to make them safer....The Treasury believes that American companies will have to increase their capital bases to compete in world markets."

In the final analysis, adequate capital can and should serve as a protective buffer to the federal safety net, particularly when we require both banks <u>and</u> their securities affiliates to observe separate capital requirements for separate operating entities. Ensuring that sufficient capital exists also achieves two other important objectives: stockholders have their own funds at risk up front and the markets themselves can exert a degree of discipline when an institution needs to raise capital.

One additional deterrent Congress may wish to consider to ensure the proper insulation of an insured institution is to increase the sanctions for violations of the norms for conducting new activities. If penalties were to be increased beyond the $1,000 per day civil money penalty for violating interaffiliate restrictions and the cost were both high enough and certain, then violations would be minimized. As you know there is recent precedent for increasing such sanctions in the area of money laundering; sanctions against interaffiliate transactions ought to be at least commensurate with those which exist for illegally laundering money through financial institutions.

5. Banks already engage in many securities activities.

The exercise of full domestic securities powers by bank affiliates is a logical extension of the existing activities of commercial banks. Banks are major players in underwriting and dealing in U.S. Government securities and municipal general obligation bonds. In recent years banks have been active as discount brokers.

Commercial banks today are permitted to underwrite and distribute obligations of the World Bank for economic development in third world countries, but they are largely precluded from underwriting and dealing in bonds for local economic development efforts in this country. Banks can underwrite the general obligation bonds of states or their political subdivisions, but they cannot underwrite securities backed by a non-tax revenue stream such as tolls or other fees. They can underwrite and deal in the full range of corporate securities abroad, but cannot compete for the long-term capital needs of American companies at home. Finally, banks can underwrite bonds to support public housing and dormitories for our students, but they are precluded from underwriting mortgage-backed securities to help finance housing for middle-income Americans.

All of these existing operations have been profitable segments of bank business and have never been the cause of a bank failure in modern times. The addition of a full range of new securities powers in the domestic product line will fill a service void left vacant largely for protectionist, rather than for real economic or safety and soundness, reasons.

6. Innovation and opportunity would be enhanced.

Reform of the Glass-Steagall Act will allow banking organizations to offer additional financial services and products to businesses that were formerly offered only by securities firms. It will also permit banks to be innovative in providing new products and services based on their understanding of the market.

Conversely, by affiliating with commercial banks, securities firms will be able to create and expand the types of financing they can offer businesses. They too will be able to offer innovations based on their perspective of the market. For businesses, there will be more financial service vendors. This should mean more favorable prices and better, more diverse products and services. The greater number of financial firms and the resulting increase in competition should focus more attention on small and specialty businesses and other niches in the market that received less attention in a less competitive environment. The resulting efficiencies would benefit the corporate and household consumers of financial services, while a less volatile stream of income across the combined entities should contribute to the stability of financial markets. Hence, Glass-Steagall reform should have a positive effect on all types of economic activity, not just on the financial services sector. Both that sector and the economy in general should be stimulated by the new, more competitive market.

7. Glass-Steagall reform is consistent with both safety and soundness and insulating a bank from its affiliates.

This Administration has gone to great lengths not to extend federal guarantees -- and expose taxpayers -- unnecessarily. We see no need to extend the federal safety net further into the financial area. We should permit the affiliation of commercial and investment banks. We have insulated insured banks to protect depositors and taxpayers, and we will continue to do so.

The federal bank regulators unanimously have endorsed reform of the Glass-Steagall Act. They believe that banks through separate entities can undertake a full range of securities activities without any threat to the safety and soundness of the banking system.

Conducting new securities activities in a separately capitalized affiliate would insulate these activities from those of the federally-insured bank. The regulators believe that appropriate barriers between the bank and the securities affiliate can fully insulate the bank from financial problems of an affiliate. Moreover, the regulators want a successful separation of bank and securities affiliates to make Glass-Steagall reform both safe and workable. There should be no reason for securities activities (or any other new business) to impose upon the federal safety net.

8. Financial services conducted safely overseas could now be done in the United States.

Reform of the Glass-Steagall Act would permit banks through separately capitalized affiliates to engage in all types of securities activities. They will finally be able to conduct domestically the broad based securities business they have long conducted overseas. American banks will thus be more competitive with their foreign counterparts who, particularly in Europe, have been able to conduct securities business at home and abroad.

American banks will be able to provide international businesses -- American and foreign -- with a greater range of financial products and services.

A number of European banks have been able to engage in both the securities and banking business in the United States since they arrived here. In 1978 many of the foreign banks had their securities activities grandfathered under the International Banking Act; they have continued those activities without any safety and soundness threats. Now domestic banks will be able to meet this foreign competition at home. Since the United States is the largest banking and securities market in the world, the ability of domestic and foreign banks and securities firms to compete here effectively should be a big boost for better financial services and continued economic growth.

U.S. banking organizations already are involved in a wide range of securities activities in major overseas markets. To restrict these organizations from engaging in comparable securities activities in the domestic markets can only lead to the eventual erosion of the primacy of U.S. capital markets and the consequent decline in employment, income and other economic benefits that accrue to the United States therefrom. Glass-Steagall reform would make such a migration of business or employment opportunities unnecessary.

9. Greater securitization is facilitated.

A major trend in financial markets currently is that of securitization of assets, a phenomenon driven by the advent of modern computer technology, telecommunications, and consumer sophistication. The initial securitization of mortgages has now been joined by the securitization of auto loans, personal loans, credit card receivables, mobile home paper, commercial paper, and others. The ability to securitize assets and distribute those securities in the financial marketplace permits direct funding by the ultimate creditors, largely circumventing the traditional funds intermediation and loan warehousing role of banks.

Glass-Steagall reform would allow banks to capitalize on their existing expertise to compete in all aspects of securitization, thereby offsetting any decline in profits attributable to diminishing loan volumes.

10. Competitive equity is promoted.

The failure to modernize Glass-Steagall could seriously undermine the principle of competitive equity between different classes of banking organizations. Just recently, the Supreme

Court upheld the right of states to authorize the full range of securities activities for state-chartered nonmember banks. Unless Glass-Steagall is overhauled, member banks will continue to be prohibited from engaging in significant securities activities, leaving them competitively disadvantaged. A situation of this type can also be expected to result in some erosion of membership in the Federal Reserve System as some state-chartered member banks leave the System, and some national banks switch to state-chartered nonmember status, to take advantage of securities activities. This situation can be avoided by amending Glass-Steagall and providing for competitive equity.

As the Committee continues its debate and advances legislation, I respectfully want to suggest a number of guiding principles that ought to serve as the foundation for your deliberations.

- o First and foremost, insured depositors ought to be protected: we need to preserve the option for safe savings instruments for small savers.

- o Second, the federal safety net should not be extended beyond insured depository institutions; securities affiliates ought to be viewed legally, publicly, and financially as separate units for safety and soundness reasons.

- o Third, the functional regulation that characterizes our financial system should be preserved and expanded; thus, depository institutions will be regulated by federal and state banking agencies while securities affiliates will be regulated by the SEC and state securities administrators.

- o Finally, the historic right of states to authorize activities for their state-chartered institutions is another principle worth maintaining and should not be pre-empted lightly to enforce a single national rule; certain national prescriptions may be appropriate for the conduct of new activities but we should acknowledge the real benefits such as product innovation and the provision of greater consumer service that flow from our dual banking system.

<u>The Financial Modernization Act of 1987</u>

The Administration applauds your yeoman efforts, Mr. Chairman, to work with us, Senator Garn and the federal bank regulators to craft legislation that truly serves the public interest. The Financial Modernization Act is worthy of strong bipartisan support and is the appropriate first step for Congress to take. Not only is it pro-competitive and pro-consumer, as I indicated at the outset, but it also adheres to high standards of safety and soundness which both the Administration and Congress share.

The fundamental structure of the Financial Modernization Act can be traced to the Administration's first proposal to modernize our banking laws through a holding company format and to the legislation which Senator Garn, with your support, spearheaded through the Senate in 1984. Many of the safeguards we suggested then and now have been incorporated and, in some important instances, enhanced in this legislation.

Title I amends Sections 20 and 32 of the Glass-Steagall Act to permit the affiliation of commercial and investment banking in a holding company structure. Commercial banking organizations would be allowed to have a securities affiliate and a holding company that is 80 percent in the securities business would be able to acquire a commercial bank. As the Committee knows, many securities firms today are affiliated with banks and are grandfathered under both CEBA and this legislation. New securities affiliates are required to be separately capitalized and that capital would not be counted as part of the bank's required capital. This provision should go a long way toward alleviating concerns about increased risk from engaging in new activities, assuming of course that capital requirements established by the regulators are sufficient. Entry into new securities activities would be monitored closely by the regulators, with both the SEC and the Board of Governors playing a major role to assure that firms have the requisite managerial talent and necessary financial strength.

Title I also prohibits the merger of the 15 largest bank holding companies with the 15 largest securities firms as measured by asset size. Existing laws (such as the anti-trust statutes and the Federal Reserve's authority under the Bank Holding Company Act), the degree of competition today, and existing market structure make this provision largely unnecessary and would create an undesirable and arbitrary precedent.

Numerous consumer and safety and soundness safeguards are contained in S. 1886 as well to assure a financial marketplace that is both efficient and safe. Because of these safeguards, the federal safety net should in no way be jeopardized and, because of the holding company format and the use of separately capitalized affiliates, clearly is not expanded. The testimony you will receive from the federal bank regulators will concur in this judgment.

Full and proper disclosure is an important safeguard in the bill. Securities affiliates, for example, must disclose to consumers that their obligations are in no way backed by their affiliate bank or insured by the FDIC, a major part of the federal safety net I have mentioned. Similarly, a bank cannot express an opinion on securities being sold by its securities affiliate without disclosing that its affiliate is selling that security. In short, proper disclosure is a key element in consumer protection in this area.

Lending between a bank and its securities affiliates is also prohibited as a general rule, with an exception for fully secured intra-day loans for the purpose of clearing government securities. While many observers can argue that the existing safeguards contained in Sections 23A and B of the Federal Reserve Act are sufficient to control lending between a bank and a securities affiliate, it can be argued that the requirements of the bill would reduce risk and prevent conflicts of interest in the credit granting role that banks perform.

Moreover, the securities affiliate cannot sell securities to the bank or its trust accounts during the underwriting period or for 30 days thereafter. Similarly, the securities affiliate cannot otherwise sell securities to the bank or its trust accounts unless the sale is at an established market price. Thus, there are additional checks on any potential conflicts of interest, real or otherwise.

One area where we do have reservations is in the area of federalism and states' rights. Sec. 107 in effect removes the exemption from the Glass-Steagall Act for subsidiaries of free-standing state-chartered, nonmember banks, an exemption recently affirmed by the Supreme Court. While other provisions in the bill are designed to ease the formation of holding companies by smaller institutions and grandfather affiliations prior to March 5, 1987, we still strongly believe that a federal preemption is unnecessary, particularly since no safety or soundness complaints have been raised and since such activity today is *de minimis* and subject to supervision by both the SEC and the FDIC under operating principles not dissimilar from those contained in the legislation. We would be pleased to work with the Committee on a solution to this issue that is consistent with the important federalism principles enunciated by the President when he issued Executive Order 12612 on October 26, 1987.

In summary, Mr. Chairman, we support the thoughtful, progressive approach that you and Senator Garn have forged in S. 1886. It is timely and carefully crafted to promote competition -- and thus consumer benefits -- while assuring that proper regulatory safeguards are in place to protect individual depositors and the public at large. I urge all of your colleagues on the Committee to lend their support to our mutual efforts to modernize the nation's banking laws.

Conclusion

These hearings are the Committee's first step to fulfill the intent of Congress (as contained in Sec. 203 of the Competitive Equality Banking Act of 1987, Public Law 100-86) to conduct a comprehensive review of our banking and financial laws in light of the changing world marketplace. The Administration applauds the Committee's efforts.

Congress also clearly stated its intent in the Competitive Equality Banking Act not to extend or renew the moratorium on new banking products and services which expires next March. Your assurances, Mr. Chairman, and those of Senator Garn, the seven signers who joined you in signing the additional views in the Senate Banking Committee Report that accompanied CEBA, and the statements of others are encouraging and certainly appreciated by the Administration. This moratorium was designed to bring the various players in the financial services arena to the table to discuss a comprehensive reform of our banking statutes. Although we did not see the necessity for such a moratorium, we genuinely welcome the dialogue that it has fostered.

Ever since this Administration came into office, we have urged Congress to conduct a major overhaul of our financial laws by breaking down outdated, protectionist provisions to better serve consumers and business alike. As President Reagan indicated in August, his willingness to sign the FSLIC recapitalization legislation was based in part on Congress' statement not to renew the moratorium, whether or not subsequent legislation is passed by Congress. An extension of the moratorium would fly in the face of needed reform and prohibit our financial institutions from becoming more competitive.

In closing, we have said before that it is time for a change. The United States needs to modernize its banking laws and to reassert itself at the leading edge of the financial services world. We have the talent, the ability, and the motivation to do it. We certainly have compelling reason to do it to have our financial institutions be competitive, both here at home and overseas.

If our nation's financial institutions cannot evolve to meet consumer demand and global competition, then the term "counting house" industry may become an epitaph like "smoke stack" or "rust bowl." This trend is still hard for many to accept, but it is real nonetheless. If Congress applies the protectionist model by trying to repair the crumbling walls of financial oligopolies, the marketplace, technology and consumer tastes will move beyond -- and abroad. The victim will be one more U.S. industry that would not -- or in this case -- could not evolve to meet today's global competition.

On behalf of Treasury Secretary James Baker and our team at Treasury, we stand ready to assist you in any way that we can in your endeavor to modernize our nation's financial system and better serve consumers in this country.

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Existing Safeguards for Regulating Bank Transactions with Affiliates

Existing Safeguards

1. Affiliate Transactions Already Restricted

Section 23A of the Federal Reserve Act (12 U.S.C. 371c) restricts transactions between federally-insured banks and their affiliates. (Section 23A does not extend to direct nonbank subsidiaries of banks, however, unless the Federal Reserve Board determines on a case-by-case basis that such subsidiaries should be covered by the restrictions of Section 23A.) It provides that "covered transactions" with a single affiliate must be restricted to no more than 10 percent of the bank's capital and surplus, and with all affiliates to no more than 20 percent. Covered transactions include:

-- loans or extensions of credit to an affiliate;

-- the purchase of or investment in securities issued by an affiliate;

-- the purchase of assets from an affiliate (unless specifically exempted by the Federal Reserve Board);

-- the acceptance of securities issued by an affiliate as collateral for a loan to any person or company; and

-- the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

All covered transactions must be on terms consistent with safe and sound banking principles and are supervised by the banking agencies. Additionally, all loans, guarantees, acceptances, and letters of credit on behalf of an affiliate must be collateralized between 100 and 130 percent.

2. Arm's Length Transactions Required

A. Restrictions on Transactions with Affiliates

New Section 23B of the Federal Reserve Act (Section 102(a) of the Competitive Equality Banking Act, P.L. 100-86) imposes additional conditions on transactions between federally-insured banks and some of their affiliates. Specifically, an insured bank may engage in certain transactions with an affiliate only if

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Source: U.S. Treasury Department, Office of Financial Institutions Policy, October 30, 1987 the terms and conditions of the transaction, including credit standards, are substantially the same as, or at least as favorable to the bank as, those prevailing at the time for comparable transactions with unaffiliated companies (i.e., arm's-length transactions). Transactions covered by Section 23B include:

-- any loan or extension of credit to an affiliate;

-- investments in securities issued by an affiliate;

-- purchases of assets of an affiliate (including agreements to repurchase);

-- acceptance of securities issued by an affiliate as collateral for a loan to any person or company;

-- issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate;

-- sales of securities or assets to an affiliate (including assets subject to an agreement to repurchase);

-- payment of money, or the furnishing of services to an affiliate under contract, lease, or other circumstances;

-- any transaction in which an affiliate acts as an agent or broker, or receives a fee for its services to the bank or any other person; and

-- any transaction or series of transactions with a third party, if an affiliate has a financial interest in the third party, or if an affiliate is a participant in such transaction.

B. <u>Banks Not Responsible for Obligations of Affiliates</u>

New Section 23B also prohibits a bank, or any subsidiary or affiliate, from agreeing, or indicating in any way, that the bank is responsible for the obligations of its affiliates.

C. <u>Banks' Fiduciary Responsibility Protected</u>

Section 23B also prohibits a bank from purchasing as fiduciary any securities or other assets from any affiliate (unless specifically permitted by court order or appropriate law). In addition, a bank, while acting as a principal or fiduciary, is prohibited from knowingly purchasing or acquiring (during the existence of any underwriting or selling syndicate) any obligation for which an affiliate of the bank is a principal underwriter, unless approved by a majority of the outside directors prior to the time at which it is initially offered for sale to the public.

3. Reports Currently Required on Bank Transactions with Affiliates

National banks are required to file with the Office of the Comptroller of the Currency (OCC) four times a year reports that disclose fully the relations between a bank and its affiliates (12 U.S.C. 161). Such reports must be verified by the oath or affirmation of each affiliate's president or other designated officer. State member banks are required to file identical reports with the Federal Reserve Board, except that they file such reports three times a year (12 U.S.C. 334). Any national or state member bank that fails to furnish the required reports on its affiliates is subject to a penalty of $100 for each day the violation continues.

4. Limitations on Loans to Individual Borrowers

The extension of credit by national banks to any one borrower is limited by the National Bank Act (12 U.S.C. 84) to no more than 15 percent of unimpaired capital and surplus. Loans secured by readily marketable collateral are permitted up to an additional 10 percent.

5. Loans to Officers, Directors, and Shareholders

The extension of credit by an insured bank to officials of that bank or officials of its affiliates is restricted by the Federal Reserve Act (12 U.S.C. 375(a) and (b)). Specifically, bank loans to the executive officers, directors, principal shareholders and related interests of insured banks and their affiliates: (i) must not be preferential or present abnormal risk of repayment; (ii) must be approved by a disinterested majority of the bank's board; and (iii) generally cannot exceed the 12 U.S.C. 84 loan limit.

6. Limitations on the Purchase of Securities from Directors

The Federal Reserve Act (12 U.S.C. 375) prohibits a member bank from purchasing securities or other property from any bank director unless such purchase is done on an arm's length basis in the regular course of business, or unless a majority of the board of directors of the bank approves such purchase. In a similar manner, a member bank cannot sell securities or other property to any bank director unless such transaction is done on an arm's length basis and in the regular course of business.

7. Restrictions on Dividends

National banks and state member banks must receive regulatory approval before paying, in any calendar year, dividends exceeding the total of that year's net profits combined with the retained net profits of the preceding two years (12 U.S.C. 60). Additionally, no dividends at all may be paid if losses equal or exceed undivided profits, after deducting losses and bad debts (12 U.S.C. 56).

8. Enforcement Remedies

Existing Civil Money Penalties for Violations

Violations of 23A, 23B and other restrictions on transactions are generally punishable by civil money penalties not exceeding $1,000 per day for each day during which violation continues, and may be assessed against any bank, officer, employee or agent responsible for the violation (12 U.S.C. 1972, 12 U.S.C. 93, 12 U.S.C. 504, 12 U.S.C. 1828).

Existing Cease and Desist Authority

The Federal Reserve Board has existing cease and desist authority (12 U.S.C. 1844(e)) to block unsafe and unsound transactions among units of a holding company. The other bank regulators have similar cease and desist authority to block unsafe and unsound transactions by banks under their supervision (12 U.S.C. 1818). This authority allows the regulatory agencies to institute cease-and-desist proceedings against any bank or bank holding company (or its directors, officers, employees, or agents) engaging in unsafe and unsound practices or otherwise violating banking law.

9. Anti-tying Restrictions in Place

The anti-tying provisions of Section 106 of the Bank Holding Company Act (12 U.S.C. 1972) currently prohibit banks from providing services or extending credit to customers subject to the condition that customers obtain additional services from a bank, or its holding company, or affiliates. These restrictions also prohibit a bank from providing a loan or service on the condition that a customer not seek services from a competitor of the bank. Injured persons can sue for and obtain injunctive relief and treble damages in connection with violations of the anti-tying prohibition.

10. FDIC's Bona Fide Subsidiary Protections

The bona fide subsidiary provisions of the Federal Deposit Insurance Corporation (FDIC) (12 C.F.R. 337.4) currently permit state chartered nonmember banks to engage in a full range of securities activities via a bank subsidiary or affiliate, provided the activities are authorized under state law. The conditions to be met for the establishment of a "bona fide" subsidiary include the following:

-- adequate capitalization;

-- separation of accounting and other corporate records;

-- observance of separate formalities such as holding of separate board of directors' meetings;

-- no sharing of common officers with the bank;

-- maintenance of separate employees who are compensated by the subsidiary;

-- having a majority of directors that are neither officers nor directors of the bank; and

-- conducting business pursuant to policies and procedures independent from the bank so as to assure customers that the bank and the subsidiary are separate organizations (including clear disclosure that the obligations of the subsidiary are not obligations of the bank).

There is no restriction on the types of securities that can be underwritten if: (1) the securities business, whether de novo or by acquisition, has been in continuous operation for five years; (2) it is in good standing with the National Association of Securities Dealers (NASD); (3) its insiders have not been convicted within five years of securities-related crimes or subject to injunction or Securities and Exchange Commission (SEC) order; and (4) each of its supervisors has five years of experience. Otherwise, underwriting is limited to investment quality debt and equity, shares of mutual funds that invest exclusively in investment quality debt and equity, and shares of money market mutual funds.

Other safeguards for the establishment and operation of a bona fide subsidiary include:

-- the requirement that the FDIC be given sixty days notice of intent to establish or acquire a securities subsidiary;

-- restrictions on the extension of credit to a securities subsidiary or affiliate (Section 23A) or to companies the securities of which are to be underwritten by the subsidiary;

-- prohibiting a bank from purchasing any security currently being underwritten by a subsidiary or affiliate unless expressly authorized by trust agreement, court order, or local law; and

-- prohibiting the parent bank from counting its investment in the sudsidiary as a part of the bank's capital.

11. Existing Application Requirements Under the Bank Holding Company Act (BHCA)

The application process (in conjunction with subsequent examination, supervision and regulation) constitutes another means by which banks in a holding company are insulated from the nonbank activities of affiliates. In particular, the Federal Reserve, which regulates all nonbank subsidiaries of bank holding companies, is required to:

-- review and approve each and every application to perform a nonbanking activity other than those specifically authorized by statute;

-- examine the bank holding company and the subsidiary performing the nonbank activity;

-- terminate the holding company's permission to engage in any activity that is judged to threaten the safety, soundness, or stability of the holding company's bank or banks; and

-- enforce the restrictions of Sections 23A and 23B.

Applications to engage in a nonbanking activity are subject to the prior approval of the Federal Reserve under Section 4(c)(8) of the BHCA. The approval process requires that:

-- the applicant apply to the Federal Reserve, and publish notice in a local newspaper, of the proposed activity; and

-- notice of the application be published in the *Federal Register* for public comments with an opportunity for a hearing should a protest be registered.

12. Application Requirements for Bank Activities

Typically, the regulatory agencies require prior notice and opportunity to disapprove those activities to be conducted in bank subsidiaries and can examine the entity performing the activity as well as terminate any activity deemed to endanger the safety and soundness of the bank.

13. Federal Securities Disclosure and Anti-Fraud Requirements

The federal securities laws variously require SEC registration of publicly-offered securities, periodic reporting by public issuers, and registration of securities industry professionals (including broker-dealers and investment advisers), and compliance with net capital, customer protection, and other regulations. These laws (and implementing SEC regulations) prohibit manipulative and deceptive acts and practices by any person in connection with securities transactions.

Banks are exempted from many of the federal securities registration and regulatory requirements, but publicly owned banks are subject to disclosure requirements. However, bank holding companies, affiliates and subsidiaries generally are not exempt from federal securities law requirements. All banks and their affiliates are subject to the anti-fraud provisions of the federal securities laws.

14. Capital Adequacy

The federal bank regulators currently have the authority to establish through administrative action the minimum capital required of banking institutions (currently 6 percent of assets). Capital requirements can be changed on a case-by-case basis or for an entire class of banks as determined by the regulators. The International Lending Supervision Act (12 U.S.C. 3907) authorizes the banking agencies to direct particular institutions to increase capital.

15. General Rulemaking Authority

In addition to the above safeguards, the banking agencies have general rulemaking authority (e.g., 12 U.S.C. 93a) which is used to provide appropriate safeguards for banks and depositors. The banking regulators can use these existing statutory authorities for extra protections should the need arise.