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The Honorable Carroll Hubbard
Chairman, Subcommittee on General
Oversight and Investigations
Committee on Banking, Finance
and Urban Affairs
House of Representatives

Dear Mr. Chairman:

This report responds to your July 18, 1989, letter requesting information about certain securities subsidiaries of bank holding companies. These subsidiaries, authorized by the Federal Reserve Board, are commonly called Section 20 subsidiaries. This is a reference to the provisions in Section 20 of the Glass-Steagall Act (12 U.S.C. sec. 377), which permits banks that are members of the Federal Reserve System to be affiliated with firms that are not principally engaged in securities activities generally forbidden to banks themselves.[1] Section 20 subsidiaries can function as investment banks by underwriting (publicly distributing new issues of securities) and as broker-dealers by buying and selling securities for their own accounts or for others.

As you suggested, we met with Committee staff during August and September 1989 to discuss further the scope of our work. We agreed to develop information on activities of Section 20 subsidiaries primarily from agency records, information in the public domain, and meetings with regulatory and industry officials. As a result of our discussions, we identified several issues that Congress and regulators need to address when considering potential modifications to the regulation of Section 20 subsidiaries.

Information on Section 20 companies is contained in eight appendixes to this letter. The first three discuss specific topics raised in your request: (1) market share, pricing, and benefits to the public; (2) risk to the holding company; and (3) the practical impact of the Board's regulatory requirements, called firewalls, on bank holding companies.

[1] This act prohibits member banks from underwriting and dealing in securities other than U.S. Government and general obligation bonds of states and municipalities and certain securities issued or insured by certain specified government agencies or instrumentalities (bank-eligible securities).

The remaining five appendixes present statistics on Section 20 companies, discuss Section 20 company capital and capital adequacy regulations, and review the legal basis for domestic and international securities activities of Section 20 subsidiaries and other bank holding company units.

Background

Except for certain specified securities, mainly government securities, member banks of the Federal Reserve System are prohibited under the 1933 Glass-Steagall Act from engaging directly in securities underwriting. However, under Section 20, member bank affiliates are permitted to participate in otherwise impermissible securities activities so long as the affiliate is not principally engaged in this activity.

In 1987, the Board began approving applications submitted by bank holding companies to allow wholly-owned nonbank subsidiaries to underwrite and deal in certain bank-ineligible securities. A majority of the subsidiaries were already engaged in permissible, or bank-eligible, securities activities such as underwriting and dealing in government bonds. As noted above, the Board determined that the types and levels of activities proposed by the bank holding companies complied with the provisions of the Glass-Steagall Act. The Board also determined that these bank-ineligible securities activities met the requirements in the Bank Holding Company Act of 1956, as amended. This statutory standard requires that two separate tests be met for an activity to be permissible for a bank holding company. First, the Board must determine that the activity is, as a general matter, closely related to banking. Second, the Board must determine that the activity may reasonably be expected to produce public benefits that outweigh possible adverse effects.

In April 1987, in its first action, the Board approved applications submitted by three bank holding companies requesting authority to underwrite and deal in municipal revenue bonds, mortgage-related securities, and commercial paper. Later that year it approved more applications and also added consumer-receivable-related securities, which are securities backed by such assets as credit card receivables or consumer auto loans. The Board placed a limit of 5 percent of a subsidiary's gross revenues on the revenues that could be generated from the bank-ineligible activities. The Board also required these companies to observe a number of prudential limitations, called firewalls, designed to insulate insured bank affiliates from the risks associated with Section 20 subsidiaries' activities by assuring the capital adequacy of the holding company and limiting both transactions and the flow of information between a securities subsidiary and other affiliates of the parent banking organization. (The firewalls are identified in app. VII.)

In January 1989, the Board approved applications by certain bank holding companies to underwrite and deal in corporate debt and equity securities. In doing so, the Board imposed a tighter set of firewall restrictions. (See app. VIII.) The Board also stipulated that holding companies cannot initiate corporate debt and equity underwriting and dealing until the Board has determined that the companies have the necessary managerial and operational infrastructures to ensure compliance with the firewall restrictions. Companies must also submit a satisfactory capital plan that complies with the Board requirements for these activities. Further, the Board placed a 1-year moratorium on equity securities activities. In September 1989, the Board raised the revenue limit for bank-ineligible activities to 10 percent for all Section 20 companies. In January 1990, the Board authorized several foreign banks to operate Section 20 subsidiaries.

Under the Securities Exchange Act of 1934, Section 20 companies must register as broker-dealers. As registered broker-dealers, they are subject to Securities and Exchange Commission (SEC) regulation under the securities laws, must comply with SEC's net capital rules, and must join an SEC-approved industry self-regulatory organization. The Board, as the primary regulator of bank holding companies, enforces the firewall requirements.

Results in Brief

In the third quarter of 1989, the 13 Section 20 firms operating at that time underwrote a total of about $69 billion in bank-ineligible securities, with commercial paper representing about 98 percent of the amount underwritten. The firms accounted for about 2 percent or less of the total market for underwriting municipal revenue bonds, mortgage-backed securities, and asset-backed securities. Comparable market share data are not available for commercial paper.

When activities of Section 20 companies in both bank-eligible and bank-ineligible securities are considered, Section 20 companies accounted for about 7 percent of all revenue realized by SEC-registered securities firms in the second quarter of 1989 (the latest quarter for which the comparison can be made). Section 20 firms also accounted for about 4 percent of total securities industry capital as of June 30, 1989. Ranked by capital, 6 of the top 50 securities firms in the Nation are Section 20 firms.

Section 20 firms have the potential, when their activities are well established and if they operate at the maximum levels authorized by the Board, to make a significant impact on the structure of the securities industry. Also, to date, regulatory officials have found no evidence that any Section 20 firm has damaged the financial condition of a bank or bank holding company. However, the scope of the bank-ineligible activities of Section 20 firms has been limited thus far, as the subsidiaries continue to organize their operations, develop the products and services they plan to offer, and identify the markets they will enter. Accordingly, it is too early to draw conclusions about Section 20 firms' impact on the market, their profitability, their riskiness, or the adequacy of the regulatory system within which they operate.

In general, bank holding company officials that we interviewed thought that the revenue limitation on the activities of Section 20 subsidiaries, as well as many of the firewall provisions, are costly and place unnecessary constraints on their competitiveness in the market. Conversely, securities industry officials said the firewalls are needed to assure fair competition and to prevent Section 20 firms from benefiting from federally insured deposits maintained by their affiliated banks. Board officials said the requirements are meeting the Board's regulatory objectives. These officials also indicated that the Board will consider modifying some of the firewalls after the Section 20 firms have obtained additional operational experience.

In authorizing Section 20 companies to underwrite and deal in bank-ineligible securities, the Board required controls, such as separate corporate identity and regulation by the SEC, that we have previously recommended should be part of any long-term solution to the problem of how banking and securities activities should be linked.[2] However, there are other aspects of Section 20 company regulation, such as the exact purpose of some of the firewalls and their consistency with the regulation of the international activities of U.S. banks, that we believe require additional scrutiny.

Objectives, Scope, and Methodology

In keeping with the request, the principal objective of our work was to identify how the activities of Section 20 firms have affected risk levels in their respective bank holding companies; how these activities have affected the securities industry in terms of market share changes, the pricing of securities, and benefits to the consumer; and how the Board's

[2] Bank Powers: Issues Related to Repeal of the Glass-Steagall Act (GAO/GGD-88-37, Jan. 22, 1988).

firewalls have affected bank holding companies. As requested, we also prepared information on bank holding company finances and the legal basis for securities activities of banking organizations that provides a broader context for discussing the activities of Section 20 companies. In addition, we identified several issues that Congress and regulators need to address when considering potential modifications to the regulation of Section 20 subsidiaries.

Our 1988 report on Glass-Steagall issues said that coming to grips with the question of Glass-Steagall repeal represents an opportunity to systematically address changes in legal and regulatory structures that are needed to better reflect the realities of the financial market place.[3] This report does not represent a comprehensive study of all of the issues associated with amending or repealing the Glass-Steagall Act, nor does it attempt to present conclusions on the way the relationships between banking and securities activities should be structured. In keeping with the nature of the request, we have limited our work to an analysis of the Federal Reserve's actions, taken under existing legislative authority, to allow banking organizations to conduct certain securities activities in separately capitalized bank holding company subsidiaries.

We interviewed officials and reviewed records at the Federal Reserve System, Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), SEC, and the National Association of Securities Dealers, Inc. (NASD) to obtain information on the operations and regulation of Section 20 companies. Our review included financial information from the reports that bank holding companies file with the Federal Reserve (Y-9 report) and information on securities activities and financial data from reports that securities firms file with the SEC (FOCUS reports).

To gain better understanding of both the operation of Section 20 firms and the firewalls, we interviewed officials at six bank holding companies that have established Section 20 subsidiaries and officials from three investment banking firms that compete with Section 20 firms. We also discussed aspects of Section 20 firms with representatives from several regional banking organizations that are considering setting up a Section 20 subsidiary. We interviewed officials from industry trade groups, including the American Bankers Association, Association of Bank Holding Companies, the Bank Capital Markets Association, and the Securities Industry Association.

[3]GAO GGD-88-37, January 22, 1988.

We reviewed industry publications to determine how the activities of Section 20 subsidiaries compare to the total markets in which these firms have been active. Because the information available on these firms was very limited, we asked Section 20 firms authorized as of September 30, 1989, to provide us with information on their underwriting activities. All 21 firms responded.

Because of the limited availability of market data, we also talked with several persons whom we judgmentally determined would have knowledge about the markets in which Section 20 firms operate. This included officials from the Government Finance Officers Association and the Federal National Mortgage Association.

In keeping with the disclosure provisions of the Federal Banking Agency Audit Act, the report contains only information about individual bank holding companies that has previously been disclosed to the public by the firms or by federal agencies.

As requested by the Subcommittee, we obtained comments on our draft report from industry groups as well as federal agencies. The draft was given to them for comment at the end of December 1989.

The Board of Governors provided some technical suggestions and indicated that the Board's staff found the draft to be satisfactory. (See app. IX.) In addition to some technical points, the comments of OCC and SEC raised several issues that are discussed in our letter. The comments of OCC and SEC, along with our views, are also contained in appendixes X and XI, respectively.

We also received written comments from the American Bankers Association, Association of Bank Holding Companies, Bank Capital Markets Association, Coalition for Regional Banks, and the Securities Industry Association. The principal points raised in these comments are discussed in the letter. The comments, along with our views, are also contained in appendixes XII to XVI. The National Association of Securities Dealers, Inc., and the New York Stock Exchange provided informal comments that required no changes to the report.

We did our work from August 1989 through January 1990 using generally accepted government auditing standards.

Principal Findings

As of September 30, 1989, 13 of the 21 bank holding companies with Section 20 subsidiaries had initiated operations involving the newly authorized bank-ineligible securities activities. Six of the 13 Section 20 subsidiaries have been doing bank-ineligible activities less than 1 year. It is therefore too early to assess the significance of Section 20 firms' bank-ineligible securities activities. However, information we have obtained about the activities of the firms, the risks these activities present, and the firewalls adopted to safeguard against those risks does provide insight into the potential market impact of these firms and the issues that require further consideration.

Market Activities of Section 20 Firms

Between the second and third quarters of 1989 the volume of bank-ineligible securities underwritten by Section 20 firms increased from $36.2 billion to $68.7 billion, or about 90 percent. This increase was due mainly to commercial paper underwriting activities, which represented about 98 percent of the total bank-ineligible securities underwritten by Section 20 firms during both quarters.

During the third quarter of 1989, Section 20 firms accounted for about 1.9 percent of the total underwriting volume of the combined markets for municipal revenue bonds, mortgage-related securities, and asset-backed securities. Total market volume data for commercial paper are not available, and therefore commercial paper is not included in this calculation of market share. In the individual markets for municipal revenue bonds, mortgage-backed securities and asset-backed securities, Section 20 firms' activities represented 1.8, 1.9, and 1.8 percent, respectively, of the total volume underwritten in these markets (see fig. IV.1). Industry analysts said Section 20 firms have not offered substantial price discounts to gain market share.

Other measures also indicate the market presence of Section 20 firms. As of June 30, 1989, operating Section 20 firms had about $1.8 billion in capital, an increase of 28 percent over the amount invested as of March 30, 1989. The $1.8 billion in capital invested in Section 20 companies represented about 4 percent of the capital of all securities firms registered with the SEC at that time. In terms of capital, 6 of the Section 20 firms appear to rank among the top 50 securities firms in the country. In the second quarter of 1989, the $1.5 billion total revenue of Section 20 firms (almost all of which is from bank-eligible activities) represented about 7 percent of the revenue of all securities firms registered with SEC.

Risks Associated With Section 20 and Bank Holding Company Activities

Although there are risks associated with Section 20 company underwriting and dealing in bank-ineligible securities, these activities also provide bank holding companies with opportunities to diversify their activities and thus limit their risks from any single activity. It is too early to tell whether Section 20 firms' activities and placing these activities in a nonbank subsidiary have actually affected the risk levels within their holding companies.

One factor tending to control risks associated with the activities of Section 20 companies is the way that the Board has authorized this expansion of power. The Board has limited the scope and pace of development of new activities, set capital requirements, and placed limitations and restrictions (firewalls) on ties between a Section 20 subsidiary and its affiliates, particularly bank affiliates. Also, the Board endeavored to prevent an expansion of powers beyond what the Federal Reserve and other regulatory officials could effectively oversee. It should be pointed out, however, that bank holding company officials and some regulatory officials have said that the regulatory structure may hamper the ability of the holding company as a whole to manage its exposure to a single customer or market segment and, thus, the risks that may result from such exposure.

Views on Impact of the Revenue Limitations and Firewalls Differ

Banking officials said that the initial 5-percent limitation on the level of revenue that could be generated from Section 20 firms' bank-ineligible securities activities hampered normal business decision processes. When the Board raised the revenue limit to 10 percent, the officials said that they believed Section 20 firms gained more flexibility to decide what activities to pursue primarily on the basis of business factors rather than the revenue limit. However, these officials anticipate that the higher revenue limit will cause problems in developing business strategies in the near future once the Section 20 firms become fully active in their underwriting and dealing activities and have started reaching the higher revenue limit set by the Board. As of June 30, 1989, the ineligible revenues generated by Section 20 firms were about 3 percent of gross revenues.

Officials of regional bank holding companies said it has been difficult for many regional firms to generate a base of eligible revenues sufficient to establish Section 20 firms. They say it is necessary to transfer into a Section 20 subsidiary some activities that may not fit well together from a business perspective in order to provide a large enough subsidiary revenue base to make doing ineligible business worthwhile.

Officials from both multinational and regional bank holding companies said other firewall requirements, intended to insulate bank subsidiaries and their customers from the activities of Section 20 firms, increased the operating costs for bank holding companies. They said the prohibition on interlocking directors, officers, and employees increases costs by duplicating staff functions and associated support systems and hampers the ability to effectively manage risks on a holding company-wide basis. Officials from regional bank holding companies were also concerned that restrictions on cross-marketing reduced the benefits that Section 20 companies could bring to the holding company and the individual and corporate customers of its bank subsidiaries.

Banking officials said some of the firewall limits on financial ties between a Section 20 subsidiary and its banking affiliates prevent bank holding companies from undertaking certain practices that would enhance revenue and benefit their corporate and individual customers. These firewalls prohibit a bank affiliate of a Section 20 subsidiary from doing such things as clearing bank-ineligible securities—that is, processing and settling securities transactions, for the Section 20 firms—guaranteeing commercial paper and revenue bonds underwritten by the Section 20 firms, or actively marketing securities underwritten by Section 20 firms to customers of the bank. They said eliminating these firewalls would not expose the banks to increased risk and would eliminate the need for banks to give business to competing firms.

Securities industry officials were concerned that the Board's revenue limitations may permit bank holding companies to expand rapidly by acquiring existing securities firms. They said that a high percentage of the revenue of many securities firms is derived from activities that are permissible for bank holding companies.

Securities industry officials also expressed concerns that the firewall requirements are not stringent enough to insulate bank subsidiaries fully from the activities of Section 20 firms or to prevent Section 20 firms from having access to funds at a lower cost than would be available to securities firms. They said that a bank holding company, because of its association with the federal safety net, which includes deposit insurance and lender of last resort assistance from the Federal Reserve, can generally obtain funds at a lower cost compared to nonbank organizations. They said that there is a perception in the market that during stressful times regulators may extend the federal safety net to nonbank subsidiaries within a holding company in order to ensure the viability of bank subsidiaries.

Federal Reserve officials said the Board has followed a conservative approach in authorizing the establishment of Section 20 companies and that to date the firewalls have adequately protected federally insured activities done in bank holding companies that have established Section 20 companies. They said that separate capitalization and other firewall requirements applicable to a Section 20 firm and its affiliates have effectively insulated bank subsidiaries from the activities of a Section 20 firm.

The Board granted bank holding companies powers to do a broader range of securities activities as a step to enhance these companies' competitiveness in the financial services market. Board officials recognized that some firewalls—designed to protect federally insured activities from risks associated with Section 20 company activities—could result in higher cost to the holding company than would occur without the restrictions. The officials said that the Board plans to review the appropriateness of the firewall requirements and noted that to date the Board has made some modifications. For example, in September 1989 the Board modified the firewall that had prohibited a Section 20 company from underwriting or dealing in certain bank-ineligible mortgage-backed securities issued by its affiliates by allowing such transactions.

In November 1989, the Board made further changes to the firewalls. In a decision currently relevant to one bank holding company, the Federal Reserve permitted the Section 20 firm's bank affiliates or parent to extend credit to customers whose debt was privately placed[1] through the Section 20 firm, even if the customer used the loan to repay principal on that debt.[2] Such extensions of credit previously were not authorized by the Federal Reserve. The Federal Reserve also allowed the parent company to buy up to half of any debt issue privately placed by its Section 20 subsidiary.

GAO Observations

Our previously cited 1988 report on issues related to repeal of the Glass-Steagall Act concluded that if the securities powers of banks were to be expanded (whether by an act of Congress or by regulation), a phased

[1]In private placements, Section 20 firms would act in an agency capacity to arrange sales of securities between an issuer and a relatively small number of institutional investors.

[2]At least 3 years must elapse from the time a customer's securities are placed through the Section 20 subsidiary before such credit may be granted.

approach should be used.[5] A phased approach is one in which authorization of new securities activities by banking organizations is done incrementally as needed changes to regulation and oversight are put in place. The actions taken by the Federal Reserve in allowing limited expansion of securities activities in Section 20 companies have been generally consistent with the approach we suggested. This contrasts sharply with the experience in the thrift industry, where many firms expanded rapidly into new activities and federal and state regulators did not exercise adequate supervision.

We cannot yet tell how the market will judge Section 20 firms. We do not know if they will prove to be profitable, if bank holding companies will choose to use them as vehicles for substantial expansion of their securities activities (perhaps by acquiring existing securities firms), or if they will prove to be a reasonably satisfactory long-run solution to bank powers issues involving securities markets.

Some features of the Section 20 arrangement (such as use of a separate SEC-regulated subsidiary and regulation of the entire holding company by the Federal Reserve) are, in our view, essential, at least in the near term, in permitting the affiliation of the banking and securities businesses. However, there are also matters that suggest the need for further review of how best to structure securities activities within a banking organization. For example, in order to comply with revenue limitations, banking organizations that want to underwrite and deal in certain securities may have to engage in bank-eligible activities, such as dealing extensively in government bonds, not otherwise closely related to the business strategy of the firm.

Our work suggests that banking and securities regulators and Congress should concentrate on seven areas in considering the need for further changes in the arrangements for Section 20 subsidiaries.

1. International perspective. Section 20 arrangements raise several questions about the interrelationship of domestic and international aspects of bank holding company regulation. U.S. banking organizations operate in countries, such as the Federal Republic of Germany, Switzerland, and the United Kingdom, that do not observe the same separation of banking and securities activities as is mandated in the United States. In these

[5] GAO/GGD-88-37, January 22, 1988, pages 2 and 3

countries, subsidiaries of U.S. banks, as well as U.S. bank holding company subsidiaries, can engage in securities operations (such as underwriting and dealing in corporate debt) as well as traditional banking activities within the limits set by the Federal Reserve and host country regulators. There is no organizational separation enforced for these activities. Allowing U.S. banks operating overseas to combine banking and securities activities in this manner allows them to be competitive in those markets. However, it also raises the question of exactly what it is that makes similar arrangements inappropriate in the U.S. market. The question is particularly relevant because applying Section 20 firewalls only to domestic operations would seem to provide an incentive for U.S. banking organizations to focus more on foreign markets. Therefore, it would be useful to know more about how the activities of Section 20 subsidiaries fit into the worldwide operations of a large banking organization.

It is also possible that firewalls intended to protect domestic banks could eventually make it easier for foreign banking organizations than domestic ones to undertake a full range of securities activities in the U.S. market and perhaps in overseas markets as well. For example, several foreign banks applying to set up Section 20 companies asked the Federal Reserve to waive certain firewalls for them on the grounds that foreign banks were not connected to the U.S. deposit insurance system and hence the firewalls were not needed. In its January 1990 Order authorizing three foreign banks to establish Section 20 subsidiaries, the Board tried, to the extent possible, to apply the firewalls to the foreign-owned Section 20 subsidiaries. However, the firewalls do not all apply to these firms in exactly the same way because foreign banks generally are not organized under the same type of holding company structure that is common in the United States, and there are limits to the restrictions that the Board can impose on foreign banks and their subsidiaries. To an unknown extent, therefore, foreign banking organizations may have greater flexibility than do domestic ones in coordinating the activities of their Section 20 firms with activities outside of the United States.

2. Organizational structure. One reason advanced for allowing Section 20 companies to engage in securities activities is the intention to strengthen banking organizations. However, it is not clear exactly whether or how the Section 20 firm will strengthen insured depository institutions that are part of the holding company. To the extent that profitable activities are moved out of the bank to provide a base of eligible revenue for the Section 20 subsidiary, it follows logically that the bank itself becomes smaller, less diversified, and perhaps less profitable.

Also, if Section 20 companies prove to be profitable, funds sent to the holding company parent may not be available to a bank subsidiary if the parent decides not to so invest them.

The relationship of a Section 20 company to insured bank affiliates is particularly important if the bank gets in trouble and is in danger of failing. The Federal Reserve has a source of strength policy, incorporated in its Regulation Y, that a bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks. However, the exact conditions under which a bank holding company can be required to use nonbanking assets to support bank subsidiaries have not been set out in detail.[7] Clarification of the operational basis of this source of strength policy would help in providing a clearer perspective on how the firewalls and source of strength policy work together in strengthening banks affiliated with a Section 20 firm.

In commenting on the draft of our report, OCC said that we appeared to endorse the Federal Reserve's view that ineligible securities activities should take place only within a securities subsidiary of a bank holding company. A similar comment was made by the Association of Bank Holding Companies. OCC said it believes that alternative arrangements, such as securities underwriting in direct subsidiaries of federally insured banks, should be considered. In addition, the Coalition for Regional Banks said in its comments that U.S. banks should be permitted to establish and fund Section 20 subsidiaries just as the Federal Reserve has permitted foreign banks to do. The Coalition also said that FDIC's regulations permit insured state nonmember banks to establish subsidiaries to engage in underwriting and dealing activities, and such activities should not become impermissible simply because the bank is owned by a bank holding company.

As stated earlier, we believe there are benefits associated with using bank holding company subsidiaries as the way to expand the securities powers of banks, at least in the near term. Although we have not endorsed any particular view of how securities activities and banking must be organized within a banking organization in the long run, we believe certain features that are provided for in the present arrangement should be preserved. These features are (1) separate corporate identity for the firm engaging in the ineligible activities; (2) regulation

[7] The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law No. 101-73, 103 Stat. 183 (1989), holds affiliated insured depository institutions liable for each others' losses but does not extend this liability to holding companies unless they themselves are depository institutions (Sec. 206(a)(7)).

of the banking and securities affiliates by a federal bank regulator and the SEC, respectively; and (3) regulation by the Federal Reserve of the financial holding company that owns the bank and securities affiliates.

If Section 20 firms were subsidiaries of a bank rather than a bank holding company, the problem mentioned earlier of how to have insured banks benefit financially from the activities of Section 20 firms would be solved. (As a bank subsidiary, all of the Section 20 firm's profits would then pass directly to the bank and the value of the securities firm would be consolidated with the assets of the bank were the bank to fail.) But there are also other considerations to weigh. It is by no means certain that all Section 20 firms will make money. (In 1989, some major securities firms lost money.) If the Section 20 firm is a bank subsidiary, losses in that subsidiary would also pass immediately to the bank and reduce its capital. Furthermore, as a bank subsidiary, a Section 20 company would be more directly linked to the federal safety net provided by deposit insurance and Federal Reserve discount loans. Extension of the federal safety net in this way may convey unwarranted competitive advantages to firms associated with banks, and it may make market participants less concerned about the riskiness of financial ventures funded through Section 20 firms.

3. Purpose of firewalls and other limitations. In evaluating whether Section 20 company arrangements represent an appropriate way to structure links between the banking and securities industries, it is important that the purpose served by each of the limitations on the powers of Section 20 companies and each of the firewalls be as clear as possible.

The problems involved in pinpointing the reasons for special provisions can be illustrated by the firewall that prohibits a bank from issuing a letter of credit to support commercial paper underwritten by its Section 20 affiliate. Looking at this firewall from a risk point of view, if the guarantee is priced correctly, the bank would be no more exposed to risk by the guarantee than if the bank simply made a loan to the company for the full amount of the securities underwritten. The question of risk in this case, therefore, is one of whether, in the absence of the firewall, bank officials can be trusted to make reasonable pricing decisions. Federal Reserve officials say that the desire to obtain fee income may lead the bank affiliate to be less than objective in assessing the risks involved when pricing the letter of credit. However, the bank already can issue letters of credit to support municipal general obligation bonds the bank itself underwrites, and the officials of the bank have many opportunities to take risks in making other pricing decisions.

In commenting on our draft report, OCC said that the report generally approved of the Federal Reserve's 10 percent revenue limitation. Along with the Association of Bank Holding Companies and the Co[illegible]on for Regional Banks, OCC also pointed out that the "engaged prin[illegible]" language of the Glass-Steagall Act is subject to different interpre[illegible]ions. OCC said that a revenue limit of greater than 10 percent would be legally permissible and that it is inappropriate to set a definitive level of gross revenues as the "engaged principally" standard for all cases. In addition, the Coalition for Regional Banks said that a revenue limit of 25 to 49 percent of gross revenues would be more realistic. OCC suggested that alternative measures other than limiting gross revenues should be explored for defining "engaged principally." The Association of Bank Holdi[illegible]g Companies and the Coalition for Regional Banks suggested that the gross revenue limit could be applied on the basis of the consolidated revenues of the bank holding company.

Our report agrees with the Board's policy of using the revenue limit to phase in bank-ineligible securities activities, but we do not have a position on the percentage of revenue that ultimately should be allowed under the act. We recogn[illegible]e that in the long run there may be other options for interpreting the "engaged principally" clause under the Glass-Steagall Act and that if that act were changed, other ways of appropriately phasing in or limiting the securities activities of bank holding companies could be devised.

4. Regulatory burden and the effectiveness of firewalls. A number of bankin[illegible] officials we talked to commented that many of the firewalls represent what can be termed regulatory "overkill." They said that the firewalls weren't needed because enforcement of basic banking and securities laws, such as those dealing with transactions within a holding company and conflict of interest situations, provide sufficient protection against risks or abuses.

In seeking to determine the best way to structure links between the banking and securities industries, we think it would be useful for banking and securities regulators to examine individual firewalls from the perspective of their cost and what they add to the general regulatory structure already in place. However, the examination must include realistic assessments of the new demands associated with expanding the securities powers of banking organizations, the capabilities of federal and state regulators to detect and deter abuses, and the adequacy of penalties for violations.

An illustration of what such an examination must include can be seen in efforts to prevent conflict of interest abuses by institutions[8] and insider abuses by employees of banking organizations. In an earlier report we said that while instances of abuse may occur, institutional abuses of conflicts of interest were not significant, widespread problems in the banking industry.[9] However, we also pointed out that expanding the securities powers of banking organizations could increase the potential for conflict of interest situations. We therefore concluded that given the harm that could result to consumers and ultimately to the banking system from abuses, the potential for abuse warrants close attention if banking institutions were granted expanded securities powers. There have been instances in which banking organizations that got into trouble have not followed general regulatory restrictions intended to prevent conflict of interest abuses.[10] In a similar vein, studies have also shown the incidence of insider abuses have existed in over 50 percent of the bank failures.[11] Opportunities for insider abuse could also be expected to increase as the securities powers of banking organizations are expanded.[12]

[8]A conflict of interest occurs when a person or business serving more than one interest can potentially benefit by favoring one interest at the expense of the others. Conflict of interest situations, which can occur in the normal course of business operations, are neither inherently wrong nor necessarily illegal. However, a conflict of interest situation represents an opportunity for abuse.

For example, the parent within a bank holding company may favor, especially during times of stress, an affiliate in which it has more invested relative to investments in other affiliates. In such a conflict situation, managers could, for example, make imprudent or unsound loans to an affiliate, transfer bad assets from the affiliate to the bank, or require the bank to purchase service from the affiliate at inflated prices.

Conflict of interest situations also exist within a securities firm. Abuses can occur, for example, when a firm buys or sells securities or provides investment advice to customers for the purpose of assisting its own trading, marketmaking, or underwriting activities rather than serving the customers' best interests.

[9]Banking: Conflict of Interest Abuses in Commercial Banking Institutions, (GAO/GGD-89-35, Jan. 1989).

[10]For example, in the mid 1970s, severe problems developed in the mortgage banking affiliate of the Hamilton National Bank, which specialized in real estate development loans. The affiliate's operations were funded through bank lines of credit and the sale of holding company commercial paper. When the parent holding company was unable to roll over its commercial paper, it forced Hamilton National Bank to buy a large amount of low-quality mortgages from the severely distressed mortgage banking affiliate of the holding company. These purchases far exceeded the amount permitted by law (Section 23A of the Federal Reserve Act) and resulted in the subsequent failure of the bank.

[11]Banking: Conflict of Interest Abuses in Commercial Banking Institutions (GAO/GGD-89-35, Jan. 1989), pp.23-25.

[12]It should be noted, however, that the fact that opportunities for insider abuse may increase does not mean that more instances of abuse will actually occur. Factors such as good internal controls can limit the occurrence of actual abuses.

In commenting on our draft report, OCC said that the draft seemed to endorse the Federal Reserve's system of firewalls and that we did not consider the safeguards, such as customer protection rules administered by SEC, or other regulatory and market safeguards that might show that firewalls are unnecessary and/or ineffective. In addition, banking groups felt we did not give sufficient emphasis to the burdens that firewalls and other restrictions imposed on well-run institutions. They also said we did not give sufficient emphasis to the reduced benefits for corporate and individual customers that result from the firewalls.

We have not endorsed the Federal Reserve's entire system of firewalls as an essential part of expanded securities of bank holding companies. However, we think a cautious approach to expanding powers is warranted. Protecting against problem situations, which experience has shown are sure to occur, is precisely a major purpose of financial market regulation. The firewalls and other restrictions provide regulators another set of tools for dealing with the types of problems that can arise when banking organizations expand their securities operations. These special provisions limit the scale of new activities and establish measures that regulators can enforce relatively easily. Of course, it remains to be seen how effective the provisions will be. When bank holding companies can demonstrate adequate capital, effective internal controls, and ability to manage new powers in a responsible ma: ıer, consideration can be given to reducing regulatory burden by rel: ing some of the firewalls in light of the other regulatory controls that are in place and provided that sufficient regulatory resources are available.

In commenting on a draft of this report, the Bank Capital Markets Association said greater emphasis ·hould be given to the point that some firewalls could increase risk rather than reduce risk. One example the Association cited was the absolute prohibition on a bank making loans to its Section 20 affiliate if the affiliate is authorized to deal in corporate debt and equity. The Association said that this prohibition could weaken the overall structure of the banking organization during a liquidity crisis such as we experienced in October 1987.

We agree with the Association's concern in the example cited. In our 1988 report on issues related to repeal of the Glass-Steagall Act, we said that to preserve the traditional liquidity role of banks, banks should be permitted to lend to their securities affiliates, but only on an arm's-length basis.[14]

[14]GAO/GGD-88-37, January 1988, pages 7 and 8.

5. Consumer protection. Clarification is needed as to the level of firewall protection that is adequate to protect retail bank customers with money to save or invest. Firewalls prevent banks from marketing securities underwritten by Section 20 affiliates. One purpose of this restriction is to keep customers from being confused about which products are insured and which are not. However, the possibility for such confusion already exists because a bank can sell securities products to its customers from a bank-owned discount brokerage subsidiary under conditions far less stringent than those applied to Section 20 companies.

In commenting on a draft of this report, the Coalition for Regional Banks said that customer confusion may be avoided by appropriate disclosures. We agree that disclosures are important, but they may not in all instances be sufficient to protect customers of insured depository institutions.

6. Costs and competition. The cost of operating a Section 20 company compared to a securities firm not affiliated with a bank is another area that deserves further study. Banking officials said Section 20 companies operate at a cost disadvantage due to capital requirements and various firewalls. Securities firms officials, on the other hand, said that association with banks gives Section 20 firms a cost advantage. Further investigation of this issue was beyond the scope of this report.

7. Reciprocal treatment of securities firms. Another issue that should be studied regarding the Section 20 arrangement is that no comparable opportunity exists for domestic securities firms to expand into domestic banking. However, determining the significance of Section 20 companies from a fairness perspective is complicated by several considerations.

Under Section 23B of the Federal Reserve Act, all transactions between holding company affiliates must be conducted on an arm's-length basis, so that a bank would not be permitted to give favorable treatment to an affiliate in issuing or pricing a letter of credit. If effective, this provision would reduce a bank's potential competitive advantage, although banks might still enjoy a competitive advantage from economies associated with being able to combine banking and securities activities in a single holding company. This advantage could result in some combination of higher profits for banking organizations and lower prices for consumers.

Another complicating factor is that securities firms possess other advantages over Section 20 subsidiaries and their bank holding companies. For example, securities firms can be affiliated with activities such as insurance, which cannot generally be undertaken within bank holding companies. Also, some securities firms are affiliated with so-called nonbank banks that were authorized prior to the Competitive Equality Banking Act of 1987 (CEBA).[11] In addition, a securities firm can be affiliated with an overseas bank, which may provide it a degree of flexibility in relating securities and banking activities in both domestic and foreign markets that is not available to banking organizations. Furthermore, the parent holding companies of securities firms are not subject to the same type of regulation that the Federal Reserve imposes on bank holding companies.

In commenting on the draft report, SEC said it agreed with our concern that the Section 20 arrangement provides no comparable opportunity for securities firms to expand into banking activities. SEC said that consideration should be given to amending the Bank Holding Company Act to permit securities firms to own banks without subjecting the securities firms and their holding companies to the full regulatory system applicable to banks and their holding companies. Various arrangements for associating banking and securities activities within a financial holding company need to be studied. However, we also believe that any structure that is adopted needs to include appropriate controls over the entire holding company comparable to the Federal Reserve's controls over bank holding company operations.

In commenting on the draft report, the Coalition for Regional Banks and the Bank Capital Markets Association both said, in essence, that if safety considerations are satisfied, maintaining competitive equality between the banking and securities industries was not an important public policy objective. We believe that competitive equality is hard to define and that attempting to maintain a concept of competitive equality should not obliterate the importance of keeping U.S. financial markets healthy. However, as a practical matter, fairness issues are hard to ignore when changes are considered that affect industries as highly regulated as the banking and securities industries.

[11]Nonbank banks were entities with bank or bank-like charters but did not meet the Bank Holding Company Act's definition of a bank (an institution that both took demand deposits and made commercial loans). Nonbank banks could be owned by firms that were not bank holding companies and were not subject to the provisions of the Bank Holding Company Act. CEBA expanded the definition of a bank to include most institutions with FDIC insurance and thus put an end to the ability of companies to avoid the provisions of the Bank Holding Company Act by establishing nonbank banks. CEBA also grandfathered the existing nonbank banks but placed certain restrictions on their growth and activities.

As arranged with the Subcommittee, we are providing copies of this report to other interested Members of Congress, appropriate committees, executive branch agencies, and the public.

The major contributors to this report are listed in appendix XVII. If you have any questions on this report, please call me on 275-8678.

Sincerely yours,

Craig A. Simmons

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

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Figures

Abbreviations

FDIC	Federal Deposit Insurance Corporation
GAO	General Accounting Office
MSRB	Municipal Securities Rulemaking Board
NASD	National Association of Securities Dealers, Inc.
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission
SIA	Securities Industry Association
SRO	Self-regulatory organization
Subs.	Subsidiaries
U.S.	United States
1Q89	First quarter, 1989
2Q89	Second quarter, 1989
3Q89	Third quarter, 1989

Market Share, Pricing, and Benefits to the Public

This appendix discusses effects on market share, prices, and benefits to the public of Section 20 firms' activity in the markets for commercial paper, municipal revenue bonds, asset-backed securities, and mortgage-backed securities. Since subsidiaries only began operations after June 1988, trend analyses and comprehensive discussions of impact are difficult to make.

Market Share

To the extent possible, we estimated the market share of Section 20 subsidiaries in underwriting bank-ineligible securities on the basis of data we compiled from the subsidiaries themselves and estimates of total market activity compiled by industry sources. We also examined other indicators of the market impact of Section 20 companies—relative shares of total revenue and capital.

Underwriting Data

We obtained market activity data from each Section 20 subsidiary that as of September 30, 1989, had received approval from the Federal Reserve to do business in any of the four categories of the securities we were requested to examine. Table I.1 shows the relevant total underwriting activity of the securities industry and, where possible, Section 20 subsidiaries' share of that volume in these securities for the third quarter of 1989. As noted, a comparable computation for market share cannot be made for commercial paper based on information available.

Table I.1: Market Share of Section 20 Subsidiaries for Selected Bank-Ineligible Securities (Third Quarter 1989)

Dollars in millions

	Total market volume	Section 20 volume	Section 20 market share
Mortgage-backed securities[a]	$30,917.4	$600.0	1.94%
Municipal revenue bonds	21,789.9	385.6	1.77
Commercial paper	NA[b]	67,659.9	NA
Consumer-related receivables	2,447.8	45.0	1.84

[a]Section 20 firms deal only in obligations that are secured by or represent an interest in one to four family residential real estate and are rated as investment quality by a nationally recognized rating agency, such as Moody's

[b]NA: Not available. Quarterly market volume data for commercial paper are not compiled by industry sources. Data are available for the total amount outstanding for a given point in time

Sources: Investment Dealer's Digest, GAO analysis.

In the third quarter of 1989, Section 20 subsidiaries underwrote a total of $68,690.5 million in bank-ineligible securities, 98.5 percent of which was commercial paper. Of the 13 Section 20 firms doing business in bank-ineligible securities during the third quarter of 1989, the greatest number had commenced activities in the municipal revenue bond market (10) and the commercial paper market (7). The top three firms accounted for about 65 percent of the total amount of ineligible securities underwritten by Section 20 firms.

The total volume of underwriting activity in bank-ineligible securities of Section 20 firms grew between the second and third quarter of 1989. Table I.2 shows that between the second and third quarters of 1989, the volume of bank-ineligible securities underwritten increased by $32,535.9 million, or almost 90 percent. As mentioned above, the share of commercial paper was approximately 98.5 percent of all bank-ineligible securities underwritten by active Section 20 firms (see app. IV). The high rate of increase reflects the fact that firms were still in a start-up period during the second quarter.

In the third quarter of 1989, revenues from bank-ineligible securities activities accounted for about 1.8 percent of the total revenue of the Section 20 firms. Under the 10 percent revenue limitation, the revenue from underwriting and dealing in bank-ineligible securities could triple if total revenue for the firms stayed constant.

Table I.2: Volume of Bank-Ineligible Securities Underwritten by Section 20 Firms During the Second and Third Quarters of 1989

Dollars in millions

Number of active firms				Increase	
2Q89	3Q89	2Q89	3Q89	Amount	Percent
13	13	$36,154.7	$68,690.6	$32,535.9	90.0

Total Revenue of Section 20 Subsidiaries

To provide additional insight into the market presence of Section 20 firms, we examined the total revenues of Section 20 firms from all sources compared to total revenues of all securities firms. Total revenues include revenues generated from both bank-eligible[1] and bank-ineligible activities, i.e., the four kinds of securities we examined plus the debt securities that were approved in January 1989 (see app. IV for a more detailed discussion of debt securities). Table I.3 compares the amount of revenues generated during the first and second quarters of 1989 by Section 20 subsidiaries to the total revenue during the same

[1]The bank-eligible revenues include bank-eligible activities that were being done by the subsidiaries prior to commencing bank-ineligible activities, as well as bank-eligible activities that may have been transferred from bank affiliates.

periods for all securities firms registered with SEC. The revenue of Section 20 firms grew from 5.2 percent of the industry total in the first quarter of 1989 to 7.2 percent in the second quarter of 1989.

Table I.3: Share of Revenue of Section 20 Firms

Dollars in millions

	1Q89	2Q89	Increase
Section 20 subsidiaries	$890	$1,461	64.2%
Total securities industry	17,147	20,185	17.7
Section 20 subsidiaries' share of total	5.2	7.2	

Source: SEC, GAO analysis.

Total Capital of Section 20 Subsidiaries

Another measure of the relative size of Section 20 companies we examined is the capital invested in the firms. Table I.4 shows the total amount of capital (ownership equity plus subordinated debt, i.e., debt with claims on assets ranked below other, more senior debt) for all of Section 20 subsidiaries as of March 31, 1989, and June 30, 1989. The table also shows total capital for all securities firms registered with SEC. As of June 30, 1989, there was a total of $1,818 million of capital in Section 20 firms. This represented 3.7 percent of total capital in the securities industry. The share of industry capital in Section 20 firms increased in the second quarter because the capital of Section 20 firms increased almost 27.5 percent while the total for the industry increased about 3 percent.

Table I.4: Comparison of Section 20 Firms' Capital to the Total Capital of the Securities Industry

Dollars in millions

	1Q89	2Q89	Increase
Section 20 subsidiaries	$1,426	$1,818	27.5%
Total securities industry	47,699	49,141	3.0
Section 20 subsidiaries' share of total	3.0	3.7	

Source: SEC, GAO analysis

The capitalization of some individual Section 20 firms placed them among some of the larger securities firms registered with SEC. When ranked according to capital, 6 of the Section 20 firms were among the top 50 broker-dealers as of the end of the second quarter of 1989. Three of these 6 were among the largest 25 broker-dealers.

Outlook

Although Section 20 firms seem to have the potential to increase their market presence, there is no way to know at this point how fast this will occur or whether it will occur at all. We observed that factors influencing the growth of these subsidiaries include the profitability (success) of the firms, regulatory arrangements, and domestic and international market conditions.

The Federal Reserve has some impact on the level of capital—and hence market penetration—available to Section 20 companies. Under the Federal Reserve's firewalls, bank holding companies must receive approval before increasing the capital the parent invests in their Section 20 subsidiaries. The Federal Reserve must also approve the acquisition of firms that might be merged into the Section 20 subsidiary. Thus, these subsidiaries cannot grow by direct investment by the parent or by acquisition without Federal Reserve approval. The firms can, however, accumulate retained earnings if they are successful. The Board also encourages Section 20 firms to seek capital infusions on their own by issuing debt directly to outside investors.

Pricing

Data were difficult to obtain concerning the impact Section 20 subsidiaries' entry into the securities market has had on pricing. Officials from both the banking and the securities industries said that profit margins were thin in most areas of activity. They also pointed out that prices were not necessarily good indications of profitability. They said that while Section 20 firms' pricing for their underwriting activities have generally followed industry trends, the profitability of each underwriting will be affected by the terms and conditions of each transaction. Securities analysts could not provide us with evidence of price-cutting.

One official from a Section 20 subsidiary said that the firm did not want to undercut prices and that it had little economic incentive to do so. Because of the 10 percent revenue limit, the official said they have no incentive to build market share by reducing prices below costs.

Benefits

This section discusses the benefits to the public of Section 20 subsidiaries. In theory, Section 20 subsidiaries may benefit customers by adding competition, convenience, and liquidity to the various securities markets. These benefits are particularly important for two reasons. First, the securities market is expanding due to such factors as technological changes that make it easier for many firms to raise money by issuing securities. Section 20 subsidiaries provide these firms with additional sources for raising money from capital markets. Second, certain segments of the securities markets are concentrated relative to the bank-eligible segments of these markets. For example, the top five securities firms underwrote approximately 93 percent of all asset-backed securities in the first 9 months of 1989. Concentration may also be present in the market for mortgage-backed securities where the top 5 firms underwrote 60 percent of these securities during the first 9 months of 1989. The top 5 firms underwrote almost 53 percent of the municipal revenue bonds issued during the first 9 months of 1989, while the top 5 firms underwrote about 37 percent of the municipal general obligation bonds issued during the same period. Additional competition may lead to lower prices and may also lead to greater innovation and better service. However, several analysts said there are significant economies of scale in securities underwriting, and therefore it was difficult to say whether Section 20 companies will make much of a difference in reducing market concentration.

Regional banks in particular said they can offer better service to customers, especially middle-sized corporations, that would not usually enter the securities market. They said this would increase the sources of lower cost funds to these firms and would also enhance the liquidity of the market due to increased activity. We heard conflicting views from analysts about how significant this untapped market is.

Section 20 subsidiaries have not existed long enough for us to measure actual benefits. To get some appreciation of the actual benefits Section 20 firms have brought to the marketplace thus far, we talked to industry specialists in some of the markets served by Section 20 firms. They all agreed that the market impact of bank-ineligible securities has been minimal.

Industry specialists, however, differed on their views of the long-term effects of Section 20 subsidiaries, depending on the particular product. One underwriting analyst predicted that Section 20 subsidiaries will add to the overcapacity already found in the industry, especially in fixed-income securities such as municipal revenue bonds. He foresaw a drop in prices, which will not benefit the subsidiaries since margins are already thin. In the short run, issuers of securities would benefit. He also suggested that in order for securities firms to defend themselves against the competition, they will need a bigger capital base. According to the official, in the long run this growth in capital would result in a more concentrated market, with only the largest firms surviving because of their ability to raise new capital. An official of an association that represents participants in the municipal revenue bond market said issuers are becoming more sophisticated and demanding more competitive arrangements. They are, for example, soliciting bids for traditionally unsolicited negotiated deals. Additional competition from the Section 20 subsidiaries will add to this trend, which he believed will eventually lead to consolidation among revenue bond underwriting.

To date, Section 20 firms have been created as new firms, resulting from reorganizations within the holding company. Since Section 20 firms were newly created entities, they have added to the number of firms in the market able to reach more potential issuers and investors in the market for bank-ineligible securities. The number of market participants will not expand if bank holding companies build up their Section 20 companies by acquiring existing securities firms. As noted in appendix III, some securities industry representatives believed that banks could easily acquire and operate existing securities firms under the 10 percent revenue limit imposed by the Federal Reserve.

Officials from the Section 20 subsidiaries suggested that these subsidiaries offered greater convenience and innovations to clients. For example, they said bank holding companies can more closely and more quickly meet the needs of the customer, especially businesses, through "one-stop-shopping," that is, being able to offer a variety of services to meet the financing needs of their customers through one entity. On the other hand, banking representatives said that firewalls, such as the inability of the bank to market the products of an affiliated securities firm, prevented some of the potential benefits of one-stop-shopping from being realized. A spokesperson for the securities industry doubted the validity of the one-stop-shopping concept. The representative said that historically, institutional customers obtain their financial services from more than one institution. They want to diversify their portfolios and sources of financing not only by type of investment, but also by suppliers of financial services.

Appendix II

Risk to the Holding Company

This appendix discusses how the operations of Section 20 subsidiaries have affected the risk levels of bank holding companies. It also discusses differences between risk to the holding company and risk to an affiliated bank. We define risk as the probability of experiencing significant financial difficulty, perhaps sufficient enough to cause the firm to fail.

The Nature of Risks in Section 20 Firms

Underwriting and dealing in securities involves market, credit, and business risks. Market risk is the situation where securities purchased by the Section 20 firm in an underwriting or dealing capacity fall in price due to changes in general economic conditions. Possible increases in interest rates are a major source of market risk. Credit risk represents the situation where an issuer is unable to pay interest and principal according to the terms of the debt offering. Credit risk generally applies only to the time that a Section 20 firm owns the security, in order to protect its reputation, a firm may feel obligated to absorb some losses in situations involving securities initially underwritten by the firm, if those losses occur within a short period of time after the underwriting. Business risk represents the inability to earn a profit from entering a new line of business. For example, some U.S. banking organizations have scaled back their securities activities in overseas markets in response to losses they experienced due to high costs and low spread margins.

Although there are risks involved in underwriting and dealing in securities, these risks need to be assessed in association with the risks of other activities of bank holding companies. Bank holding companies are already authorized to assume many risks through such activities as making and holding commercial loans, trading in government bonds, and entering into forward contracts in the foreign currency markets.

In approving broader bank holding company securities powers in Section 20 holding company subsidiaries, the Federal Reserve Board determined that this would allow them to diversify further their activities and generate new sources of revenue at a manageable level of risk, thus strengthening the overall banking organization. This action of the Board was consistent with the observation financial analysts have made that, considered in isolation, underwriting securities involves less risk than extending and holding loans. For example, Robert E. Litan wrote in a 1987 Brookings Institution Study:

"In a typical securities offering, the underwriter bears the risk of loss for only a few days, whereas a commercial bank bears the risk of a loan default until the loan is due. In addition, by definition, the underwriter deals in assets that are liquid and readily traded; despite the progressive securitization of commercial bank balance sheets, most bank loans remain illiquid because they are specific to the borrower."[1]

The Section 20 companies are also fully SEC-regulated as is any securities firm.

The financial statements of the nation's top 25 bank holding companies illustrate the scale of bank holding company activities that can generate risks. The combined balance sheet assets of these companies as of June 30, 1989, was $1.4 trillion. Of this amount, $216 billion, or about 15 percent of the total, was in commercial and industrial loans held by banking or nonbanking subsidiaries. Another $38 billion (about 3 percent of assets) was held in trading accounts. Off-balance sheet commitments as of that date that could also generate risks included $2.2 trillion in commitments to purchase foreign currencies and U.S. dollars; $1.1 trillion in interest rate swaps; over $600 billion in futures, forwards, and standby contracts;[2] and about $600 billion in various loan commitments and letters of credit.

The fact that Section 20 firms allow bank holding companies the opportunity to reduce risk by additional diversification does not mean that the companies will actually use the new powers to reduce risk. At the present time, experience does not allow a determination on whether the new activities, either individually or collectively, have actually increased or decreased risk to the holding company. For example, it is not possible to draw conclusions at this time about how profitable the new subsidiaries will be.

To date, a number of the Section 20 firms have been examined by NASD and the Federal Reserve. We have been advised by officials of these organizations that no significant uncorrected problems in the operations of these firms have been detected. Similarly, officials at the Federal Reserve System cannot point to any known instance since the Section 20 subsidiaries have commenced bank-ineligible activities in which the activities of a Section 20 subsidiary have adversely affected a bank holding company.

[1] Robert E. Litan, What Should Banks Do?, Washington, DC: The Brookings Institution, 1987, pp. 88-89.

[2] Interest rate swaps are transactions used to hedge against or displace interest rate risks. Futures contracts are exchange traded contracts for delayed delivery of securities or money market instruments in which the buyer agrees to purchase and the seller agrees to deliver, at a specified future date, of a specified instrument at a specified price or yield. Standby contracts are optional delivery contracts

The recent thrift industry debacle demonstrated clearly the dangers associated with allowing financial institutions to engage in new activities that, if not well managed or regulated, can destroy the financial health of the firms. Undercapitalized thrifts were able to expand rapidly into new activities after 1982, and thrift regulators were unprepared to supervise and control the activities of many problem institutions.[1]

Federal Reserve authorization of new activities for Section 20 subsidiaries has followed a different set of policies from those that characterized the thrift industry. The Board has approved Section 20 subsidiaries on a case-by-case basis. This has allowed the Federal Reserve Board to assess the adequacy of each holding company's capital and management systems before new activities could be undertaken. Furthermore, a number of specific restrictions (firewalls) were placed on the firms to limit the risk to the holding company that could result from the new activities. These included the following:

- The subsidiary must be separately capitalized such that the capital meets SEC standards and industry norms and does not detract from the adequacy of the capital associated with holding company activities outside of the Section 20 subsidiary. The financial press, such as the American Banker, had reported several instances in which holding companies had to increase their equity capital in order to obtain Federal Reserve approval to expand the powers of a securities subsidiary.
- The scale of new activities is controlled by requiring approval of all funds invested in the subsidiary and by limiting revenues from new activities to 10 percent of the revenues of the subsidiary. The revenue limitation means that 90 percent of the revenues of the subsidiary must come from activities authorized to be conducted directly by a national bank or a state member bank. The result of these limitations is that only a small portion of the revenue of the Section 20 subsidiary can be derived from heretofore ineligible activities, and only a small portion of the holding company's capital is at risk in these new activities.
- Restrictions are placed on the internal operations of the holding company to limit the extent to which the bank can incur risks in support of affiliate Section 20 companies.

These restrictions and their practical effect on holding company operations are discussed at greater length in appendix III.

[1]It should be emphasized, however, that by no means can all of the problems in the thrift industry be attributed to new activities.

The firewall restrictions imposed by the Federal Reserve are not, however, all designed simply to protect the safety and soundness of the bank. Some of them serve other purposes as well. These other purposes include protecting customers against conflict-of-interest abuses and isolating selected securities activities from the federal safety net for banks, especially deposit insurance. Competitive considerations associated with having banking and nonbanking organizations participating in securities markets also played a part in the design of the firewalls.

The firewalls most directly related to protecting the safety and soundness of the bank are those concerned with bank extensions of credit and purchases of assets in situations that involve the activities of Section 20 companies. It should be noted that many of these firewalls do not apply to the overseas activities of bank holding companies.

It is, of course, too early to say whether the various provisions will work as intended to protect the holding company from exces· ·e risks. However, the controlled ex·ansion of Section 20 companies has given the Fed·ral Reserve System, as regulator of the holding company, time to dev··p expertise in regulating the new activities.

Risk to Affiliated Banks

In a 1987 report on insulating banks from potential downside risks of expanded activities, we concluded that risks to the bank and its insured deposits cann· . be completely eliminated.[1] We pointed out, however, that risks to the bank would be minimized by separating the nonbank activities legally, economically, and in the perception of the market. The specific means for accomplishing these objectives involved such things as separation of boards of directors and places of business; restrictions on flow of funds from the bank to the affiliate; and controls over pricing of services to affiliates, marketing arrangements, and corporate powers.

The restrictions placed on Section 20 companies seem generally to conform to the conditions that we found would be necessary for insulation.

To date, there is no evidence that the acti ·ities of Section 20 companies have adversely affected bank affiliates. It should also be noted, however, that such damage, were it to occur, would be most likely to occur at a time when either the bank or the Section 20 firm was under great

[1] Bank Powers: Insulating Banks From the Potential Risks of Expanded Activities, (GAO/GGD-87-35, Apr. 14, 1987).

financial stress. To date, none of the Section 20 firms have operated under these conditions.

As discussed in greater length in appendix III, holding companies believe that the Board's limitations on the revenues a Section 20 firm can generate from bank-ineligible securities activities can force them to make business decisions based strictly on regulatory considerations. For example, the revenue limitation requires a sufficient level of revenues from bank-eligible securities activities to assure that a Section 20 firm does not exceed the revenue limitation. Since the start-up costs for securities activities are significant, holding companies may opt to transfer bank-eligible securities activities from both bank and nonbank subsidiaries into the Section 20 subsidiary. Transfer of such profitable activities from a bank could negatively affect the overall performance and financial condition of the bank. It would also, by definition, make the bank smaller and less diversified. Some capital may also be moved out of the bank along with the transfer of functions.

Federal Reserve officials acknowledge that the indirect effect of the revenue limitation may be counter-productive in that a less risky activity may be transferred from a bank to a Section 20 subsidiary. However, these officials note that the 10 percent revenue limitation is based on legal, rather than financial, considerations. The Federal Reserve officials also point out that the firewalls are based on the concept that risks from securities activities must be kept separate from and insulated from the bank. They said that losses, if any, from securities activities:

- should not enjoy protection of deposit insurance or other aspects of the federal safety net for depository institutions; and
- should not be transmitted to a bank's income statement because volatility of reported earnings may cause loss of confidence in a bank.

There exists a trade-off between potential benefits and losses relative to the bank. The outcome of this trade-off depends on whether the activities turn out to be profitable or only some securities activities are required to be done outside the bank.

If Section 20 companies are profitable, the holding company is strengthened. It is not clear, however, how this necessarily contributes to strengthening an affiliated bank. Funds sent to the parent by the Section

20 subsidiary are directly available to an affiliated bank only if the parent decides to reinvest them in the bank.[5]

The Federal Reserve has a policy incorporated in its Regulation Y that a holding company shall serve as a source of financial and managerial strength for its banks. However, the exact conditions under which the holding company can be required to use nonbanking assets of the holding company to support an affiliated bank and protect the deposit insurance fund have not been set out in detail.

Questions can also be raised about the net effects of some of the firewalls. If it is true that there are benefits from combining banking and securities activities within one banking organization, many of these benefits would likely show up as additional profitable bank activities. By restricting the ability of the bank to participate with securities affiliates, the firewalls may make it harder for the bank to benefit from the expanded powers.

In addition, some banking officials have suggested that the management structure required to comply with firewall restrictions may make it harder to control risk exposure on a holding company-wide basis. This is discussed in appendix III.

[5]Payments to the parent by the Section 20 subsidiary may, however, make it easier for the parent to leave more bank profits in the bank. In addition, the parent would be in a better position to inject additional capital into the bank to comply with capital requirements if asked to do so by the Federal Reserve.

Impact of Revenue Limitation and Firewalls

This appendix summarizes the comments of industry officials and regulators about the practical impact of special regulatory restrictions the Federal Reserve Board imposed on the operations of Section 20 subsidiaries. These restrictions, often called firewalls, can be grouped into the four following categories:

- revenue limitation;
- capital adequacy conditions;
- restrictions and prohibitions on financial ties between banks and Section 20 affiliates;[1] and
- prohibition against banks sharing employees or confidential information, or engaging in marketing activities on behalf of a Section 20 affiliate.

Except for the revenue limitation, the firewalls supplement provisions in federal statutes that govern the relationships between banks and their affiliates and regulate securities activities.

The Board has actually issued two sets of firewalls. The first set, contained in the 1987 Order, appli to Section 20 companies that have be authorized to underwrite and d al only in municipal revenue bonds, mortgage-related securities, consumer-receivable-related securities, and commercial paper. (This act is contained in app. VII.) The latter set of firewalls, contained in the 1989 Order, applies to Section 20 companies that are also authorized to underwrite debt and equity securities. (See app. VIII.)

Our judgments about the practical impact of the firewalls were limited by the short time Section 20 subsidiaries have been operating, the lack of nonproprietary information, and limited time available to complete this assignment. We addressed the practical effects of firewalls by interviewing officials in the regulatory agencies and the commercial banking and investment banking industries. In the banking industry, we obtained the views of officials who operate Section 20 subsidiaries and those who are considering doing so. We included representatives of both multinational and regional bank holding companies in our discussions.

We have summarized the general comments of the industry officials and regulators as well as some of the specific comments made about each category of firewall restrictions.

[1] Restrictions that apply to insured bank affiliates generally apply in the same manner, and to the same extent, to federally insured thrift affiliates and to subsidiaries of bank or thrift affiliates.

General Comments

In general, banking officials with whom we spoke said that the process the Board used in approving Section 20 subsidiary activities was appropriate. They said that the Board's case-by-case approval process and limits on the scale of new underwriting and dealing activities allowed the Board to ensure that individual companies would carry out the new activities gradually and cautiously, while also maintaining regulatory requirements. While the banking officials with whom we spoke also saw the necessity of imposing some restrictions in order to protect the bank, its depositors, and the federal safety net, some officials expressed concern that the Board has gone too far in attempting to provide that protection. They said the firewalls unnecessarily raised costs, created management problems, and made it harder to service customers competitively. A number of banking representatives believed that regulatory tools available to bank regulators, SEC, and the Federal Reserve could sufficiently protect against abuses without the additional costs incurred with the firewall provisions.

Securities industry officials with whom we spoke said that requiring bank holding companies to establish a separate underwriting subsidiary that is operationally and financially independent of insured bank affiliates is the most appropriate way to permit bank expansion into securities underwriting. However, these officials questioned the need for allowing bank holding companies to underwrite securities. In support of this view, they pointed to the low profitability in the underwriting activities that have been authorized and the generally higher profit margins of regional and smaller banks that were not engaged in domestic or overseas securities activities.

Some securities industry officials also questioned the effectiveness of some of the firewalls and said that Section 20 companies would benefit from special federal programs for banks such as deposit insurance. The officials also said that existing arrangements would allow bank holding companies eventually to acquire most independent broker-dealers.

Comments From Regulators

In its 1987 Order, the Board said that the existing regulatory framework for banks, bank holding companies, and securities firms has not yet been proven effective in protecting against potential conflicts of interest, unsound banking practices, and other adverse effects associated with commercial bank and investment bank affiliation. Accordingly, in approving expanded activities for bank holding companies, the Board determined that the existing framework should be supplemented by the additional limitations contained in the firewalls. The Board indicated.

however, that it would consider modifying some of the firewalls and other restrictions.

To date, the Board has modified several firewalls. Federal Reserve officials recognized that the firewalls created some inefficiencies and increased the operating costs for bank holding companies. However, they believed that the potential conflicts of interest and unfair competition would be difficult to monitor and control without the firewalls. Moreover, they believe that need to minimize the transfer of risk to federally insured depository institutions and the federal safety net outweigh the benefits to the holding company of efficient operations or lower operating costs.

Revenue Limitation

The Board's 1987 Order concluded that engaging in bank-ineligible activities would not violate Section 20 of the Glass-Steagall Act if the subsidiary derived only 5 percent to 10 percent of its gross revenues from underwriting and dealing in bank-ineligible activities. As previously noted, the revenue limitation, originally set at 5 percent, was raised to 10 percent in 1989.

Comments From Bank Company Officials

The revenue limit was a concern among all the bank holding company officials with whom we spoke. Officials in multinational bank holding companies said the 10-percent limit has allowed them more flexibility than did the 5-percent limit. They reported that they currently do not have significant difficulties operating within the 10-percent limit because they have proceeded slowly. However, they projected that the 10-percent limit could become a constraint over the next few years because, as their operations continue to mature, the Section 20 firms will probably generate ineligible revenues that will approach the current revenue limit. Regional bank holding company officials said that although the new 10 percent revenue limit has eased entry for some regional bank holding companies, the revenue limit continues to constrain their operations because of the difficulty in transferring bank-eligible activities into the Section 20 firm sufficient to support anticipated levels of bank-ineligible activities.

Both multinational and regional bank holding company officials shared the concern that the revenue limit forces managers to make decisions about how to structure their products lines and services primarily on the basis of the amount of revenue the activity would generate. This particularly concerned companies that were not primary dealers or that otherwise did not trade a large volume of government securities.[2] Officials commented that in order for many companies not involved in extensive government securities trading to establish a Section 20 subsidiary, it would be necessary to combine some operations that may not fit well together from a business perspective.

Some officials were reluctant to consolidate nonbanking operations in the Section 20 subsidiary. While these activities would generate eligible revenue, the officials said that the SEC net capital rule and the firewall requiring a bank holding company to deduct investments in the Section 20 subsidiary from regulatory capital make funding these operations more expensive than if the activities were done outside the subsidiary. This appears to have had the greatest impact on regional holding companies.

Comments From Securities Industry Officials

One securities industry official commented that the 10 percent revenue limit effectively permits bank holding companies to rank among the top investment bank companies. This official noted that the entire investment industry's underwriting revenues were only about 8 percent of gross revenues in the first half of 1989 and said that n st of the other revenues earned by the investment industry were derived from bank-eligible activities. Theref e, the official suggested that a bank holding company could buy an ex sting large investment bank and still be within the 10 percent revenue l it.

While not disputing the point that banks may find acquisition of an existing securities firm an attractive expansion route, another securities industry official noted that underwriting securities is not the only activity that generates bank-ineligible revenues for securities firms. For example, the official said underwriting mutual funds and insurance-related products and secondary market trading associated with bank-ineligible securities are important sources of bank-ineligible revenues to some securities firms.

[2]Bank holding company officials have said that Secti n 20 subsidiaries that are not primary dealers find it difficult to generate sizeable levels of eligible revenues to measure against ineligible revenues. A number of bank holding company officials have commented to the Federal Reserve that it is difficult to enter the over-the-counter U.S. government securities market because margins have declined and start-up costs and overhea e significant.

Comments From Regulators

Federal Reserve officials said that in principle the firewalls do not prohibit a bank holding company from acquiring an investment banking firm. However, they said it is not obvious from investment banks' reports of income what portion of their revenues is derived from bank-eligible or bank-ineligible activities. Accordingly, they have no way of knowing whether a bank holding company could, in fact, purchase a diversified broker-dealer and operate within the firewall requirements.

The officials said that they are not concerned about whether the 10 percent revenue limit allows Section 20 subsidiaries to rank among the largest investment banking firms. They said that the market should determine the size of the firm. In addition, the officials said that the Glass-Steagall Act does not specify what size bank-affiliated underwriting subsidiaries should be, as long as they are not "engaged principally" in underwriting and dealing in bank-ineligible securities. At the present time, they said, the revenue limit, rather than size, is the appropriate measure of the extent to which a firm can underwrite bank-ineligible securities without being "engaged principally" in that activity.

Capital Adequacy Conditions

The firewalls related to capital require Section 20 subsidiaries and their parent bank holding companies to maintain adequate capital at all times. The firewalls also require that investments in a Section 20 subsidiary be deducted from the parent company's regulatory capital for determining compliance with capital adequacy guidelines. (See app. V.) In addition, the 1989 Order requires that unsecured extensions of credit to the Section 20 subsidiary by the parent bank holding company or any of its nonbank subsidiaries also be deducted from the parent company's regulatory capital. Together, these restrictions are intended to ensure that a bank holding company maintains a strong capital position to support its subsidiary banks and that the resources needed for that support would not be put at risk to fund the securities activities of the Section 20 subsidiary.

Comments From Bank Company Officials

Overall, the officials with whom we spoke did not identify significant problems with the requirement that the Section 20 subsidiary be adequately capitalized in accordance with industry norms. However, there was no consensus about what the industry norm really is for a Section 20 subsidiary. Broker-dealers tend to have capital that is several times greater than SEC's net capital requirements. The officials believed that the market determines the appropriate level of capital for a broker-dealer.

Regional bank holding company officials raised concerns about deducting capital investments in the Section 20 subsidiary from the regulatory capital of the parent bank holding company. They believed that the market for new capital is such that it is prohibitively expensive for regional companies to raise new capital. In that regard, the officials said the capital requirement would be met primarily by moving part of the capital base from the bank subsidiary to the Section 20 subsidiary. They believed these transfers could potentially weaken the bank by reducing its capital base and by leaving its balance sheet less diversified.

Officials of some multinational bank holding companies said the requirement that unsecured extensions of credit between the parent or any of its nonbank subsidiaries and the Section 20 company be deducted from the parent company's capital is unnecessary and costly.[3] The officials said that this requirement essentially cuts the Section 20 subsidiary off from a relatively low cost of funding—the parent company's access to the capital markets—and increased the subsidiary's cost of raising funds relative to its competitors' costs. For example, in order for a parent company loan to a Section 20 subsidiary to be exempt from the deduction from the parent's regulatory capital, the subsidiary must collateralize the loan in the same manner and to the same extent that would be required under Section 23A of the Federal Reserve Act.[4] Because competitors of Section 20 subsidiaries do not have to contend with such a restriction, and can therefore raise funds through their parent relatively easily, officials believed that the Sectio 20 subsidiary's funding costs are higher than those of their competitors.

Some officials we spoke with said that the firewalls encourage the Section 20 subsidiary to raise funds by borrowing from nonaffiliated companies. Under this alternative, the subsidiary simply borrows funds from unaffiliated banks at market rates. The officials said that they

[3]This requirement primarily affects the bank holding companies that received expanded powers under the Board's 1989 Order. In the Board's earlier Order, no limit was placed on the amount of funds that a holding company and its nonbank affiliates could lend to the Section 20 subsidiary.

[4]Although Section 23A of the Federal Reserve Act governs extensions of credit between member banks and affiliates, the Board specifically required that its collateral requirements apply to extensions of credit between a Section 20 subsidiary and affiliates. Under this requirement, extensions of credit must be collateralized with securities valued between 100 and 130 percent of the value of the loan. For example, if 100 percent of the amount of an advance from the holding company is secured by U.S. government securities, no deduction from the holding company's capital is required. If marketable equity securities are used to secure the advance, the market value of these securities must be equal to 130 percent of the amount of the loan in order to avoid deduction from the holding company's capital.

would prefer to pay market rates to their affiliates for funds rather than pay these rates to competitors.

Comments From Securities Industry Officials

Securities industry officials said that the market already awards bank holding companies a lower cost of funds than some of its competitors that have higher credit ratings because of the implicit extension of the federal safety net from the bank subsidiary to the entire holding company. They believed that Section 20 subsidiaries should not be allowed to obtain funding through their parent bank holding companies, because such funding would jeopardize the financial resources that should be available for the bank subsidiaries and would give Section 20 subsidiaries an unfair competitive advantage because of their ability to obtain low cost-funding.

Comments From Regulators

In the Board's 1989 Order, it noted that in view of the amount of the investment that may be required to support the activities of Section 20 firms, it was important to ensure that the holding company does not impair its financial resources through its funding of a Section 20 subsidiary. Under the Board's source of strength policy, a holding company should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks.

The Board also noted that these requirements were essential because they tend to ensure that the Section 20 subsidiary maintains adequate levels of capital to support its operations on a stand-alone basis. The Board believed it essential to limit the Section 20 subsidiary's ability to draw on the resources of the parent holding company to help ensure that the market would evaluate the financial standing of the Section 20 subsidiary on the basis of its own resources.

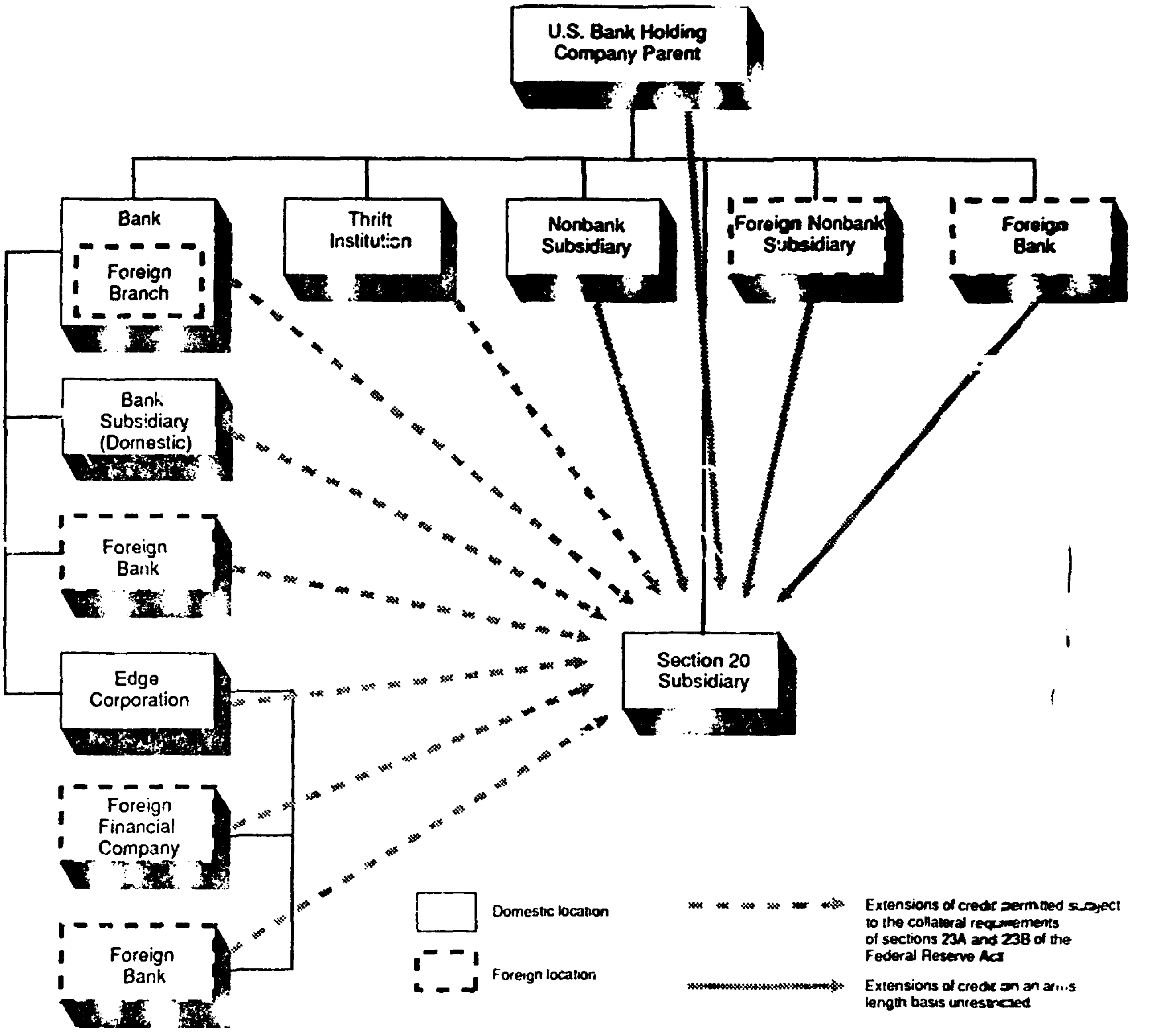
In both the 1987 and 1989 Orders, the Board noted that with respect to investment bank officials' claims, no evidence showed that a Section 20 subsidiary would by reason of its affiliation with federally insured banks necessarily have access to lower cost funds than its competitors that were not affiliated with banks. The Board indicated that rates paid by bank holding companies on their commercial paper have generally been the same as those paid by corporations of similar size and credit ratings. Furthermore, according to the Orders, a corporation's funding costs are a function of a variety of economic factors, including size, capital, and earnings. The Orders also noted that while the regulatory framework under which a corporation operates is a factor that might affect the cost of funds, the same bank regulatory structure that provides deposit insurance also imposes restraints and costs on the operation of banks and their affiliates that were not imposed on other corporations.

Restrictions and Prohibitions on Financial Ties Between Banks and Section 20 Affiliates

In both the 1987 and 1989 Orders, the Board specified a number of firewalls designed to limit the transfer of risk in the activities of the Section 20 subsidiary to the federal safety net and to federally insured banks.[5] In the 1987 Order, banks could lend to Section 20 affiliates, subject to the limitations on loans and other transactions between banks and affiliates contained in Sections 23A and 23B of the Federal Reserve Act. (See fig. III.1.) However, under the 1989 Order, the Board required a prohibition (see fig. III.2) rather than a limitation on extensions of credit from banks to Section 20 affiliates (with the exception of credit incidental to clearing services with respect to U.S. government or agency securities). The 1989 Order also prohibited the purchase and sale of financial assets between banks and Section 20 affiliates, while the 1987 Order permitted these transactions. Both Orders prohibited banks from providing credit enhancements for securities issued by a Section 20 affiliate. The Orders also prohibited banks from extending credit to customers of the Section 20 affiliate for the purpose of paying principal, interest, or dividends on securities underwritten or dealt in by the Section 20 affiliate.

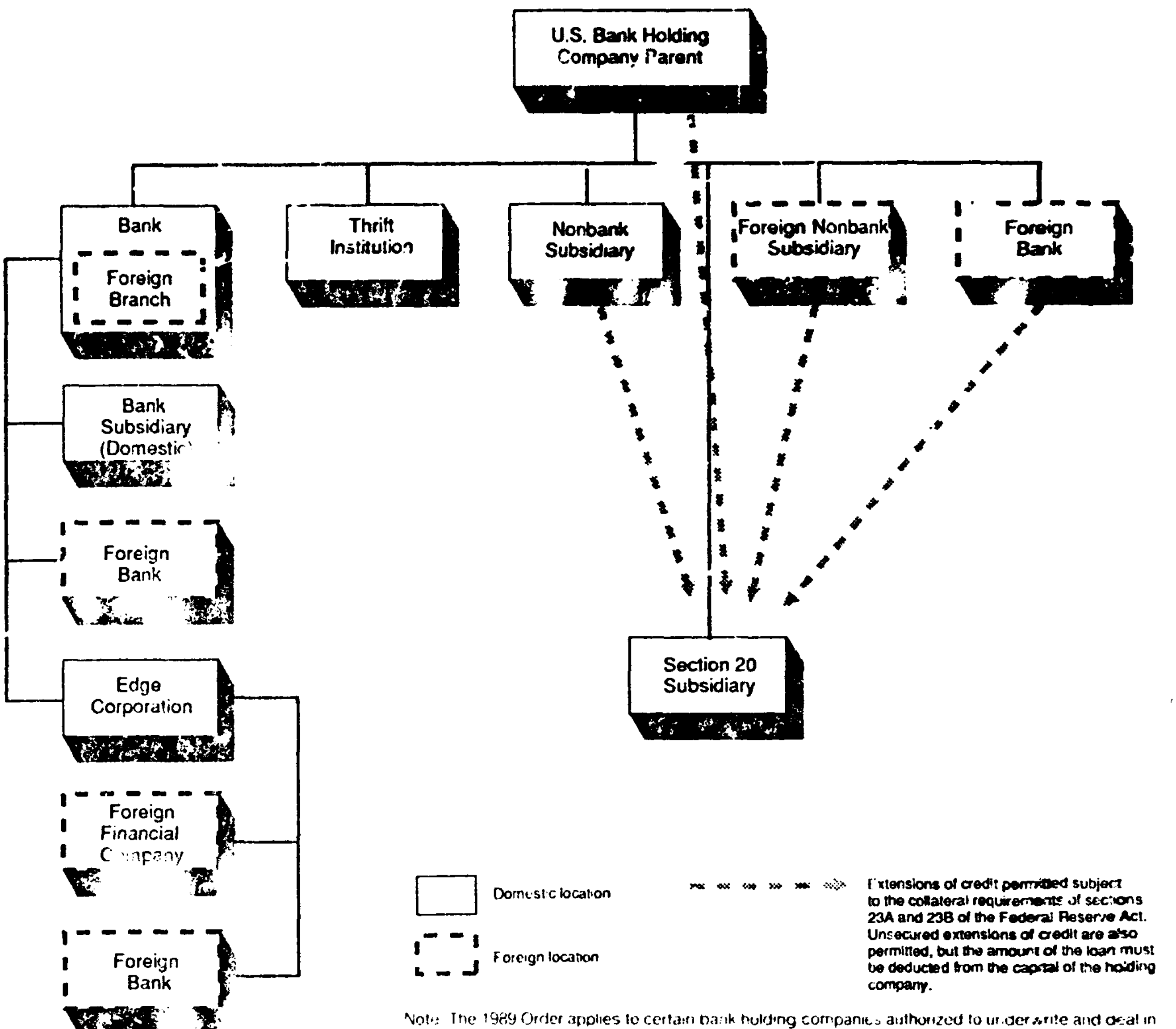
[5]Note that use of the term "bank" refers to federally insured domestic bank and thrift affiliates and their direct and indirect subsidiaries. Accordingly, the term bank does not include foreign bank subsidiaries of the parent holding company.

Figure III.1: Permissible Extensions of Credit to a Section 20 Affiliate Under the 1987 Order



Note The provisions of the April 30 1987 Order apply to certain bank holding companies authorized to underwrite and deal in only municipal revenue bonds, mortgage-related securities, consumer-receivable-related securities and commercial paper

Figure III.2: Permissible Extensions of Credit to a Section 20 Affiliate Under the 1989 Order



Note: The 1989 Order applies to certain bank holding companies authorized to underwrite and deal in corporate debt securities (and conditionally authorized to underwrite and deal in corporate equity securities) in addition to the securities authorized in the 1987 Order. For those bank holding companies, the restrictions in the 1989 Order apply in the same manner and to the same extent with respect to securities activities authorized in the 1987 Order.

Comments From Bank Company Officials

Some bank holding company officials with whom we spoke said that establishing a limit on extensions of credit from banks to Section 20 affiliates is a reasonable measure to protect the bank. However, officials from multinational bank holding companies that received expanded authority under the Board's 1989 Order commented that the prohibition against extensions of credit is unnecessary since such transactions were already limited by Sections 23A and 23B of the Federal Reserve Act. Some regional and multinational bank holding company officials said that firewalls prohibiting affiliated banks from entering into agreements that enhance the creditworthiness of securities underwritten or distributed by the Section 20 subsidiary were unnecessary. Some officials argued that under existing law and regulations, a bank can provide letters of credit to issuers of certain bank-eligible securities (for example, municipal general obligation bonds) that the bank underwrites. They said the risk exposure that results from such credit enhancement, if priced correctly, is no greater than the risk associated with making a direct loan to the issuer of the security. They also commented that this restriction precludes affiliated banks from a potentially profitable source of business.

Some officials commented that the inability of banks to provide credit enhancements for securities underwritten by affiliates gives some foreign banking organizations a competitive advantage over U.S. bank holding companies. The officials said that some foreign banks operating in the United States are permitted to, and do, provide such enhancements for securities underwritten by their affiliates.[6] Thus, they believed some foreign banks are able to offer a more complete line of services to customers compared to U.S. bank holding companies.

The ABA, in commenting on our draft report, stated that this prohibition on credit enhancements is uneconomical and creates inefficiencies and negative public perceptions. It believes customers will have to pay more for credit-enhancement services because they would have to obtain these services from another bank not involved in underwriting

[6] The officials are referring to the 17 foreign banks that were grandfathered under Section 8 of the International Banking Act of 1978 (IBA). Under Section 8 of the IBA, any foreign bank that controls a bank that operates in the U.S. shall be subject to the Bank Holding Company Act of 1956 and subsequent amendments in the same manner and to the same extent as if it were a bank holding company. The purpose of this provision was to bring the permissible nonbanking activities of foreign banks more in line with those of domestic bank holding companies. However, a foreign bank could continue to engage in nonbanking activities in the United States in which it was lawfully engaged prior to enactment of the IBA but the bank is generally not permitted to expand its grandfathered nonbank activities by developing new product lines or through acquisition of or merger with another company.

the securities. Additionally, the ABA believes the public may draw negative inferences from instances where a bank does not issue a credit enhancement for securities underwritten by its affiliate.

Additionally, the ABA said that the firewall prohibition on the purchases by a bank of debt issues privately placed by its Section 20 subsidiary affiliate is unnecessary and could prove detrimental to the bank's reputation in the community. As an example, ABA said that an underwriting subsidiary affiliate could underwrite a revenue bond offering for constructing a local airport. Normally, as a member of the community a bank would be expected to purchase a part of the offering for its own portfolio. The ABA stated that the firewall would prohibit the bank from purchasing the securities underwritten by its Section 20 affiliate and that this could reflect poorly on the bank's reputation in the community.

Some multinational bank holding company officials with whom we spoke questioned the practicality of the firewall that prohibits banks from extending credit to customers of a Section 20 affiliate for the purpose of paying principal and interest on ineligible securities underwritten by that affiliate. The officials said this firewall imposes undue burden on banks and impedes the ability of the Section 20 affiliate to offer a full range of services to its customers. For example, customers of the Section 20 subsidiary that issued debt securities or other securities underwritten by the Section 20 subsidiary may find it to their advantage to swap out of the securities into a bank loan, or vice versa. Under this scenario, the customer would either use the proceeds of a bank loan to pay off outstanding debt or use the proceeds of a debt issue to pay off a bank loan. The officials said that while the Section 20 subsidiary may underwrite debt securities for the customer, the proceeds of which could be used to pay off loans held by bank affiliates, under the firewall provisions, the Section 20 subsidiary must send the customer to unaffiliated banks to secure the loan to pay off the debt issue. Thus, they said, the Section 20 subsidiary is forced to encourage some customers to develop relationships with competitors. Moreover, the officials pointed out that some foreign banks operating in the United States are able to provide this service to their customers.

Some multinational company officials said that such transactions as a bank purchasing financial assets from a Section 20 affiliate are part of banks' normal operations. They noted that these transactions were permitted in the 1987 Order and believed that such transactions were effectively regulated by Sections 23A and 23B of the Federal Reserve Act.

The officials believed that in that light, a prohibition is unnecessary. Some officials were concerned that it is not clear whether and/or how this prohibition applies to overseas affiliates and believed that this lack of clarity impedes the efficiency of their U.S. operations.

Officials with whom we spoke expressed concerns about the prohibition against affiliated banks providing clearing services for the Section 20 subsidiary with respect to securities other than government securities.[5] They argued that it is inefficient and costly to clear through nonaffiliates because of the additional costs of establishing a relationship with an unaffiliated company. The officials pointed out that providing intra-day credit with respect to clearing services is a normal part of doing business with a securities company, and they did not see a need to exclude banks from earning money by providing this service to Section 20 affiliates. The officials were displeased that the holding company is forced to put money in the pockets of its competitors in the form of fees for clearing services.

Comments From Securities Industry Officials

Securities industry officials said that to allow banks to provide any funding at all for Section 20 affiliates would not only create a competitive advantage for the Section 20 subsidiary by its access to low cost bank funds (in the form of insured deposits), but would also expose the federal safety net to the risk of the Section 20 affiliate's activities. They said that without a prohibition against banks providing funding to Section 20 affiliates, a bank could be pressured to lend substantial amounts of federally insured funds to a Section 20 affiliate to avert that affiliate's demise. The officials said such exposure to the activities of the Section 20 affiliate would threaten the integrity of the entire banking system.

Comments From Regulators

In its 1987 Order, the Board permitted banks to lend to and engage in transactions involving the purchase and sale of financial assets with Section 20 affiliates, subject to the limitations of Sections 23A and 23B of the Federal Reserve Act, because of the "limited range of activities authorized" in that Order. However, in its 1989 Order, the Board believed it essential to prohibit those transactions in order to limit the risk of the expanded activities from being transferred to affiliated

[5] Under the Board's 1989 Order, prohibitions on extensions of credit do not apply to credit extended by a bank to a Section 20 subsidiary that is incidental to the provision of clearing services for U.S. government securities.

banks. The Board believed such prohibitions would also promote corporate separateness by ensuring that the operations of Section 20 subsidiaries would be carried out on a stand-alone basis and would not be financed by affiliated banks.

The Board noted that Sections 23A and 23B of the Federal Reserve Act permit banks to lend substantial amounts of their resources—up to 10 percent of their capital—to or in support of a Section 20 affiliate. However, the Board noted that its experience has shown that the restrictions of Sections 23A and 23B are not completely effective to insulate the risks of Section 20 subsidiaries from affiliated banks, and, given the complexity of their provisions, Sections 23A and 23B are subject to avoidance by creative interpretation, particularly in times of stress.

For the same reasons relating to funding of the Section 20 affiliate, the Board believed that federally insured banks should not for their own account purchase financial assets from, or sell such assets to, a Section 20 affiliate. In addition, Federal Reserve officials said the firewalls are directed toward eliminating any competitive advantage that a Section 20 subsidiary may have by reason of its bank affiliation over that of a securities firm not affiliated with a bank.

Corporate Separateness: Prohibition Against Banks Sharing Employees and Information and Engaging in Marketing Activities

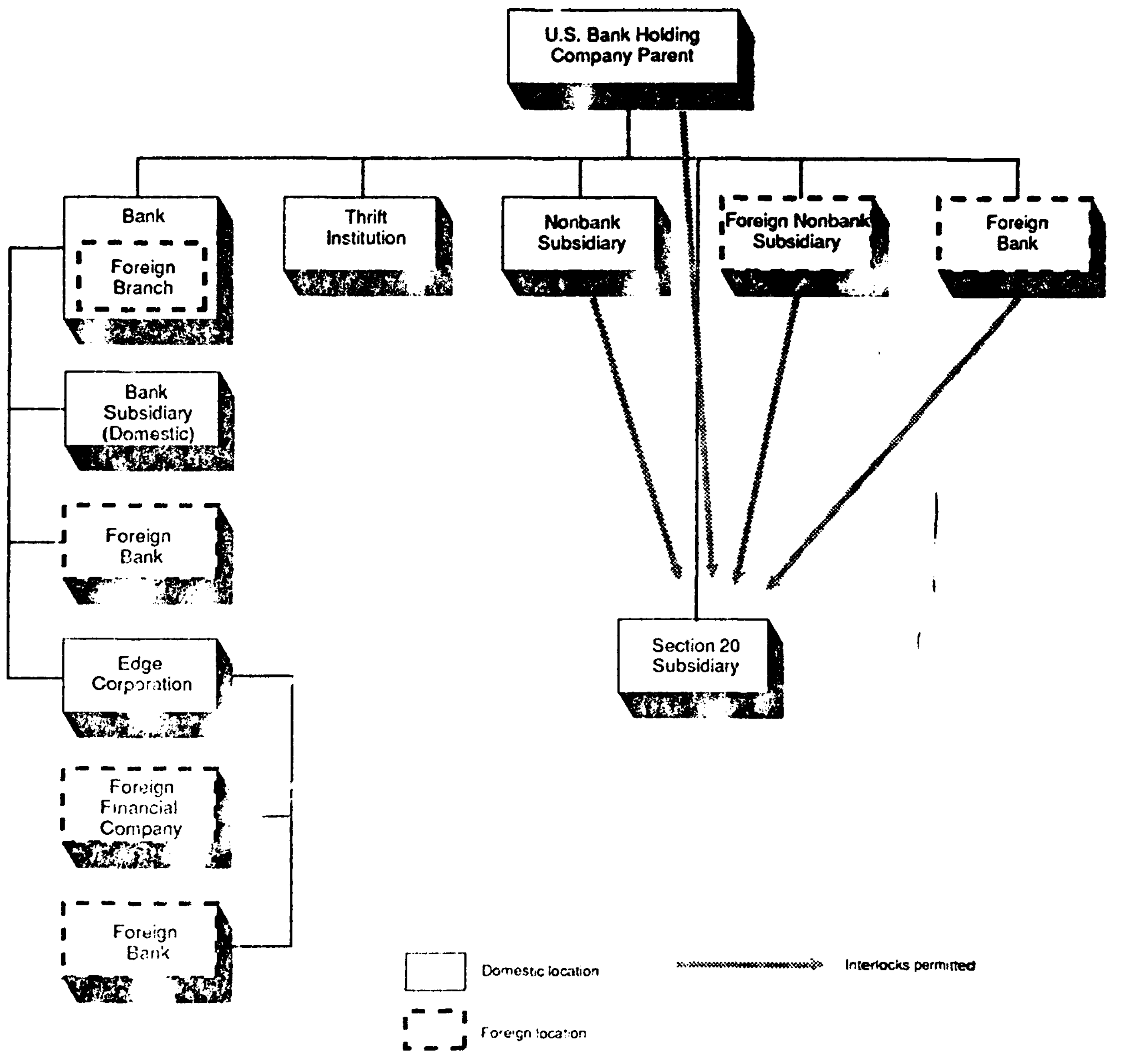
The prohibitions against common officers, directors, and employees in the Section 20 subsidiary and affiliated banks (interlocks); marketing by bank affiliates on behalf of Section 20 subsidiaries; and transfers of nonpublic information about a customer were designed to ensure that insured depository institutions are insulated both structurally and operationally from the activities of the Section 20 subsidiary.

Comments by Bank Company Officials

Bank holding company officials in general said that both bank holding companies and investment banking firms have successfully managed the potential conflicts these firewalls were designed to prevent. Moreover, officials said existing regulation by SEC of broker-dealers, rules of NASD and the Municipal Securities Rulemaking Board (MSRB) applicable to broker-dealers, and fiduciary requirements under common law and banking regulation adequately address potential conflicts. The officials with whom we spoke said that in that light, these firewalls are unnecessary and impede their ability to compete.

Both regional and multinational bank holding company officials said the prohibition against officer, director, or employee interlocks (see fig. III.3) make it difficult to comply with the provisions of other firewalls because it impedes the flow of necessary information between affiliates. For example, officials said that it is difficult to monitor extensions of credit by bank subsidiaries to clients of the Section 20 subsidiaries when managers in the subsidiaries must report to different individuals. (This problem is compounded by the prohibition against bank subsidiaries disclosing information about their customers to Section 20 affiliates.) A problem could occur when the Section 20 subsidiary serves a client that has bad loans with an affiliated bank. According to some bank holding company officials, because the affiliated bank may not disclose information about the creditworthiness of its customers without prior customer consent, the holding company's ability to adequately monitor its credit risk exposure adequately is hampered.

Figure .3: Permissible Officer, Director, or Employee Interlocks Between Section 20 Subsidiaries and Affiliates Under the 1987 and 19 Orders



Both multinational and regional bank holding company officials said this restriction has forced them to make awkward changes in the organization of a holding company. For example, some officials said they have securities operations in various subsidiaries of the holding company. Thus, the bank's treasury department manages the bank's liquidity; the trust department executes trades on behalf of customers; the parent company raises funds in capital markets; and the Section 20 subsidiary and overseas securities subsidiaries execute trades for customers and deal, or make a market, in various securities. The officials said the ability to have one individual coordinate and manage the securities activities in various parts of the holding company is essential to the efficiency and adequate risk management of the holding company.

Officials said this firewall has caused personnel duplication throughout the holding company. Although both multinational and regional officials complained that this duplication has significantly raised the personnel expenses for the holding company, the problem appears to be greater for regional firms. According to regional bank holding company officials, regional firms are too small to bear the expense of such duplications of personnel.

Bank holding company officials reported that the firewall prohibiting bank affiliates from engaging in marketing activities on behalf of the Section 20 subsidiary has impeded the ability of both regional and multinational bank holding companies to provide a full range of financial services to their customers.[8] Officials with whom we spoke said they would be able to meet the financing needs of their customers more economically, efficiently, and effectively if one person could explain the nature of the various products and services that the company has to offer. Officials said this is of particular concern when a customer needs financing that involves, for example, a combination of bank loans and debt securities. The officials pointed out that this firewall makes it difficult to give proper advice on the financing vehicles that best suit their client's needs, and then to structure and close the deal, because it requires that the client talk to several employees.

The prohibition against affiliated banks disclosing nonpublic information (including an evaluation of the creditworthiness of an issuer or other customer of that bank affiliate) to the Section 20 subsidiary causes problems for both regional and multinational companies. The

[8] Under the prohibition, bank officers may inform a customer that the services of the Section 20 subsidiary exist but may not distribute prospectuses and sales literature to the public.

officials said that having the customer sign a consent form usually takes care of the problem. However, they said that when a customer does not give consent, this firewall diminishes the cost savings that a Section 20 subsidiary would otherwise accrue if it were able to draw on the results of activities, such as credit investigations, that are done as a normal part of business in bank affiliates.

Comments From Securities Industry Officials

Securities industry officials said that firewalls prohibiting Section 20 subsidiaries and bank affiliates from sharing employees and nonpublic customer information and engaging in cross-marketing activities are necessary to prevent abuses and conflicts of interest. They also said that Section 20 subsidiaries would have an unfair competitive advantage over securities firms that are not affiliated with banks if they had ready access to confidential information about bank affiliates' customers.

Comments From Regulators

Federal Reserve officials reiterated that while recognizing that the firewalls cause some duplications and inefficiencies, the restrictions are necessary because the potential conflicts of interest and unsound banking practices would be difficult to monitor and control without the firewalls.

Section 20 Subsidiaries' Activities

To date, the Board has authorized 21 bank holding companies to establish Section 20 subsidiaries. This appendix provides general information about these companies.

In 1987, the Board first authorized bank holding companies to underwrite and deal, to a limited extent, in municipal revenue bonds, mortgage-related securities, consumer-receivable-related (asset-backed) securities, and commercial paper.[1] As of September 30, 1989, a total of 21 bank holding companies--9 multinational, 10 regional, and 2 foreign banks—have applied for and received Board approval to engage in the above bank-ineligible activities.[2,3] (See table IV.1.)

[1]The Board's April 30, 1987, Order authorized certain bank holding companies to underwrite and deal in bank-ineligible municipal revenue bonds, 1 to 4 family mortgage-backed securities, and commercial paper. The Board's July 14, 1987, Order authorized certain bank holding companies to underwrite and deal in consumer-receivable-related-securities. The 2d Circuit upheld the Board's 1987 Orders in Securities Industry Ass'n. v. Federal Reserve System, 839 F.2d, 62 (2d Cir.), cert. denied, 108 S.Ct. 2830 (1988). In a January 18, 1989, Order, the Board authorized certain bank holding companies to add underwriting and dealing in corporate debt securities and, conditionally, corporate equity securities to their list of approved bank-ineligible activities.

[2]The Bank of Montreal has received authority to underwrite and deal in only commercial paper.

[3]As of February 15, 1990, the Board had authorized five additional Section 20 subsidiaries—two owned by domestic bank holding companies and three owned by foreign banks—and had received applications for two others from foreign banks.

The Federal Reserve Board authorized Norwest Corporation and Sovran Financial Corporation to underwrite and deal in municipal revenue bonds, mortgage-related securities, asset-backed securities and commercial paper on December 20, 1989, and February 12, 1990, respectively. On January 4, 1990, the Federal Reserve Board authorized three foreign banks: Canadian Imperial Bank of Commerce, Toronto, Ontario, Canada; The Royal Bank of Canada, Montreal, Quebec, Canada; and Barclays Bank PLC, London, England to underwrite and deal to a limited extent in all types of debt securities in the United States through Section 20 subsidiaries. In addition, after appropriate management reviews were completed, Canadian Imperial Bank of Commerce and The Royal Bank of Canada were also authorized to underwrite and deal in equity securities.

The Section 20 subsidiaries of Canadian Imperial Bank of Commerce and The Royal Bank of Canada were U.S. securities firms purchased by the banks in 1988. Under the terms of the acquisitions authorized by the Board, the banks agreed to terminate all bank-ineligible activities that were being done at that time by the securities firms. The Section 20 subsidiary of Barclays Bank PLC was a subsidiary established by Barclays that had been engaged in bank-eligible securities activities prior to the Board's January 1990 action.

Although the Board first authorized Section 20 subsidiaries in April 1987, none of the subsidiaries actually commenced bank-ineligible activities until after June 1988.[1] Thus, as of September 30, 1989, most of the subsidiaries had been doing bank-ineligible activities barely more than a year, and eight of the Section 20 subsidiaries had not begun bank-ineligible activities at all. (See table IV.2.)

Bank holding companies have proceeded slowly with the authorized bank-ineligible activities. Many have not pursued the full range of these activities but have concentrated instead on those bank-ineligible securities that most complement their current activities. Accordingly, table IV.3 and figure IV.1 show that Section 20 subsidiaries have underwritten a relatively small volume of bank-ineligible securities. In addition, figures IV.2 through IV.5 show the volume of bank-ineligible securities underwritten by Section 20 firms.

[1] The actual effective date for starting the activities was delayed by two events. First, the Congressional moratorium contained in the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552, delayed any expansion of bank powers until after March 1, 1988. Second, bank holding companies were issued a stay on commencing the new powers until the United States Court of Appeals affirmed the validity of the Board's interpretation of "engaged principally," which was based on limiting the revenues that could be generated from bank-ineligible activities to 5 to 10 percent of gross revenues. See Securities Industry Ass'n. v. Federal Reserve System, 839 F. 2d, 62 (2d Cir.), cert. denied 108 S. Ct. 2830 (1988).

Table IV.1: Bank Holding Companies Authorized to Establish Section 20 Subsidiaries as of September 30, 1989

Bank holding company	Headquarters	Section 20 subsidiary
Multinational		
Bankers Trust New York Corp.	NY	BT Securities Corp.
Bank of Boston Corp.	MA	BancBoston Securities, Inc.
Chase Manhattan Corp	NY	Chase Securities, Inc.
Chemical Banking Corp	NY	Chemical Securities, Inc.
Citicorp	NY	Citicorp Securities Markets, Inc.
First Chicago Corp.	IL	First Chicago Capital Markets, Inc.
J.P. Morgan & Co., Inc.	NY	J.P. Morgan Securities, Inc.
Manufacturers Hanover Corp.	NY	Manufacturers Hanover Securities Corp.
Security Pacific Corp.	CA	Security Pacific Securities, Inc.
Regional		
Bank of New England Corp.	MA	BNE Capital Markets, Inc.
Barnett Banks, Inc.	FL	Barnett Brokerage Service, Inc.
CoreStates Financial Corp.	PA	CoreStates Securities Corp.
First Union Corp.	NC	First Union Securities, Inc.
Fleet/Norstar Financial Group	RI	Adams McEntee, Fleet/Norstar Securities, Inc
Huntington Bancshares, Inc.	OH	The Huntington Company
Marine Midland Banks, Inc	NY	Marine Midland Capital Markets Corp.
NCNB Corp.	NC	NCNB Capital Markets, Inc
PNC Financial Corp.	PA	PNC Securities Corp
SouthTrust Corp	AL	SouthTrust Securities, Inc.
Foreign		
The Bank of Montreal	Canada	Nesbitt Thomson Securities, Inc
Westpac Banking Corp.	Australia	Westpac Pollock Government Securities, Inc

Source: Federal Reserve

Table IV.2: Section 20 Subsidiaries That Had Commenced Bank-Ineligible Activities as of September 30, 1989

Section 20 subsidiary	Date authorized	Ineligible activity commenced
BT Securities Corp.	Apr. 87	2nd qtr 88
Citicorp Securities Markets, Inc.	Apr. 87	2nd qtr 88
J P Morgan Securities, Inc.	Apr. 87	2nd qtr 88
Chemical Securities, Inc	May 87	2nd qtr 88
Manufacturers Hanover Securities Corp.	May 87	3rd qtr 88
Chase Securities, Inc.	May 87	3rd qtr 88
Marine Midland Capital Markets Corp.	Jul. 87	3rd qtr 88
BNE Capital Markets, Inc.	Jul. 87	1st qtr 89
PNC Securities Corp	Jul. 87	1st qtr 89
First Chicago Capital Markets, Inc.	Aug. 88	1st qtr 89
Adams McEntee, Fleet/Norstar Securities, Inc.	Oct. 88	4th qtr 88
The Huntington Company	Nov. 88	4th qtr 88
Westpac Pollock Government Securities, Inc.	Mar. 89	2nd qtr 89

Note: Eight Section 20 subsidiaries had not commenced bank-ineligible activities as of September 30, 1989

Source: Federal Reserve

Table IV.3: Section 20 Subsidiaries Underwriting in Selected Bank-Ineligible Securities by Volume From July 1, 1988, to September 30, 1989

Dollars in millions

Period	Municipal revenue bonds	Mortgage-related securities	Asset-backed securities	Commercial paper
3rd qtr 88	$150.0	$148.0	$9.4	$11,98[illegible].6
4th qtr 88	385.7	311.1	350.5	29,05[illegible].0
1st qtr 89	291.7	873.6	342.0	41,36[illegible].6
2nd qtr 89	453.6	400.0	53.0	35,24[illegible].1
3rd qtr 89	385.6	600.0	45.0	67,65[illegible].9

Figure IV.1: Section 20 Firms' Market Share of Underwriting for Selected Bank-Ineligible Securities, From July 1, 1988, to September 30, 1989

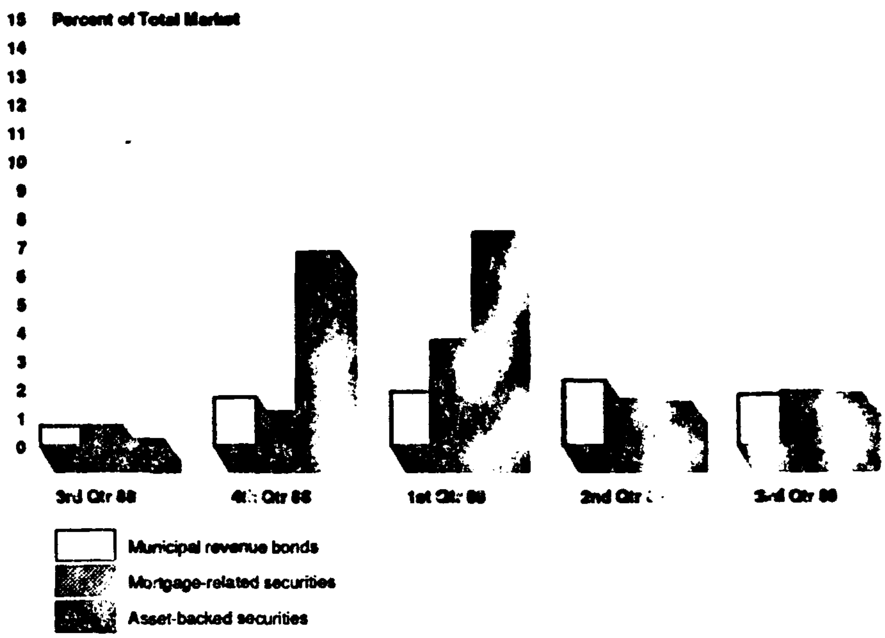


Figure IV.2: Bank-Ineligible Municipal Revenue Bonds Underwritten by Section 20 Firms, From July 1, 1988, to September 30, 1989

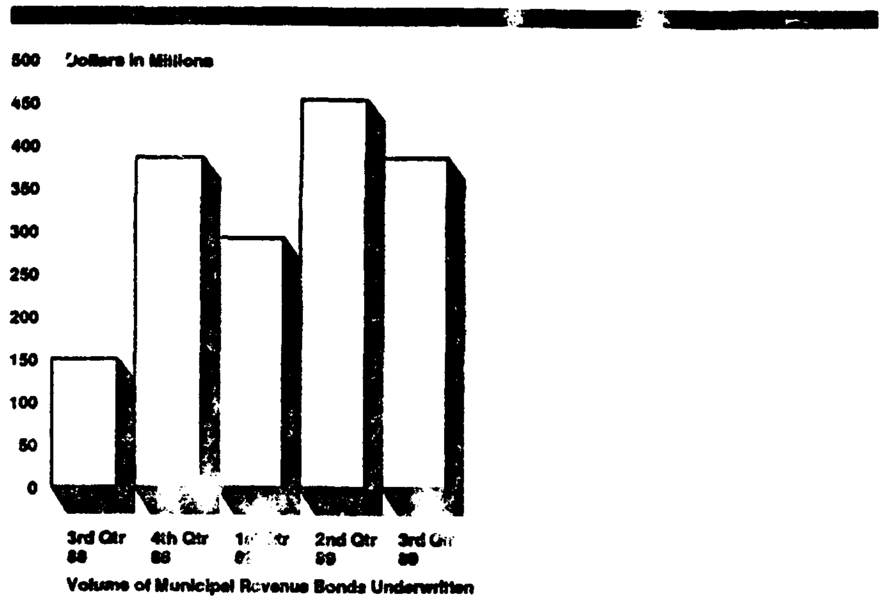


Figure IV.3: Bank-Ineligible Mortgage-Related Securities Underwritten by Section 20 Firms, From July 1, 1988, to September 30, 1989

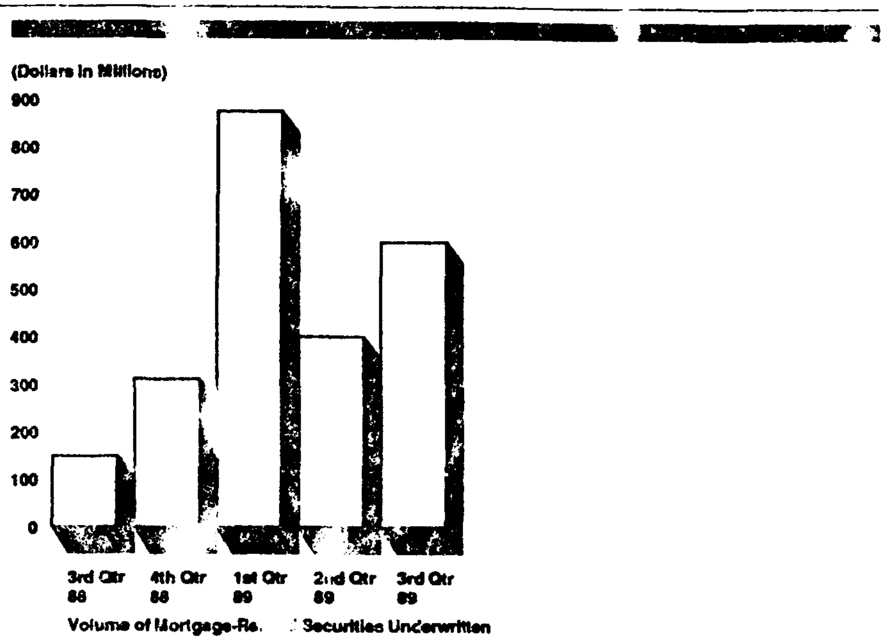


Figure IV.4: Bank-Ineligible Asset-Backed Securities Underwritten by Section 20 Firms, From July 1, 1988, to September 30, 1989

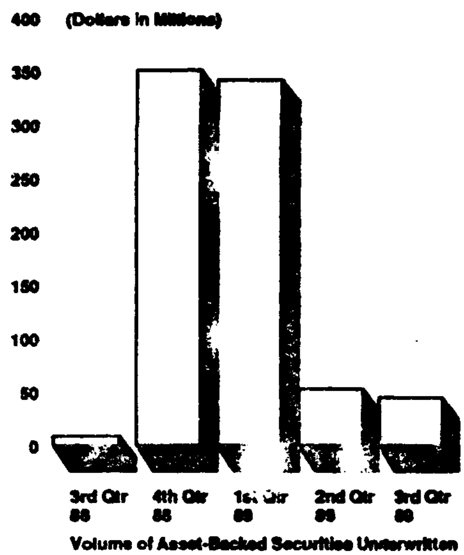
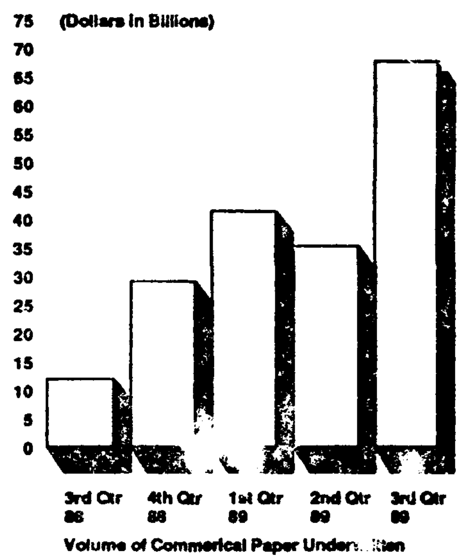


Figure IV.5: Bank-Ineligible Commercial Paper Underwritten by Section 20 Firms, From July 1, 1988, to September 30, 19



To generate a base of eligible revenues against which revenues from bank-ineligible activities can be measured, bank holding companies generally transfer bank-eligible activities, such as underwriting and dealing in obligations of the United States, general obligations of states and their political subdivisions, investment advisory and securities brokerage services, and placement of commercial paper and other types of securities as agent from their bank and nonbank subsidiaries into the Section 20 subsidiary. Relative to other bank-eligible activities, government securities activities generate substantial revenues. Seven Section 20 subsidiaries that are primary dealers in government securities include

- BT Securities Corp;
- Chase Securities, Inc.;
- Chemical Securities, Inc.;
- Citicorp Securities Markets, Inc.;
- J.P. Morgan Securities, Inc.;
- Manufacturers Hanover Securities Corp; and
- Westpac Pollock Government Securities, Inc.

During the second quarter of 1989, the 13 Section 20 subsidiaries that were operating during that time generated about $50 million in revenues from their bank-ineligible activities. (See table IV.4.) These revenues made up a small portion (about 3.3 percent) of the second quarter 1989 gross revenues for those subsidiaries, well within the Board's 10 percent revenue limitation. (See fig. IV.6.)

Bank holding companies have continued to capitalize their Section 20 subsidiaries as they organize their operations. In terms of assets and capital, most of the Section 20 subsidiaries are still small relative to the size of the parent holding company. (See table IV.5 and table IV.6.)

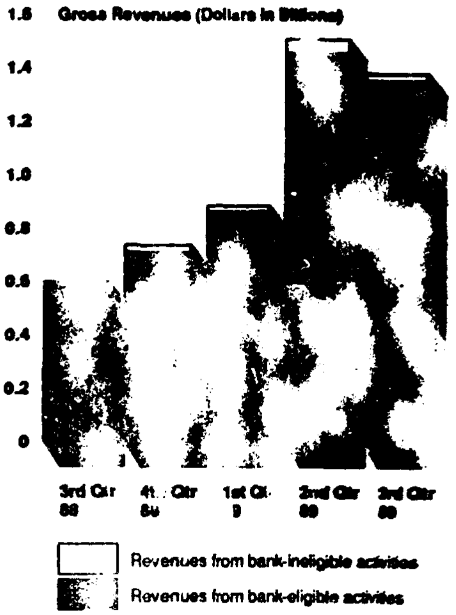
Table IV.4: Revenues of Section 20 Subsidiaries, From July 1, 1988, to September 30, 1989 (Unaudited)

Dollars in millions

Period	Number of active firms	Eligible revenues	Ineligible revenues	Gross revenues	Ineligible as a percent of gross revenues
3rd qtr 88	7	$592	$2	$594	.34
4th qtr 88	9	708	25	733	3.41
1st qtr 89	12	859	21	880	2.39
2nd qtr 89	13	1,452	50	1,502	3.33
3rd qtr 89	13	1,349	25	1,374	1.82

Source: Federal Reserve

Figure IV.6: Revenues of Section 20 Firms, From July 1, 1988, to September 30, 1989



This chart is based on unaudited data

Source: Federal Reserve

Table IV.5: Section 20 Firms' Assets as a Percent of Parents' Assets as of June 30, 1989 (Unaudited)

Percent range	Number of Section 20 firms
< 1 percent	6
1 percent < 5 percent	2
5 percent < 15 percent	2
15 percent < 24 percent	3
Total	**13**

Note: Eight Section 20 subsidiaries are excluded from this analysis

Table IV.6: Section 20 Firms' Capital as a Percent of Parents' Capital as of June 30, 1989 (Unaudited)

Percent range	Number of Section 20 firms
< 1 percent	4
1 percent < 3 percent	4
3 percent < 6 percent	2
6 percent < 8 percent	3
Total	**13**

Note: Eight Section 20 subsidiaries are excluded from this analysis

Capital Structure and Capital Adequacy Requirements for Bank Holding Companies and Section 20 Firms

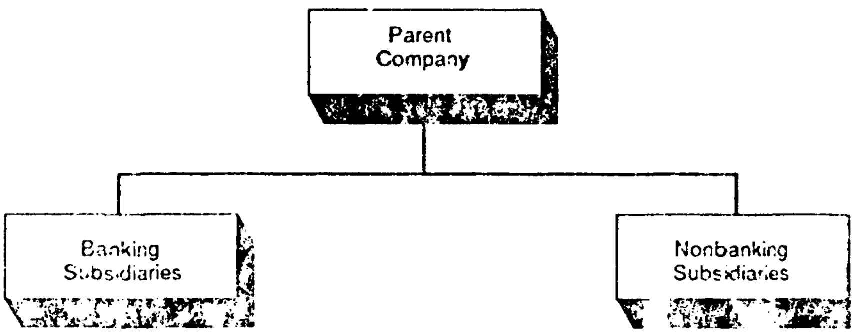
This appendix discusses the capitalization of Section 20 companies and the regulatory capital requirements that apply to these bank holding company subsidiaries.

The first section discusses the concept of capital, citing some statistics of bank holding companies that had received Federal Reserve approval to set up Section 20 subsidiaries as of September 30, 1989. The second section discusses capital adequacy standards relevant to Section 20 subsidiaries and their holding companies.

The Capital Structure of a Bank Holding Company

A simplified illustration of a bank holding company with banking and nonbanking subsidiaries, all wholly owned, is shown in figure V.1. The capital structure can be considered from the point of view of the parent, each subsidiary, and the entire holding company on a consolidated basis. Other ways of looking at capital are the market value of the capital stock and regulatory capital.

Figure V.1: Simplified Structure of a Bank Holding Company



Parent

A bank holding company parent is typically financed by a combination of debt and equity. Some of the funds from these sources are used to finance activities of the parent company itself. However, most of the funds are used to support subsidiaries in the form of equity investments or loans.

[1]This is typically referred to as downstreaming funds.

The capital structure of the parent companies of the Nation's largest bank holding companies is summarized in table V.1. The table compiles financial data from the parent companies of the top 25 bank holding companies as of June 30, 1989. These companies had a total of $77 billion in equity capital,[2] $69 billion in long-term debt and other liabilities, and $48 billion in commercial paper and other short-term debt. Of the $194 billion in parent company assets, $102 billion represents funds invested in subsidiaries involved in banking-related activities, $66 billion represents investments in nonbanking subsidiaries, and $26 billion represents investments in other activities of the parent.

Table V.1. Capital Structure of the Parent Companies of the 25 Largest Bank Holding Companies as of June 30, 1989

Dollars in billions

Assets		
Investments in banking subsidiaries		$102
Loan advances and other receivables	(24)	
Equity investments	(78)	
Investments in nonbanking subsidiaries		66
Loan advances and other receivables	(52)	
Equity investments	(14)	
Other assets		26
		$194
Liabilities and equity		
Commercial paper and other short-term debt		$48
Long term debt and other liabilities		69
Equity capital		77
		$194

Notes: Banking subsidiaries include both banks and bank holding companies.

This table is an aggregation of financial data from the 25 largest bank holding companies.

Source: Federal Reserve Form Y-9

The information contained in table V.1 is summarized on a percentage basis in table V.2. For the top 25 bank holding companies, investments in banking subsidiaries represent just over half (53 percent) of parent company assets. As a general rule, a much greater portion of the investment in banking subsidiaries is equity than is the case with the investment in nonbanking subsidiaries.

[2] For this purpose, all types of equity capital have been added together.

The proportion of parent company assets invested in banking subsidiaries varies, of course, among bank holding companies. Table V.3 summarizes the variation among the 19 U.S. bank holding companies that have been authorized, as of September 30, 1989, to set up Section 20 subsidiaries. This table is comprised of data from the year ending December 31, 1988, the most current end-of-year data available during our study. The proportion of assets invested in banking subsidiaries is less than 40 percent for two of the companies and 80 percent or greater for six of the companies.

Table V.2: Capital Structure of the Parent Companies of the 25 Largest Bank Holding Companies as of June 30, 1989

Figures in percent

Assets		
Investments in banking subsidiaries		53
Loan advances and other receivables	(13)	
Equity investments	(40)	
Investments in nonbanking subsidiaries		34
Loan advances and other receivables	(27)	
Equity investments	(7)	
Other assets		13
		100
Liabilities and equity		
Commercial paper and other short-term debt		25
Long-term debt and other liabilities		35
Equity capital		40
		100

Notes: Banking subsidiaries include both banks and bank holding companies.

This table is based on an aggregation of financial data from the 25 largest bank holding companies.

Source: GAO analysis based on table V.1

Table V.3: Proportion of Parent Company Assets Invested in Banking Subsidiaries for U.S. Bank Holding Companies Authorized to Set Up Section 20 Subsidiaries as of December 31, 1988

Parent company investments in banking subsidiaries	Number of U.S. bank in banking subsidiaries holding companies authorized to set up Section 20 subsidiaries
less than 40%	2
40-59	7
60-79	4
80-100	6
Total	**19**

Notes: Information is not available for two foreign bank holding companies.

Banking subsidiaries include both banks and bank holding companies.

Source: GAO analysis based on Federal Reserve Form Y-9.

Subsidiaries

Loans and equity investments received from the parent company are two important elements in the financial arrangements of bank holding company subsidiaries. Each subsidiary also has assets, liabilities, and retained earnings associated with its line of business. The principal liabilities of banking subsidiaries are typically deposits.

Funds sent from the subsidiary to the parent company take the form of payments of interest and principal on loans and dividends on stock.[1] The subsidiary may purchase services from the parent or another subsidiary or may lend money to the parent or another subsidiary.

A simplified hypothetical example of the capital structure of holding company subsidiaries is shown in figure V.2. The numbers used are based on the percentages found in table V.2.[2]

The concept of leveraging is important when the capital structure of a bank holding company subsidiary is examined. Financial leverage is the use of debt to supplement equity in a company's capital structure. A situation called double leveraging exists when a parent company invests borrowed funds in a subsidiary as equity.

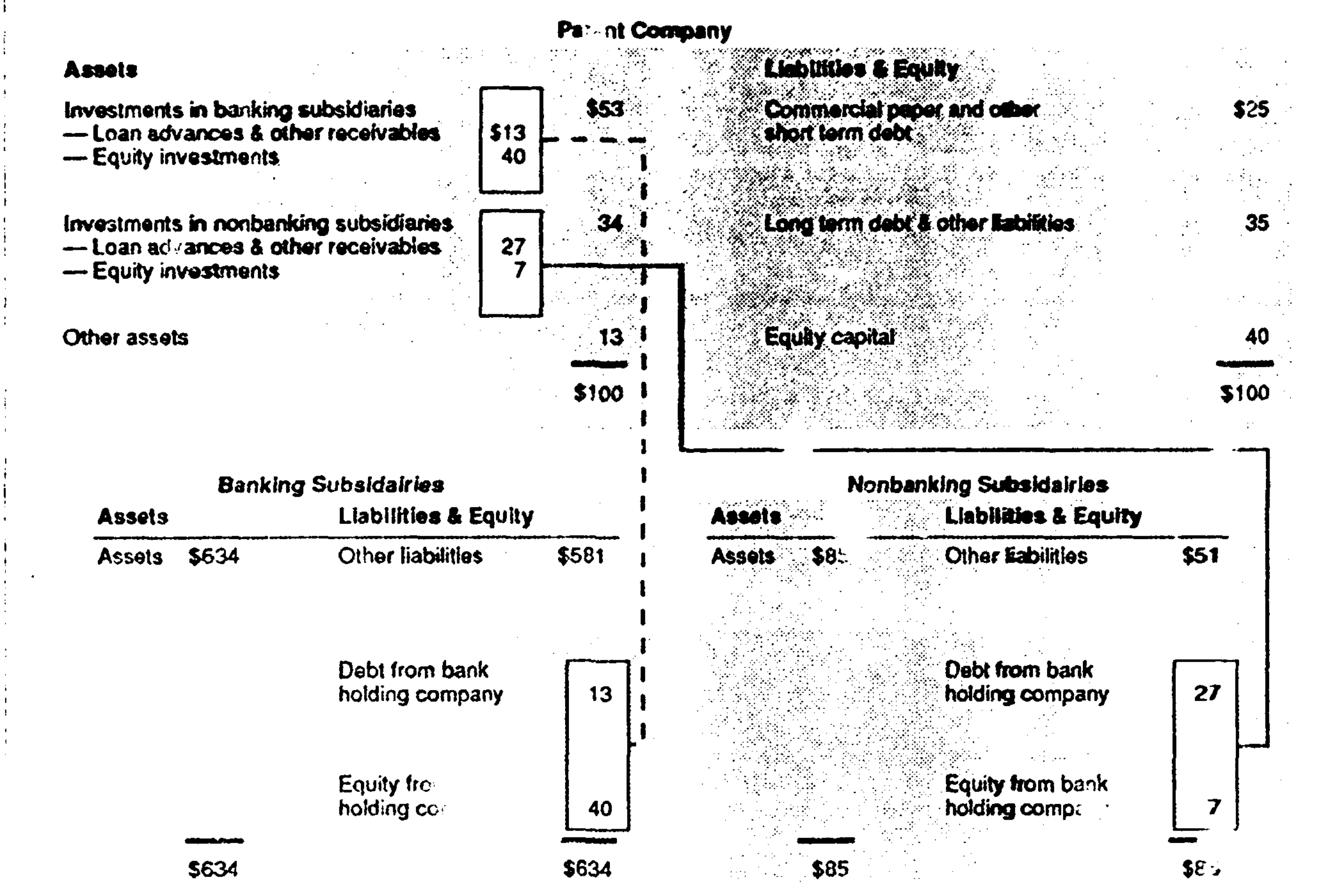
An example of double leveraging is found in figure V.2. The parent's equity investment in the bank and nonbank subsidiaries is $47 million.

[1]This is typically referred to as upstreaming funds.

[2]In this example, parent company assets, which were equal to 100 percent in table V.2, equal $200 million. Using this as a baseline figure, we developed the relative sizes of the bank and nonbank subsidiaries based on balance sheet data as of year end 1988 for the top 25 bank holding companies.

However, the equity capital of the parent company is only $40 million. Dividing the equity invested in the subsidiaries by the equity of the parent gives a ratio that measures the extent to which a company is double leveraged. Double leveraging exists when the ratio exceeds 100 percent. In this example, the ratio is 118 percent.

Figure V.2: Hypothetical Example of the Capital Structure of Bank Holding Company Subsidiaries (Dollars in millions)



Note: Banking subsidiaries includes both bank and bank holding companies

Source: GAO analysis based on Table V.2 and Federal Reserve Form Y.9

Table V.4 shows the extent to which the 19 U.S. bank holding companies authorized to set up Section 20 subsidiaries were double leveraged as of December 31, 1988. Three of the companies have ratios below 100 percent, and seven of the companies have ratios of 120 percent or greater.

In order to evaluate double leveraging in a bank holding company, the Federal Reserve uses a "building block" approach when examining the capital of a bank holding company. This means that the Federal Reserve looks at both the amount and components of capital of the consolidated holding company and of the bank and nonbank subsidiaries.

Table V.4: Frequency of Double Leveraging in the U.S. Bank Holding Companies Authorized to Set Up Section 20 Subsidiaries as of December 31, 1988

Equity invested in subsidiaries divided by total equity of parent	Number of U.S. bank holding companies authorized to set up Section 20 subsidiaries
90%-99%	3
100-109	3
110-119	6
120-129	4
greater than 129	3
Total	**19**

Notes: Information is not available for two foreign bank holding companies.

Double leveraging exists when the equity invested in the subsidiaries as a percentage of the total equity of the parent is greater than 100 percent.

Source: GAO analysis based on Federal Reserve Form Y-9.

Consolidated

A consolidated statement of assets, liabilities, and capital for the hypothetical bank holding company used in figure V.2 is shown in table V.5. Equity capital of $40 million supports $732 million in assets. Equity capital represents the shareholders' financial ownership and is the principal component of regulatory capital. The ratio of equity capital to assets in this hypothetical holding company is 5.5 percent.

Table V.5: Hypothetical Example of the Capital Structure of a Consolidated Bank Holding Company

Dollars in millions	
Assets	
Assets	$732
Liabilities and Equity Capital	
Liabilities	$629
Equity capital	40
	$732

Source GAO analysis based on table V.4 and Federal Reserve Form Y-9

The ratio of equity capital to holding company assets varies among bank holding companies. An analysis of the equity capital ratio of the 19 U.S. bank holding companies authorized to set up Section 20 subsidiaries is shown in table V.6. As of December 31, 1988, four of the companies had ratios between 4.5 percent and 5 percent, while six of the companies had ratios greater than 6.5 percent.

Table V.6: Equity Capital as a Percentage of Bank Holding Company Assets for U.S. Bank Holding Companies Authorized to Set Up Section 20 Subsidiaries as of December 31, 1988

Equity capital divided by total assets	Number of U.S. bank holding companies authorized to set up Section 20 subsidiaries
4 5%-4 9%	4
5 0-5 4	3
5 5-5 9	3
6 0-6 4	3
greater than 6 4	6
Total	**19**

Note Information is not available for two foreign bank holding companies

Source GAO analysis from Federal Reserve Form Y-9

Market Value

Financial market analysts often look at the capital of bank holding companies (or any company) from the point of view of the market value of the company. This is calculated by multiplying total shares outstanding by the price per share. The market value may be greater or less than the book value or equity shown on the company's financial statements. The ratio of market value to book value is one indication of the company's financial strength.

The range of the market to book value ratio for 16 U.S. bank holding companies authorized to set up Section 20 companies is shown in table V.7. As of December 31, 1988, the ratios ranged from between 50 percent and 69 percent to more than 130 percent.

Table V.7: Market Price as a Percentage of Book Value Per Share for U.S. Bank Holding Companies Authorized to Set Up Section 20 Subsidiaries as of December 31, 1988

Market price divided by book value	Number of U.S. bank holding companies authorized to set up Section 20 subsidiaries
50%-69%	3
70-89	2
90-109	3
110-129	3
greater than 129	5
Total	**16**

Note: Information is not available for two foreign and three domestic bank holding companies.

Source: Federal Reserve

Regulatory Capital

The Federal Reserve's basic capital standard for bank holding companies is defined in terms of the holding company's consolidated financial statements and is stated as a percentage of holding company assets. At present, bank holding companies must have what is termed primary capital equal to at least 5.5 percent of assets and total capital of at least 6 percent of assets.[5] Total capital is comprised of primary and secondary capital.[6] The primary and secondary capital ratios applied to the holding company are the same ratios that the Federal Reserve and other federal regulators apply to commercial banks. Regulatory officials can also raise the capital requirements of any individual holding company or bank if circumstances warrant.

Table V.8 shows the primary capital as a percentage of the bank holding company assets for the 19 U.S. bank holding companies authorized to set up Section 20 subsidiaries. This table shows that as of December 31, 1988, all of the companies were at least 1 percentage point above the minimum 5.5 percent requirement, and most were well above the minimum.

[5] Primary capital consists of common and perpetual preferred stock, surplus (excluding surplus relating to limited-life preferred stock), undivided profits, allowance for loan and lease losses, capital reserves, minority interest in consolidated subsidiaries, and a limited amount of perpetual debt instruments and mandatory convertible instruments.

[6] Secondary capital includes perpetual debt, perpetual preferred stock, and mandatory convertible instruments in excess of the limits allowed as primary capital. It also includes limited-life preferred stock, subordinated notes and debentures, and unsecured long-term debt of the parent company and its nonbank subsidiaries.

Table V.8: Primary Capital as a Percentage of Consolidated Bank Holding Company Assets for U.S. Bank Holding Companies Authorized to Set Up Section 20 Subsidiaries as of December 31, 1988

Primary capital divided by total assets	Number of U.S. bank holding companies authorized to set up Section 20 subsidiaries
less than 6.5%	0
6.5-7.4	3
7.5-8.4	6
8.5-9.4	6
9.5-10.0	4
Total	**19**

Note: Information is not available for two foreign bank holding companies.

Source: GAO analysis from Federal Reserve Form Y-9

By the end of 1990, bank holding companies must also meet a new risk-based capital standard. The Federal Reserve is requiring that new risk-based capital requirements applying to banks, bank holding companies, and other federally regulated banking agencies be phased in. This standard takes account of the off-balance sheet commitments, such as letters of credit and guarantees, in addition to the assets included on the balance sheet. The various assets and off-balance sheet items are placed into risk categories that are then weighted by degree of risk.

A bank holding company's risk-based capital ratio is calculated by dividing its qualifying capital for regulatory purposes by the sum of its risk-weighted assets. By year-end 1990, banking organizations are expected to meet a minimum interim target ratio for qualifying total capital to risk-weighted assets of 7.25 percent, and by 1992 the target ratio is 8 percent. At least one-half of these capital targets must be in the form of Tier 1 capital[7] and the rest can be Tier 2 capital.[8]

The Section 20 subsidiaries of bank holding companies are required to meet the capital standards for broker-dealers set by SEC. These requirements are explained in the following section, together with other aspects of holding company capital regulations applicable to Section 20 subsidiaries.

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[7]Tier 1 capital consists of core capital elements, such as common stockholders' equity, minority interests in equity accounts of consolidated subsidiaries, and perpetual preferred stock (limited amounts), less goodwill.

[8]Tier 2 capital includes perpetual preferred stock (unlimited amounts) and related surplus, allowances for loan and lease losses, hybrid capital instruments, and term-subordinated debt and intermediate term-preferred stock, including related surplus.

Capital Adequacy Rules for Section 20 Subsidiaries and Their Holding Companies

SEC Rules

To ensure that broker-dealers can meet financial responsibilities to their customers and to other market participants, Section 20 firms and all other broker-dealers must comply with SEC's net capital rule, which is designed to address the liquidity of securities firms. The net capital rule requires that broker-dealers maintain a minimum capital level at all times.

Capital in securities firms consists of equity and various forms of subordinated debt. The net capital rule requires broker-dealers to compute their capital from financial statements prepared by valuing the firm's security positions at current market prices rather than at historical values as banks are permitted to do. The rule then requires that deductions be made from capital for fixed assets, unsecured receivables, and for risk characteristics of particular assets. The risk-related deductions, known as "haircuts," reflect price fluctuations based on historical experience. When a broker-dealer's net capital falls below required levels, the broker-dealer must immediately notify its regulators and cease operations unless additional capital is obtained.

One significant difference between SEC and bank holding company capital regulations should be noted. The SEC net capital rule applies only to the capital of broker-dealers registered with SEC. The rule does not extend beyond broker-dealers to parent companies, other affiliates, or holding companies on a consolidated basis unless their activities are specifically subject to SEC regulations. Therefore, there is no formal regulatory control over double leveraging or over other activities of the parent or affiliates of an SEC firm comparable to the regulation that the Federal Reserve applies to bank holding companies with Section 20 subsidiaries. A full comparison between the treatment of capital investments in broker-dealer subsidiaries made by bank holding companies and securities holding companies was beyond the scope of this report.

Bank Holding Company Rules

In addition to ensuring that Section 20 subsidiaries meet SEC capital requirements, bank holding companies with Section 20 subsidiaries are also required to meet the Federal Reserve's capital requirements that apply to the consolidated holding company. The Federal Reserve System's capital adequacy standards for bank holding companies involve several components. First, as pointed out above, bank holding companies must have sufficient capital as a percentage of the holding company's total assets on a consolidated basis. The Board also requires holding companies to capitalize all nonbanking subsidiaries in accordance with industry standards and with the risk factors involved in the particular firm. Furthermore, the Federal Reserve can control the amount of investment made in any subsidiary. The aim of the Federal Reserve's capital regulation is to ensure, to the extent feasible, that the subsidiary can support itself on a stand-alone basis while at the same time maintaining the bank holding company's ability to serve as a source of financial strength to its subsidiary banks.

In computing bank holding company capital ratios, the assets and liabilities of any bank holding company subsidiary that is not consolidated for supervisory or regulatory purposes are deducted from the assets, liabilities, and capital of the holding company. A Section 20 company, which must comply with SEC's net capital rule, is such a subsidiary. Hence, the parent's investment in the Section 20 subsidiary, together with the assets and liabilities of the Section 20 subsidiary, are deducted from the assets, liabilities, and capital of the bank holding company. In approving Section 20 subsidiaries, however, the Federal Reserve has held that the parent investment in the subsidiary cannot weaken the capital of the holding company.

Appendix VI

The Regulatory Framework Affecting the Securities Activities of Banks

This appendix highlights the legislation affecting banking organizations' domestic and foreign activities and summarizes the actions taken by the Federal Reserve Board in allowing Section 20 companies to underwrite and deal in bank-ineligible securities. It also describes SEC's role in regulating Section 20 companies' bank-ineligible securities activities.

Primary Legislative Provisions Affecting the Securities Activities of Banking Organizations

The following gives a very basic picture of the legal framework underlying the securities activities of banking organizations. The relevant statutes are addressed in the order in which the basic statutes were enacted.

National Banking Act and State Laws

The securities activities of banks are determined by a variety of federal and state laws. A number of state laws permit state-chartered banks to engage in some securities activities that are not permitted for national banks.

The National Currency Act of 1863 and the National Bank Act of 1864, administered by the Office of the Comptroller of the Currency (OCC), created a system of national banks that today includes about 4,300 banks with about $1.8 trillion in assets. The National Bank Act precluded national banks from underwriting corporate securities directly. However, the statute did not prohibit national banks from being affiliated with organizations that did securities activities. This allowed national banks the opportunity to establish state-chartered affiliates that could do securities activities.

Under regulatory guidance from OCC, national banks are allowed to engage in a full range of government securities activities, make private placement of corporate securities, and buy and sell all types of securities as agent for customers. National banks can also own for their investment account a limited amount of corporate bonds, provided they are marketable and investment quality. In a 1987 ruling upheld in September 1989 by the United States Court of Appeals for the Second Circuit, OCC permitted national banks to offer mortgage pass-through certificates, representing interests in mortgage loans originated by the bank. The court found the sale of such certificates within the business of banking and not in violation of Glass-Steagall's prohibition on underwriting securities.[4]

Federal Reserve Act

In 1913, Congress enacted the Federal Reserve Act, which established the Federal Reserve System and its Board of Governors. This act requires national banks to be members of the Federal Reserve System. It also contained provisions allowing state-chartered banks to join the Federal Reserve System, making them member banks and subject to Board regulation. State member banks are subject to the same limitations on their securities activities that apply to national banks.

The act also contains provisions that affect the transactions between a bank and its affiliates. Section 23A of this act prohibits a member bank from extending credit to, or purchasing assets from, an affiliate in excess of 10 percent of the bank's capital and places an aggregate cap of 20 percent of capital for transactions to all affiliates. This section also requires generally that any bank loans to an affiliate be fully collateralized as a minimum, or up to 130 percent of the loan amount, depending on the composition of the collateral. Section 23B of this act requires that covered transactions, such as the sale of assets or services purchased under contract, between a bank and an affiliate must be on terms substantially the same as those prevailing at the time for comparable transactions involving nonaffiliates. The limitations of Section 23B were made applicable to all FDIC-insured banks in 1987.

McFadden Act

Under the McFadden Act of 1927, banking activities were limited by provisions prohibiting the interstate branching by banks. However, the law reaffirmed the authority of national banks to buy and sell investment securities.

Glass-Steagall Act

The Banking Act of 1933 significantly limited the securities activities of banks. Popularly referred to as the Glass-Steagall Act, it contains the following four sections which deal with the separation of commercial banking from investment banking.

[4] See Securities Industry Ass'n v. Clarke, 885 F.2d 1034 (2d Cir. 1989), which is currently on appeal to the Supreme Court. It should be noted that mortgage related securities activities carried out in a securities subsidiary of a bank holding company have been considered a "bank-ineligible" activity when permissible levels of such activity are calculated for Section 20 purposes. If the OCC interpretation is upheld by the Supreme Court, the Federal Reserve would have to determine whether revenue from the activity constitutes bank eligible revenue, which would increase the revenue base, as opposed to bank-ineligible revenue, which would not.

- Section 16 prohibits a national bank from underwriting securities other than U.S. government and general obligation bonds of states and municipalities and certain securities issued or insured by certain specified government agencies or instrumentalities. It does, however, allow a national bank to purchase or sell securities without recourse, solely on the order, and for the account of, customers. Section 5(c) of the act extends these prohibitions to state-chartered member banks.
- Section 21 prohibits any firm engaged in the deposit-taking business, including a bank, from engaging in the business of issuing, underwriting, selling, or distributing securities, except as permitted under Section 16.
- Section 20 prohibits a member bank from being affiliated with any firm engaged principally in the issue, flotation, underwriting, public sale, or distribution of securities.[2]
- Section 32 prohibits management and employee interlocks between member banks and firms primarily engaged in the issue, flotation, underwriting, public sale, or distribution of securities, except as permitted by regulation of the Federal Reserve Board.

Bank Holding Company Act

The Bank Holding Company Act of 1956, as amended, administered by the Board, allows bank holding company nonbank subsidiaries to engage in activities that are permissible for banks as well as those that banks are not permitted to engage in. A holding company must, however, comply with the provisions contained in the Glass-Steagall Act. Board regulations promulgated under the Bank Holding Company Act are contained in its Regulation Y.

Under Section 4(c)(8) of the act, the Board can authorize bank holding companies—and their subsidiaries—to engage in activities that it determines are closely related to and a proper incident to banking. This section of the act also requires the Board to determine that an approved new activity may be expected to produce public benefits, such as greater convenience or increased competition, that outweigh possible adverse effects, such as unsound banking practices and conflicts of interest.

In authorizing Section 20 companies, the Board used its authority under the Bank Holding Company Act to impose requirements regarding revenue limitations, capitalization, and firewalls.

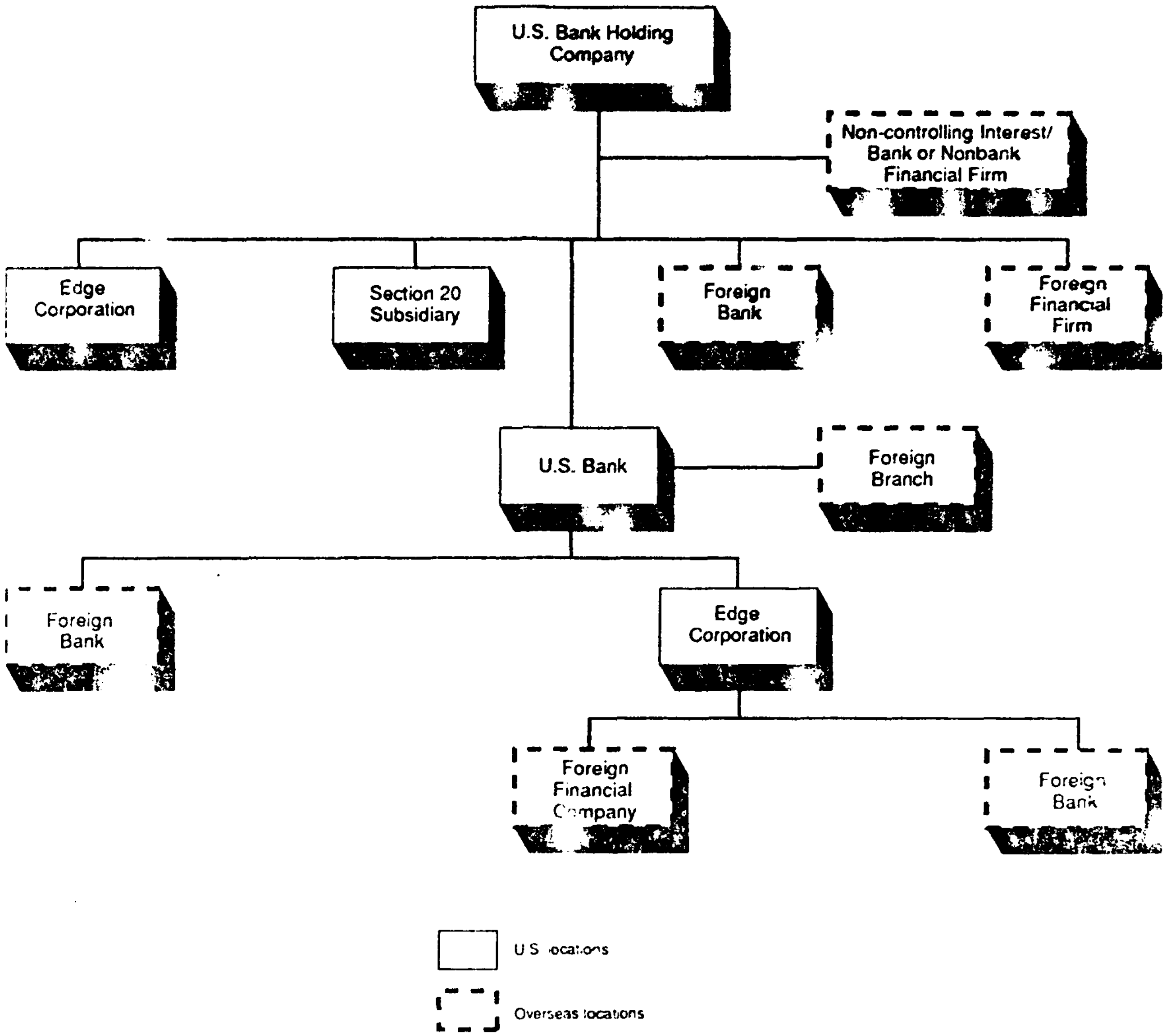
[2]This prohibition does not extend to the securities underwriting activities permissible under Section 16 of the act. See Securities Industry Ass'n v. Federal Reserve System, 839, F.2d 47 (2d Cir.), cert. denied, 108 S. Ct. 2830 (1988).

International Securities Activities of U.S. Commercial Banking Organizations

To allow U.S. banking organizations to be more competitive in foreign markets, the federal regulatory structure permits domestic commercial banks and bank holding companies to do a range of securities activities overseas that is broader than those permitted in the U.S. market. One primary reason this occurs is that provisions contained in the Glass-Steagall Act do not apply to U.S. banks' foreign activities. U.S. banking organizations do international securities and other activities primarily through some combination of foreign branches of the domestic parent bank, or through foreign bank and nonbank subsidiaries, Edge Act corporation subsidiaries,[1] and joint venture companies (noncontrolling interests in foreign banks and financial companies) of the parent bank or bank holding company. An example of the organizational structures that are possible within the holding company is shown in figure VI.1.

[1] Section 25(a) of the Federal Reserve Act (the Edge Act) authorizes the Board of Governors to charter corporations for the purpose of engaging in international or foreign banking or other international and foreign operations.

Figure VI.1: Possible Organization Structure for the Conduct of U.S. Bank Holding Company's International Operations



All of these organizational structures must comply with applicable U.S. laws regarding powers, capitalization, and transactions within the holding company. In addition, all of the organizational arrangements must comply with the banking laws and regulations of the host country.[4]

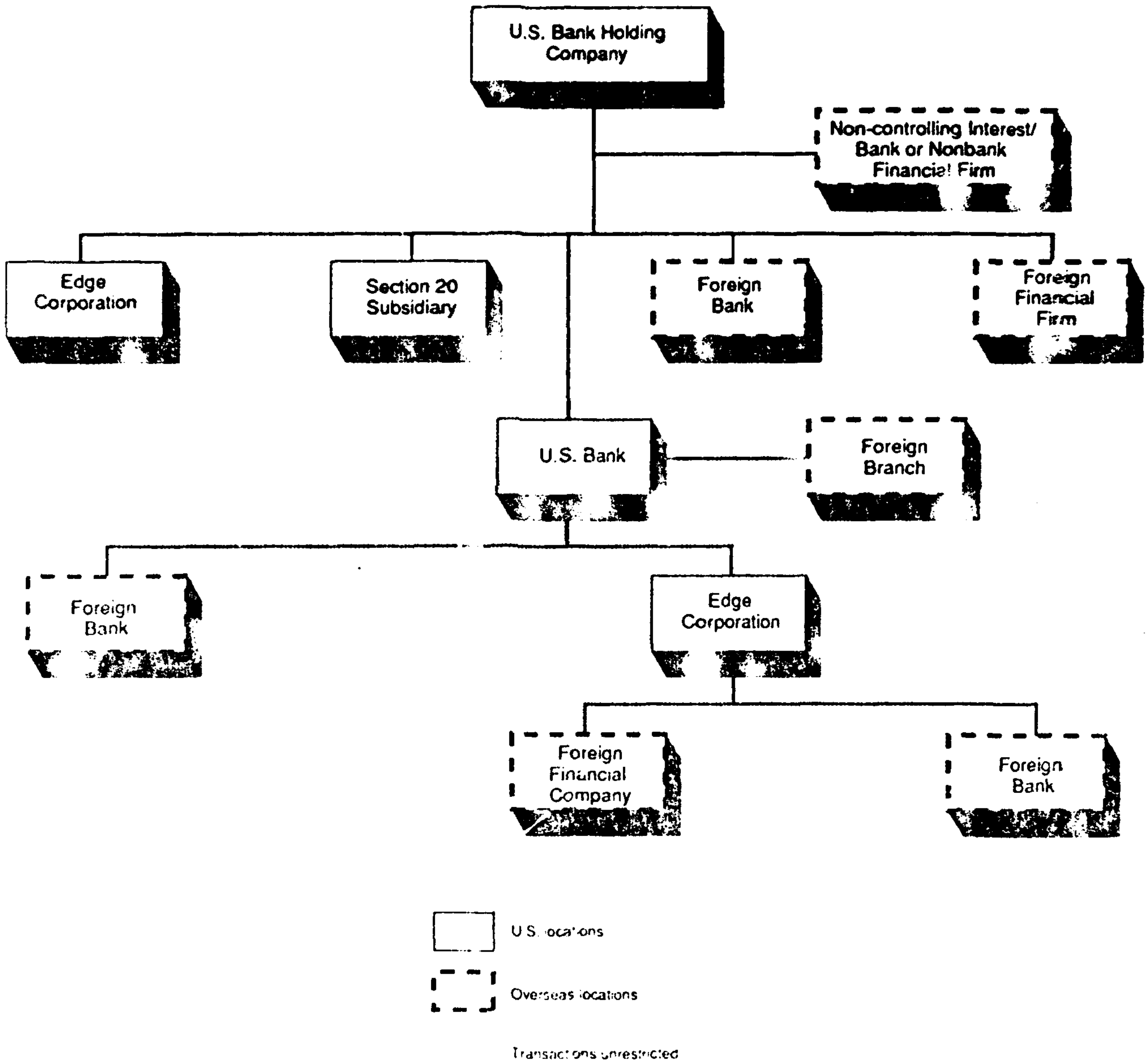
The following statutory provisions of the Federal Reserve Act and the Bank Holding Company Act are the key guidelines for the overseas activities of member banks and bank holding companies.

- Section 25 of the Federal Reserve Act permits national banks to establish foreign branches, invest directly in foreign banks, and exercise other powers, including limited securities activities that are usual in connection with banking in the place where foreign branches transact business.[5] Branches are limited by statute to underwriting and distributing only government securities of the country in which the branch is located.
- Section 25(a) of the Federal Reserve Act authorizes national banks to own Edge Act corporations and gives Edge Act corporations a broad range of foreign investment powers.
- Section 4(c)(13) of the Bank Holding Company Act allows U.S. bank holding companies to make direct foreign investments.
- Sections 23A and 23B of the Federal Reserve Act limit transactions between the domestic bank and the bank holding company parent or its affiliates. The relationships to which these limitations apply are summarized in figure VI.2. The restrictions do not apply to transactions taking place within the shaded box shown in figure VI.2. Everything in the shaded box is owned by the bank and, for bank regulatory purposes, can be viewed on a consolidated basis.

[4]Banking and securities regulatory structures and rules vary among countries. For example, the Glass-Steagall Act in the United States and its equivalent, Article 65, in Japan separate the securities and banking industries and thus result in different regulatory structures than in the United Kingdom, where banks are allowed to engage in securities activities.

[5]Under the provisions of Section 9 of the Federal Reserve Act, the Federal Reserve interprets Section 25 to also apply to state-chartered member banks.

Figure VI.2: Limitations on Transactions Between Affiliates in U.S. Ban[illegible]g Organization's International Operations

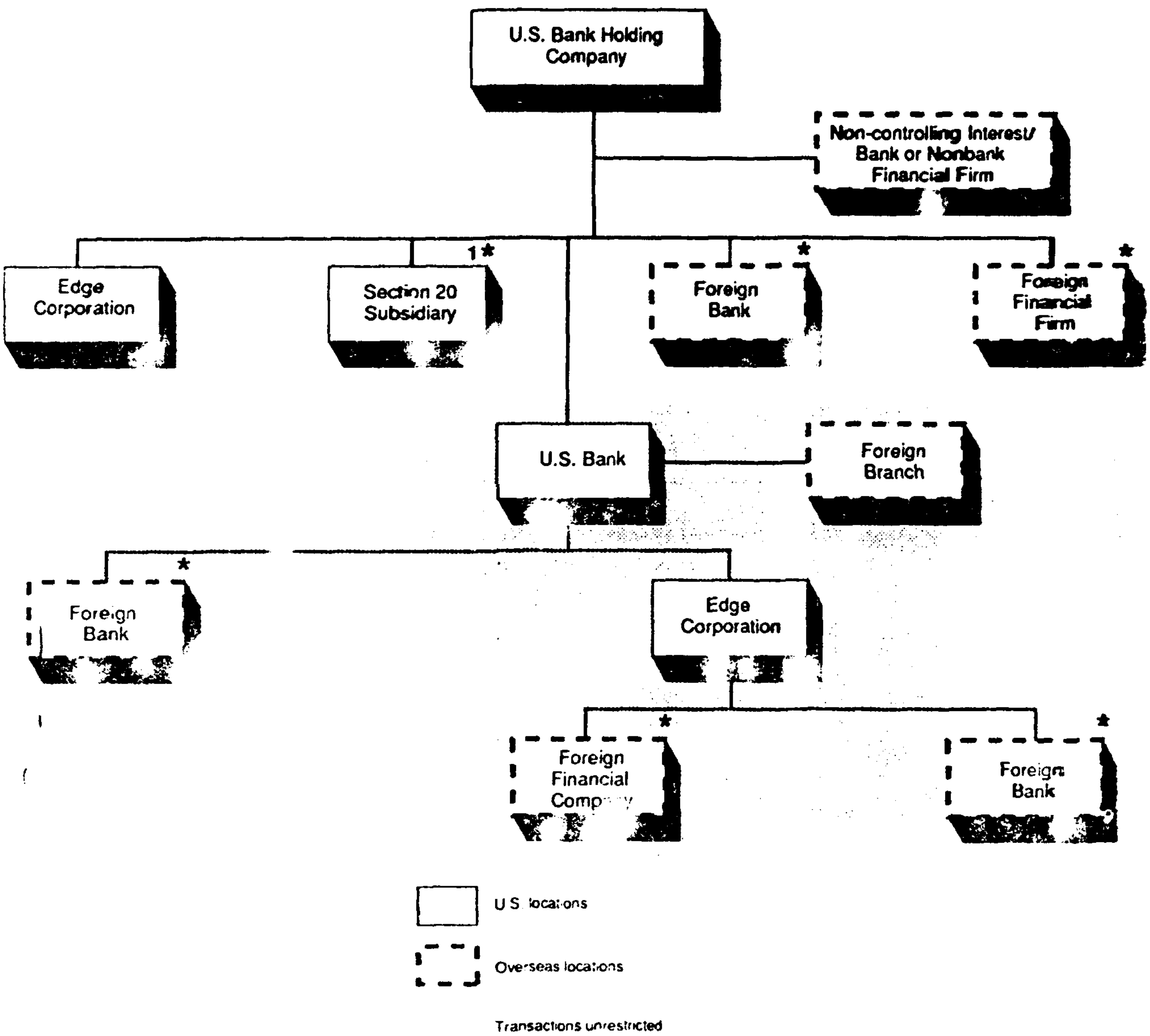


Regulation K implements key sections of the Federal Reserve and Bank Holding Company Acts.[a] It describes the activities that banks and bank holding companies may engage in overseas through foreign branches, foreign subsidiaries, and Edge Act corporations. The activities permitted by Regulation K generally encompass all domestic banking powers plus some additional banking powers (in the case of branches) and investment banking powers, such as underwriting and dealing in equity securities (in the case of subsidiaries). Generally, U.S. banking organizations may engage in activities permitted by Regulation K to the extent that these activities are permitted by host country regulators. Subject to prior Board approval, banks or bank holding companies may also engage in activities that are not prescribed in Regulation K but are permissible by the regulations of the host country.

To illustrate the opportunities that exist overseas for bank holding companies to engage in securities activities, the constituent elements of bank holding companies eligible to underwrite corporate debt are shown in figure VI.3. Except for the Section 20 firms, all of this underwriting must take place in entities of the bank or its holding company that cannot operate in U.S. domestic securities markets. Section 20 companies can underwrite corporate debt and equity only after receiving prior approval from the Federal Reserve.

[a] Regulation K also implements the International Banking Act of 1978 (which addresses the U.S. activities of foreign banks), the Bank Export Services Act (which relates to export trading companies), and the International Lending Supervision Act (which strengthened federal supervision of the foreign lending of U.S. banks). As noted above, general regulations implementing the Bank Holding Company Act are contained in Regulation Y.

Figure VI.3: Constituent Elements of U.S. Bank Holding Companies Eligible to Underwrite Corporate Debt



★ Organizational elements eligible to underwrite corporate debt

1 Only 4 Section 20 companies authorized to underwrite corporate debt as of September 30, 1989

Regulation K contains specific limitations on some of the activities that are allowed. For example, the aggregate commitment of a banking organization and its subsidiaries to underwrite shares of an issuer cannot exceed $15 million. In addition, the total loans and extensions of credit, including underwriting commitments, to any one person by an Edge Corporation or foreign bank subsidiary of a member bank when aggregated with loans and extensions of credit by the member bank to that person cannot exceed the member bank's limitations on loans and extensions of credit to any one person.

Regulation K does not impose on the foreign operations of U.S. banking organizations many of the so-called firewall provisions that apply to nontraditional domestic activities. For example, there are no such restrictions on interlocking boards of directors or joint marketing activities between a bank and nonbank affiliate. A reason for this is that many of the firewalls are designed to protect the investing public and depositors in the United States and to encourage competition in the U.S. market. Regulation K does, however, require that all U.S. banking organizations' operations be in accordance with high standards of banking or financial prudence.

The Federal Reserve is reviewing Regulation K now and intends to publish a revised regulation for comment by early 1990. Federal Reserve officials said that they expect a significant area of industry concern to be the quantitative limitations that Regulation K imposes on securities underwriting and dealing activities.

The international activities of U.S. banking organizations are subject to supervisory examinations and inspections by the Federal Reserve, OCC, and the Federal Deposit Insurance Corporation (FDIC).[7] In addition, these U.S. bank regulators reached an agreement with the central banks and banking supervisors of 11 other industrialized countries on international guidelines for uniform, risk-based capital standards.[8] These guidelines are explained in appendix V. Regulators from these countries, including the United States, have also agreed to broad supervisory guidelines.

[7] The Federal Reserve is responsible for regulating and supervising the foreign operations of member banks and bank holding companies. The Federal Reserve also charters, regulates, and supervises Edge Act corporations. OCC charters and supervises national banks. State nonmember banks, which are regulated by FDIC, have relatively small international operations.

[8] The 11 other industrial countries include Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, and the United Kingdom.

Recent Board Actions Affecting the Securities Activities of U.S. Banking Organizations

The Board may use two methods to allow bank holding companies to initiate new activities that it determines are closely related to banking. The Board can amend its regulations to determine that an activity is closely related to banking. Once added to this list of permissible activities, the approval process for a bank holding company to engage in this activity is simplified. The Board can also approve applications submitted to it by individual holding companies seeking its approval to initiate new activities specified in their applications. As of October 1989, the Board's Regulation Y listed 24 activities that it determined are closely related to banking and appropriate activities for holding companies to do; 6 of them are related to securities activities. (See table VI.1.) Through its application process, the Board has also approved requests by holding companies to do 25 additional new activities that were not specifically listed in the Board's regulations.

Beginning in 1987, the Board began approving, on a case-by-case basis, applications submitted by bank holding companies seeking to underwrite and deal in bank-ineligible securities through wholly owned nonbank subsidiaries. When the Board approved these additional securities powers for bank holding companies and determined that the activities of the companies were consistent with Section 20 of the Glass-Steagall Act, it used its authority under the Bank Holding Company Act to establish firewall requirements.

Table VI.1: Activities Closely Related to Banking and Approved for Bank Holding Companies Contained in Regulation Y

Activities	Securities-related
Making and servicing loans	No
Industrial banking	No
Trust company functions	Yes
Investment or financial advice	Yes
Leasing personal or real property	No
Community development	No
Data processing	No
Insurance agency and brokerage in connection with credit extensions	No
Underwriting insurance related to an extension of credit	No
Providing courier services	No
Management consulting to non-affiliated bank and nonbank deposit institutions	No
Issuing and selling money orders, savings bonds, and travelers checks	No
Real estate and personal property appraising	No
Arranging commercial real estate equity financing	No
Securities brokerage	Yes
Underwriting and dealing in government obligations and money market instruments	Yes
Foreign exchange advisory and transactional services	No
Future commission merchant	Yes
Investment advice on financial futures and options on futures	Yes
Consumer financial counseling	No
Tax planning and preparation	No
Check-guaranty services	No
Operating a collection agency	No
Operating a credit bureau	No

SEC Regulation of Section 20 Companies

SEC regulates Section 20 companies no differently from any other broker-dealer. A securities subsidiary registers with SEC and a self-regulatory organization (SRO), such as NASD or NYSE, depending on the type of activity it plans to pursue. SROs monitor the activities of registered securities firms. SEC, in turn, oversees the rules and activities of the SROs and, on a selective basis, of individual firms as well. The regulatory system is thus a mixture of self-regulation and direct regulation by SEC. SEC provides direct oversight by doing investigations, by taking disciplinary actions against firms or against an SRO itself for not doing an adequate self-regulatory job, and by implementing or changing its existing regulations. SRO rules are subject to SEC approval.

SROs evaluate members for financial health and compliance with both SEC regulations and their own. Enforcement is carried out through periodic, unannounced examinations; investigations of alleged violations; disciplinary action against members; and assessment of penalties where appropriate. The SRO tests individuals before they can be registered as principals or representatives (except for individuals associated with firms solely engaged in government securities transactions). Principals are responsible for the management and/or supervision of the securities firm.

All but three of the Section 20 companies that were authorized as of September 30, 1989, have designated NASD as their primary SRO. NASD-registered members can engage in investment banking and deal in over-the-counter securities. Three Section 20 companies have designated NYSE as their primary SRO.

Generally, SEC has no authority over the underwriting, dealing, or securities brokerage activities of banks. The Federal Reserve enforces its firewalls applicable to Section 20 firms since these firms are affiliated with bank holding companies. SEC specifies its own regulations regarding capital and personnel but makes no mention of separating the banking and securities subsidiaries of bank holding companies. The Federal Reserve instructs its examiners not to duplicate the function of the SRO or SEC. SEC and the Federal Reserve have no formal contact with each other regarding firewalls.

An SEC attempt to regulate a securities activity within a bank (i.e., not within a subsidiary corporation) was invalidated by a court ruling. Specifically, in 1985, SEC adopted Rule 3b-9, which would have required banks engaging in securities business for profit to register as broker-dealers with SEC under the Securities Exchange Act of 1934. The Circuit Court of Appeals for the District of Columbia declared Rule 3b-9 unlawful under the 1934 act. The court noted, however, that despite recent FDIC and Federal Reserve Board interpretations of the Glass-Steagall Act permitting banks to engage in brokerage services for nonbanking customers, the 1934 act still specifically excluded banks from rules governing broker-dealers and suggested any change in this interpretation would require action by Congress. (See American Bankers Ass'n. v.

S.E.C., 804 F.2d 739, 750 (D.C. Cir. 1986).) In 1987, SEC supported legislation that Congress did not enact, which would have given SEC power to regulate certain securities activities of banks.[9]

[9]Both the House and the Senate introduced legislation in 1988 (H.R. 5094 and S.1886, respectively) that would have amended the Glass-Steagall Act and expand SEC's power to regulate certain bank securities activities. Congress did not enact this legislation.

Firewalls Applicable to Section 20 Firms That Underwrite and Deal Only in Municipal Revenue Bonds, Mortgage-Related and Asset-Backed Securities, and/or Commercial Paper

This appendix quotes the firewall requirements the Board established in April 1987. The Board still applies these firewalls to Section 20 companies having authority to underwrite and deal only in municipal revenue bonds, mortgage-related and asset-backed securities, and/or commercial paper.

"A. Types of Securities to be Underwritten

1. The underwriting subsidiaries shall limit their underwriting and dealing in ineligible securities to the following:[1]
a. Municipal revenue bonds that are rated as investment quality (i.e., in one of the top four categories) by a nationally recognized rating agency, except that industrial development bonds in these categories shall be limited to "public ownership" industrial development bonds (i.e., those tax exempt bonds where the issuer, or the governmental unit on behalf of which the bonds are issued, is the sole owner, for federal income tax purposes, of the financed facility (such as airports and mass commuting facilities)).
b. Mortgage-related securities (obligations secured by or representing an interest in 1-4 family residential real estate), rated as investment quality (i.e., in one of the top 4 categories) by a nationally recognized rating agency.
c. Commercial paper that is exempt from registration and prospectus requirements of the S.E.C. pursuant to the Securities Act of 1933 and that is short term, of prime quality, and issued in denominations no smaller than $100,000."

"B. Capital Investment

2. Each Applicant's investment in an underwriting subsidiary and the assets of the underwriting subsidiary shall be excluded in determining the holding company's consolidated primary capital under the Board's Capital Adequacy Guidelines."

"C. Capital Adequacy

3. The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.
4. Applicants shall submit quarterly to the Federal Reserve Bank of New

[1] Authority to underwrite and deal in consumer-receivable-related securities was not included in the April 1987 Order. This authority was added in a separate Order in May 1987.

York FOCUS reports filed with the NASD or other self-regulatory organizations, and detailed information breaking down the underwriting subsidiaries' business with respect to eligible and ineligible securities, in order to permit monitoring of the underwriting subsidiaries' compliance with the provisions of this Order."

"D. Credit Extensions by Lending Affiliates to Customers of the Underwriting Subsidiary

5. No Applicant or subsidiary shall extend credit, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten by an affiliated underwriting subsidiary.
6. No lending affiliate of an underwriting subsidiary shall knowingly extend credit to a customer secured by, or for the purpose of purchasing, any ineligible security that an affiliated underwriting subsidiary underwrites during the period of the underwriting, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market. This limitation extends to all customers of lending affiliates, including brokers-dealers, and unaffiliated banks, but does not include lending to a broker-dealer for the purchase of securities where an affiliated bank is the clearing bank for such broker-dealer.
7. No Applicant or any of its subsidiaries may make loans to issuers of ineligible securities underwritten by an affiliated underwriting subsidiary for the purpose of the payment of principal and interest on such securities. To assure compliance with the foregoing, any credit lines extended to an issuer by any lending subsidiary of the bank holding company shall provide for substantially different timing, terms, conditions and maturities from the ineligible securities being underwritten. It would be clear, for example, that a credit has substantially different terms and timing if it is for a documented special purpose (other than the payment of principal and interest) or there is substantial participation by other lenders.
8. Each Applicant shall adopt appropriate procedures, including maintenance of necessary documentary records, to assure that any extensions of credit to issuers of ineligible securities underwritten or dealt in by an underwriting subsidiary are on an arm's length basis for purposes other than payment of principal and interest on the issuer's ineligible securities being underwritten or dealt in by the subsidiary. An extension of

credit is considered to be on an arm's length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiaries.
9. The requirements relating to credit extensions to issuers noted in paragraphs 5-8 above shall also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds."

"E. Limitations to Maintain Separateness of an Underwriting Affiliate's Activity

10. There will be no officer, director, or employee interlocks between an underwriting subsidiary and any of the holding company's bank or thrift subsidiaries. The underwriting subsidiary will have separate offices from any affiliated bank."

"F. Disclosure by the Underwriting Subsidiary

11. An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its banking affiliates and pointing out an affiliated bank could be a lender to an issuer and referring the customer to the disclosure documents for details. The statement shall also indicate that the obligations of the underwriting subsidiary are not those of any affiliated bank and that the bank is not responsible for securities sold by the underwriting subsidiary. The underwriting subsidiary should disclose any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.
12. No underwriting subsidiary nor any affiliated bank or thrift institution will engage in advertising or enter into an agreement stating or suggesting that an affiliated bank is responsible in any way for the underwriting subsidiary's obligations.
13. No bank or thrift affiliate of the underwriting subsidiary will act as agent for, or engage in marketing activities on behalf of, the underwriting subsidiaries. In this regard, prospectuses and sales literature of an underwriting subsidiary may not be distributed by a bank or thrift affiliate; nor should any such literature be made available to the public at any offices of any such affiliate, unless specifically requested by a customer."

"G. Investment Advice by Bank/Thrift Affiliates

14. An affiliated bank or thrift institution may not express an opinion with respect to the advisability of the purchase of ineligible securities underwritten or dealt in by an underwriting subsidiary unless the bank or thrift affiliate notifies the customer that its affiliated underwriting subsidiary is underwriting or making a market in the security."

"H. Conflicts of Interest

15. No Applicant nor any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period, or shall purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market except that, in the case of ineligible securities that are being issued in a simultaneous cross-border underwriting in which the underwriting subsidiary and a foreign affiliate or affiliates are participating, such securities may be purchased or sold pursuant to an intersyndicate agreement for the period of the underwriting where the purchase or sale results from bona fide indications of interest from customers. Such purchases or sales shall not be made for purposes of providing liquidity or capital support to the underwriting subsidiary or otherwise to evade the requirements of this Order. An underwriting subsidiary shall maintain documentation on such transactions.[2]

16. No Applicant nor any of its bank, thrift, or trust or investment advisory company subsidiaries shall purchase, as a trustee or in any other fiduciary capacity, for accounts over which they have investment discretion ineligible securities
(i) underwritten by the underwriting subsidiary as lead underwriter of syndicate member during the period of any underwriting or selling syndicate, and for a period of 60 days after the termination thereof, and
(ii) from the underwriting subsidiary if it makes a market in that security, unless, in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.

17. An underwriting subsidiary may not underwrite or deal in any ineligible securities issued by its affiliates or representing interests in, or secured by, obligations originated or sponsored by its affiliate (except for grantor trusts or special purpose corporations created to facilitate

[2]This firewall was modified, as above, in a January 1990 Board Order.

underwriting of securities backed by residential mortgages originated by a non-affiliated lender) unless such securities are rated by an unaffiliated, nationally recognized rating organization or are issued or guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association or represent interests in securities issued or guaranteed by such agencies.[3]

18. No bank or thrift shall, directly or indirectly, for its own account, purchase financial assets of an affiliated underwriting subsidiary or a subsidiary thereof or sell such assets to the underwriting subsidiary or subsidiary thereof. This limitation shall not apply to the purchase and sale of U.S. Treasury securities or direct obligations of the Canadian federal government that are not subject to repurchase or reverse repurchase agreements between the underwriting subsidiary and its bank or thrift affiliates.[4]"

"I. Limitations to Address Possible Unfair Competition

19. No lending affiliate of an underwriting subsidiary may disclose to the underwriting subsidiary any nonpublic customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary (other than as required by securities laws and with the issuer's consent) and no officers or employees of the underwriting subsidiary may disclose such information to its affiliates."

"J. Formation of Subsidiaries of an Underwriting Subsidiary to Engage in Underwriting and Dealing

20. Pursuant to Regulation Y, no corporate reorganization of an underwriting subsidiary, such as the establishment of subsidiaries of the underwriting subsidiary to conduct the activities, may be consummated without prior Board approval."

[3]This firewall was modified, as above, in a September 1989 Board Order.

[4]This firewall was modified, as above, in January 1989 and January 1990 Board Orders.

Firewalls Imposed by the Federal Reserve Board on Section 20 Companies Authorized to Underwrite and Deal in Corporate Debt and Equity Securities

This appendix quotes the firewall requirements applicable to Section 20 companies authorized by the Board to underwrite and deal in corporate debt and equity securities. These requirements, first promulgated in January 1989, apply to all ineligible securities activities carried out in those Section 20 firms, not just corporate debt and equity. At the present time, no Section 20 company has been permitted to commence underwriting and dealing in corporate equities.

"A. Capital Adequacy Conditions

1(a). In determining compliance with the Board's Capital Adequacy Guidelines, each Applicant shall deduct from its consolidated primary capital any investment it makes in the underwriting subsidiary that is treated as capital in the underwriting subsidiary. In accordance with the risk-based component of the Board's Capital Guidelines, Applicant shall deduct 50 percent of the amount of any investment in the underwriting subsidiary from Tier 1 capital and 50 percent from Tier 2 capital. In calculating primary capital and risk-based capital ratios, Applicant should also exclude the underwriting subsidiary's assets from the holding company's consolidated assets.

(b). Applicant shall also deduct from its regulatory capital any credit it or a nonbank subsidiary extends directly or indirectly to the underwriting subsidiary unless the extension of credit is fully secured by U.S. Treasury securities or other marketable securities and is collateralized in the same manner and to the same extent as would be required under section 23A(c) of the Federal Reserve Act if the extension of credit were made by a member bank.[1] In the case of the risk-based component of the Board's Capital Guidelines, the deductions for unsecured or not fully-secured or inadequately collateralized loans shall be taken 50 percent from Tier 1 and 50 percent from Tier 2 as described above. Notwithstanding these adjustments, Applicant should continue to maintain adequate capital on a fully consolidated basis.

2. No Applicant nor any of its nonbank subsidiaries shall, directly or indirectly, provide any funds to, or for the benefit of, an underwriting subsidiary, whether in the form of capital, secured or unsecured extensions of credit, or transfer of assets, without prior notice to and approval by the Board.

3. Before commencing the new activities, each Applicant must submit to the Board acceptable plans to raise additional capital as required by this Order or demonstrate that it is strongly capitalized and will remain so after making the capital adj[illegible]nts authorized or required by this

[1] An extension of credit means any loan, guarantee, or other form of credit exposure, including those described in condition 5.

Order. An Applicant may not commence the proposed activities until it has received a Board determination that the capital plan satisfies the requirements of this Order and has raised the additional capital required under the plan.
4. The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms."

"B. Credit Extensions to Customers of the Underwriting Subsidiary[2]

5. No applicant or subsidiary shall directly or indirectly extend credit, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, guarantee, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten or distributed by the underwriting subsidiary.
6. No Applicant or subsidiary (other than the underwriting subsidiary) shall knowingly extend credit to a customer directly or indirectly secured by, or for the purpose of purchasing, any ineligible security that an affiliated underwriting subsidiary underwrites during the period of the underwriting or for 30 days thereafter, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market. This limitation extends to all customers of Applicant and its subsidiaries, including broker-dealers and unaffiliated banks, but does not include lending to a broker-dealer for the purchase of securities where an affiliated bank is the clearing bank for such broker-dealer.
7. No Applicant or any of its subsidiaries may, directly or indirectly, extend credit to issuers of ineligible securities underwritten by an affiliated underwriting subsidiary for the purpose of the payment of principal, interest or dividends on such securities. To assure compliance with the foregoing, any credit lines extended to an issuer by any bank holding company or any subsidiary shall provide for substantially different timing, terms, conditions and maturities from the ineligible securities being underwritten. It would be clear, for example, that a credit has substantially different terms and timing if it is for a documented special purpose (other than the payment of principal, interest or dividends) or there is substantial participation by other lenders.
8. Each Applicant shall adopt appropriate procedures, including maintenance of necessary documentary records, to assure that any extension

[2] Unless otherwise stated, these conditions shall apply to a subsidiary of a bank or thrift institution to the same extent as they apply to the bank or thrift institution.

of credit by it or any of its subsidiaries to issuers of ineligible securities underwritten or dealt in by an underwriting subsidiary are on an arm's length basis for purposes other than payment of principal, interest, or dividends on the issuer's ineligible securities being underwritten or dealt in by the underwriting subsidiary. An extension of credit is considered to be on an arm's length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiary.

9. In any transaction involving an underwriting subsidiary, Applicants' thrift subsidiaries shall observe the limitations of sections 23A and 23B of the Federal Reserve Act as if the thrifts were banks.

10. The requirements relating to credit extensions to issuers noted in paragraphs 5 - 9 above shall also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds.

11. Applicants shall cause their subsidiary banks and thrifts to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in financing transactions underwritten or arranged by an underwriting subsidiary as set forth in this Order. The Reserve Banks shall ensure that these policies and procedures are in place at Applicants' subsidiary banks and thrifts and Applicants shall assure that loan documentation is available for review by Reserve Banks to ensure that an independent and thorough credit evaluation has been undertaken in connection with bank or thrift participation in such financing packages and that such lending complies with the requirements of this Order and section 23B of the Federal Reserve Act.

12. Applicants should also establish appropriate policies, procedures, and limitations regarding exposure of the holding company on a consolidated basis to any single customer whose securities are underwritten or dealt in by the underwriting subsidiary."

"C. Limitations to Maintain Separateness of an Underwriting Affiliate's Activity

13. There will be no officer, director, or employee interlocks between an underwriting subsidiary and any of the holding company's bank or thrift subsidiaries. The underwriting subsidiary will have separate offices from any affiliated bank or thrift.[1]"

[1]An underwriting subsidiary may have offices in the same building as a bank or thrift affiliate if the underwriting subsidiary's offices are clearly distinguished from those of the bank or thrift affiliate.

"D. Disclosure by the Underwriting Subsidiary

14. An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its bank and thrift affiliates and pointing out that an affiliated bank or thrift could be a lender to an issuer and referring the customer to the disclosure documents for details. In addition, the statement shall state that securities sold, offered, or recommended by the underwriting subsidiary are not deposits, are not insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation, are not guaranteed by an affiliated bank or thrift, and are not otherwise an obligation or responsibility of such a bank or thrift (unless such is the case). The underwriting subsidiary should also disclose any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates."

"E. Marketing Activities on Behalf of an Underwriting Subsidiary

15. No underwriting subsidiary nor any affiliated bank or thrift institution will engage in advertising or enter into an agreement stating or suggesting that an affiliated bank or thrift is responsible in any way for the underwriting subsidiary's obligations as required under section 23B of the Federal Reserve Act.
16. No bank or thrift affiliate of the underwriting subsidiary will act as agent for, or engage in marketing activities on behalf of, the underwriting subsidiary.[1] In this regard, prospectuses and sales literature relating to securities being underwritten or dealt in by an underwriting subsidiary may not be distributed by a bank or thrift affiliate; nor should any such literature be made available to the public at any offices of any such affiliate, unless specifically requested by a customer."

"F. Investment Advice by Bank/Thrift Affiliates

17. An affiliated bank or thrift institution may not express an opinion on the value or the advisability of the purchase or the sale of ineligible securities underwritten or dealt in by an affiliated underwriting subsidiary unless the bank or thrift notifies the customer that the underwriting

[1]This condition does not prevent a bank or thrift from informing its customers of the available services of the underwriting subsidiary.

subsidiary is underwriting, making a market, distributing or dealing in the security.
18. No Applicant nor any of its bank, thrift, or trust or investment advisory subsidiaries shall purchase, as a trustee or in any other fiduciary capacity, for accounts over which they have investment discretion ineligible securities (a) underwritten by the underwriting subsidiary as lead underwriter or syndicate member during the period of any underwriting or selling syndicate, and for a period of 60 days after the termination thereof, and (b) from the underwriting subsidiary if it makes a market in that security, unless, in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered."

"G. Extensions of Credit and Purchases and Sales of Assets

19. No Applicant nor any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period, or shall purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market except that, in the case of ineligible securities that are being issued in a simultaneous cross-border underwriting in which the underwriting subsidiary and a foreign affiliate or affiliates are participating, such securities may be purchased or sold pursuant to an intersyndicate agreement for the period of the underwriting where the purchase or sale results from bona fide indications of interest from customers. Such purchases or sales shall not be made for purposes of providing liquidity or capital support to the underwriting subsidiary or otherwise to evade the requirements of this Order. An underwriting subsidiary shall maintain documentation on such transactions.[5]

20. An underwriting subsidiary may not underwrite or deal in any ineligible securities issued by its affiliates or representing interests in, or secured by, obligations originated or sponsored by its affiliates (except for grantor trusts or special purpose corporations created to facilitate underwriting of securities backed by residential mortgages originated by a non-affiliated lender) unless the securities are rated by an unaffiliated, nationally recognized rating organization or are issued or guaranteed by the Federal National Mortgage Corporation, or the Government National

[5]This firewall was modified, as above, in a January 1990 Board Order.

Mortgage Association or represent interests in securities issued or guaranteed by such agencies."

21(a). Applicants shall assure that no bank or thrift subsidiary shall, directly or indirectly, extend credit in any manner to an affiliated underwriting subsidiary or a subsidiary thereof; or issue a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, for the benefit of the underwriting subsidiary or a subsidiary thereof.

(b). This prohibition shall not apply to an extension of credit by a bank or thrift to an underwriting subsidiary that is incidental to the provision of clearing services by the bank or thrift to the underwriting subsidiary with respect to securities of the United States or Canada or their agencies, or securities on which the principal and interest are fully guaranteed by the United States or Canada or their agencies, if the extension of credit is fully secured by such securities, is on market terms, and is repaid on the same calendar day. If the intra-day clearing of such securities cannot be completed because of a bona fide fail or operational problem incidental to the clearing process that is beyond the control of the bank or thrift and the underwriting subsidiary, the bank or thrift may continue the intra-day extension of credit overnight provided the extension of credit is fully secured as to principal and interest as described above, is on market terms, and is repaid as early as possible on the next business day.[7]

22. No bank or thrift shall, directly or indirectly, for its own account, purchase financial assets of an affiliated underwriting subsidiary or a subsidiary thereof or sell such assets to the underwriting subsidiary or subsidiary thereof. This limitation shall not apply to the purchase and sale of U.S. Treasury securities or direct obligations of the Canadian federal government that are not subject to repurchase or reverse repurchase agreements between the underwriting subsidiary and its bank or thrift affiliates."[8]

"H. Limitations on Transfers of Information

23. No bank or thrift shall disclose to an underwriting subsidiary, nor shall an underwriting subsidiary disclose to an affiliated bank or thrift, any nonpublic customer information (including an evaluation of the

[6] This firewall was modified, as above, in a September 1989 Board Order.

[7] This firewall was modified, as above, in a January 1990 Board Order.

[8] This firewall was modified, as above, in a January 1990 Board Order.

creditworthiness of an issuer or other customer of that bank or thrift, or underwriting subsidiary) without the consent of that customer."

"I. Reports

24. Applicants shall submit quarterly to the appropriate Federal Reserve Bank FOCUS reports filed with the NASD or other self-regulatory organizations, and detailed information breaking down the underwriting subsidiaries' business with respect to eligible and ineligible securities, in order to permit monitoring of the underwriting subsidiaries' compliance with the provisions of this Order.[9] "

"J. Transfer of Activities and Formation of Subsidiaries of an Underwriting Subsidiary to Engage in Underwriting and Dealing

25. The Board's approval of the proposed underwriting and dealing activities extends only to the subsidiaries described above for which approval has been sought in the instant applications. The activities may not be conducted by Applicants in any other subsidiary without prior Board review. Pursuant to Regulation Y, no corporate reorganization of an underwriting subsidiary, such as the establishment of subsidiaries of the underwriting subsidiary to conduct the activities, may be consummated without prior Board approval."

"K. Limitations on Reciprocal Arrangements and Discriminatory Treatment

26. No Applicant nor any of its subsidiaries may, directly or indirectly enter into any reciprocal arrangement. A reciprocal arrangement means any agreement, understanding, or other arrangement under which one bank holding company (or subsidiary thereof) agrees to engage in a transaction with, or on behalf of, another bank holding company (or subsidiary thereof), in exchange for the agreement of the second bank holding company (or any subsidiary thereof) to engage in a transaction with, or on behalf of, the first bank holding company (or any subsidiary thereof) for the purpose of evading any requirement of this Order or any prohibition on transactions between, or for the benefit of, affiliates of banks established pursuant to federal banking law or regulation.
27. No bank or thrift affiliate of an underwriting subsidiary shall, directly or indirectly:

[9]The Board will make available in the future a form on which this information should be submitted

(a) acting alone or with others, extend or deny credit or services (including clearing services), or vary the terms or conditions thereof, if the effect of such action would be to treat an unaffiliated securities firm less favorably than its affiliated underwriting subsidiary, unless the bank or thrift demonstrates that the extension or denial is based on objective criteria and is consistent with sound business practices; or
(b) extend or deny credit or services or vary the terms or conditions thereof with the intent of creating a competitive advantage for an underwriting subsid ary of an affiliated bank holding company."

"L. Requirement for Supervisory Review Before Commencement of Activities

28. An Applicant may not commence the proposed debt and equity securities underwriting and dealing activiti until the Board has ermined that the Applicant has established policies and procedures to ensure compliance with the requirements of th Order, including computer, audit and accounting systems, internal risk management controls and the necessary operational and managerial infrastructure. In this regard, the Board will review in one year whether Applicants may commence underwriting and dealing in equity securities based on a determination by the Board that they have established the managerial and operational infrastructure and other policies and procedures necessary to comply with the requirements of this Order."

Appendix IX

Comments From the Board of Governors of the Federal Reserve System

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

January 23, 1990

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

This is in response to your letter of December 22nd to Chairman Greenspan enclosing for our review and comment a draft report "Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies". Our staff subsequently conveyed some suggestions for editorial and technical changes to your staff in oral discussions and we understand that these changes will be incorporated in the final report. Except for these suggestions for language changes, the staff found the report to be satisfactory.

If you have any further questions with respect to this matter, please call Robert S. Plotkin, Assistant Director, 452-2782.

Very truly yours,

Frederick M. Struble
Associate Director

Appendix X

Comments From the Office of the Comptroller of the Currency

Note GAO comments supplementing those in the report text appear at the end of this appendix

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

February 7, 1990

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

We have reviewed your draft of a proposed report entitled Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies. The study reviews the principal legislation affecting the securities powers of bank affiliates. It discusses the reasoning behind the Federal Reserve Board's (Board) decision to allow banks to underwrite "ineligible securities" on a limited basis under Section 20 of the Glass-Steagall Act. It examines the conflicts of interest that arise when investment and commercial banking are combined. It discusses the firewalls that have been established by the Board to ensure the safety and soundness of the banking system, to control conflict of interest abuse, and to insulate the deposit insurance fund from risks associated with securities transactions. The study also includes statistics on the volume of securities activities, as well as on the market penetration of Section 20 subsidiaries, and identifies seven areas requiring further study.

We interpret the statement on page 19 that the use of a "separate SEC-regulated subsidiary and regulation of the entire holding company by the Federal Reserve [are] essential in permitting the affiliation of the banking and securities businesses" to be an endorsement of the Federal Reserve's view that ineligible securities activities should take place only within a securities affiliate of a bank holding company. We recommend that the draft acknowledge that there are reasonable alternatives to the affiliate structure, e.g. securities underwriting in direct subsidiaries of federally insured banks. A proper choice among alternative organizational structures could be made once the costs and benefits of each are weighed. Looking at alternative organizational structures might be included in your list of topics for furthe study.

Similarly, the study seems to endorse the Federal Reserve's system of firewalls as an effective means of preventing underwriting risks from being transmitted from the securities affiliate to the federally insured bank. There is no discussion of safeguards, such as customer protection rules administered by the SEC, that might show firewalls to be unnecessary and/or ineffective. We recommend that the discussion on pages 22 and 23 of the draft be adjusted to recognize that the need for particular firewalls be examined in light of their cost and of other regulatory and market safeguards.

See comment 2

Now on pp 15-17

In addition, the report generally approves the Federal Reserve's 10 percent limit on income from bank-ineligible securities activities. We have previously stated that we believe that some greater level of bank-ineligible activity would be legally permissible under Section 20 and that it is inappropriate to set a definitive level of gross income as the "engaged principally" standard for all cases. We have also stated that tests other than gross income are legally permissible and should be explored for determining the meaning of "engaged principally" under Section 20. We recommend that the draft recognize the possibility of alternative approaches for defining "engaged principally" under Section 20.

See comment 3

One of the stated objectives of the report is to "identify how the activities of Section 20 firms have affected risk levels in their respective bank holding companies." Appendix II would better meet that objective by describing the risks associated with securities underwriting and how they compare with traditional risks and by evaluating the impact and effects of diversification.

See comment 4

We also had some comments of a technical nature that were provided separately for your consideration in putting the draft into final report form.

Thank you for the opportunity to comment.

Sincerely,

Judith A. Walter

Judith A. Walter
Senior Deputy Comptroller for Administration

The following are GAO's comments on the Office of the Comptroller of the Currency's letter dated February 7, 1990.

GAO Comments

1. We have recognized some benefits associated with the holding company structure, including the ability to generally accommodate the expanded powers of banking organizations while organizationally insulating federally insured activities from the risks associated with the expanded powers. However, we have not endorsed the holding company structure as the only structure appropriate in the long run to be used with the expansion of securities powers that may be approved for banking organizations. We have modified our discussion of these points in the report on pages 12 to 14.

2. Our report recognizes that the general intent of the firewalls—insulating federally insured institutions from the risks associated with the activities of securities affiliates—is appropriate and that they provide a basis for maintaining regulatory controls as new powers are being phased in. Our work did not include assessing the effectiveness of the firewalls. Therefore, we have no basis for endorsing the present set of firewalls as a permanent feature of how banking organizations are organized. Our draft report discussed the need to further study the purpose of the firewalls and the potential regulatory burden they could impose. We expanded our discussion of this point on pages 15 to 17 of the report.

3. We agree with the Board's policy of the revenue limit as an approach to phasing in bank-ineligible securities activities. However, we have not endorsed any definitive level of gross revenues as the most proper interpretation of the "engaged principally" clause. The report has been modified to recognize that alternative approaches for defining "engaged principally" under Section 20 of the Glass-Steagall Act could be explored once experience can be relied upon to determine the impact of such approaches, and once the purpose of the firewalls and other limitations are further clarified. See pages 14 and 15.

4. A more detailed discussion of the risk characteristics of securities activities, particularly when done within bank holding companies, would no doubt be useful for readers. However, we do not believe the report needs to be modified to incorporate additional material in this area. Appendix II discusses the nature of the risks associated with Section 20 subsidiary securities activities and recognizes that these activities could allow bank holding companies the opportunity to reduce risk

through diversification of activities. Our report also notes that the limited time that Section 20 firms have been active does not allow a determination on whether the new activities have actually increased or decreased risk to the holding company. See pages 37 to 39.

Appendix XI

Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE GENERAL COUNSEL

January 26, 1990

Richard L. Fogel
Assistant Comptroller General
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to comment on the General Accounting Office's December 22, 1989 draft report entitled Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies. My Office and the staff of the Divisions of Market Regulation, Enforcement, and Investment Management have reviewed the draft report. Based upon that review, a number of technical suggestions have been orally provided. This letter comments on several issues addressed in the draft report which are of particular concern to the Commission.

I agree with your conclusion that requiring banks to conduct bank-ineligible securities activities in subsidiaries, subject to the regulatory scheme for broker-dealers which Congress designed for the protection of investors, is an essential condition to permitting the affiliation of banking and securities firms. The Commission has supported this requirement and has recommended that any legislation to expand the securities powers of banks require banks to conduct most of their new and existing securities activities in separate entities subject to full Commission regulation.

I also agree with your observation that another concern raised by the Section 20 arrangement is that no completely comparable opportunity exists for securities firms to expand into banking activities. Although securities firms could engage in certain banking activities if the firms and their parent holding companies complied with the same banking regulations applicable to banks and bank holding companies engaging in those activities, this would be impracticable. It would be much more difficult for securities firms, which are not organized within a bank holding company structure, to comply with these regulations, than it is for banks, which are already organized within that structure. Accordingly, consideration should be given to amending the Bank Holding Company Act to permit securities firms to own banks

See comment 1

Richard L. Fogel
Page 2

without subjecting these firms and their holding companies to the full regulatory system applicable to banks and bank holding companies.

In order to accommodate your time schedule, the staff has not submitted this comment letter to the Commission for its review. Again, I appreciate this opportunity to comment on the draft report.

Sincerely,

Daniel L. Goelzer

Daniel L. Goelzer
General Counsel

The following are GAO's comments on the Securities and Exchange Commission's letter dated January 26, 1990.

GAO Comments

1. We believe an arrangement for combining banking and securities affiliates within the same financial holding company needs to provide for regulatory controls over the entire holding company comparable to the Federal Reserve's controls over bank holding companies. A discussion of this point has been included in the letter. See pages 18 to 20.

Appendix XII

Comments From the American B:.nkers Association

Note GAO comments supplementing those in the report text appear at the end of this appendix.

AMERICAN BANKERS ASSOCIATION

1120 Connecticut Avenue, N.W. Washington, D.C. 20036

AGENCY RELATIONS, TRUST AND SECURITIES

DIRECTOR James D. McLaughlin 202-663-5324

January 8, 1990

Richard L. Fogel
Assistant Comptroller General
General Government Division
United States General
Accounting Office
Washington, DC 20548

RE: Draft Report -- Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies

Dear Mr. Fogel:

The American Bankers Association ("ABA") appreciates the opportunity to review and comment on the General Accounting Offices ("GAO") draft report on bank-ineligible securities activities carried out by wholly-owned subsidiaries of bank holding companies. At the outset, the GAO is to be commended on the thorough effort given to compiling the report. As the GAO has recognized, the nature and extent to which banks conduct securities activities through Section 20 subsidiaries is only just evolving. In consideration of the infancy of those activities and in recognition that the viewpoints of various persons will change as comfort levels increase, the ABA believes that the report sets out fairly the current thoughts of interested persons regarding those activities.

See comment 1

The ABA does, however, wish to offer the following comments and suggestions regarding the report. First and foremost, the ABA believes it is important that the report note that the securities industry has recently announced that it no longer opposes repeal of the Glass-Steagall Act. Accordingly, the report should state that positions articulated by the securities industry and contained in the report may have changed.

See comment 2

Now pp. 18-20

Another issue involves the competitive concerns between the banking and securities industries. The GAO, in its report, has expressed the opinion that the case for continued maintenance of the firewalls may be much stronger when viewed in terms of competitive concerns (pp. 21 and 24). ABA agrees that the extensive list of burdensome firewalls does keep many banks from competing in securities services. On the other hand, the report cites, as evidence of competitive disadvantages to securities

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CONTINUING OUR LETTER OF

January 8, 1990

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firms, the fact that securities firms competing with Section 20 subsidiaries are not affiliated with banks and have no comparable opportunity to exp d into banking. The ABA disagrees and would direct the GAO's a ention to t fact that several securities firms own banks. A discussion of these firms' banking activities would be helpful to clear understanding of the issues involved.

See comment 3.
Now pp. 50-52.

With regard to the report's discussion on the firewall prohibiting banks from supplying any form of credit enhancement for ineligible securities to be unde ritten by the underwriting subsidiary (p. 70), mention should also be made that this prohibition is uneconomical and creates market inefficiencies and negative public perceptions. Specifically, customers seeking credit enhancements for their securities to b underwritten by a bank holding company subsidiary will have to go to another bank and inevitably will pay more for the credit enhancement feature. In addition, the public may draw negative inferences regarding the worth of the underwritten securities if the bank does not issue the credit enhancement for securities being underwritten by its affiliate.

Now pp. 56 and 57.
See comment 3.

The discussion regarding the prohibition on cross-marketing (p. 79) should include the thought that this prohibition is both uneconomical and inefficient. For example, customers that have a long history of dealing with specific corporate lending personnel will not be able to use the same bank holding company personnel for its underwriting nee and will have to negotiate separately fo those needs with ot bank holding company personnel. Inefficiencies are creat d when such a situation occurs. As a result, customers may choose to go elsewhere whe their financial needs can be addressed in one package. Competitors can offer all these services and more.

See comment 3

The firewall discussion should also include a discussion regarding the affiliate purchase restriction firewall. Specifically, that firewall prevents, under certain conditions, bank holding companies and their affiliates from purchasing, as principal, ineligible securities that are underwritten by the Section 20 subsidiary. While that prohibition has been somewhat modified, as the report recognizes, in that bank holding companies and their nonbank affiliates may purchase less than 50% of any debt issue privately placed by the Section 20 subsidiary, the prohibition is nevertheless unnecessary and m , in fact, prove detrimental to the bank's reputation in the community. For example, an underwriting subsidiary may be engaged in a large revenue bond offering in connection with construction at the

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local airport. Normally, a bank, as a member of that community, would be expected to purchase part of that offering for its own portfolio. However, the prohibition against purchasing securities underwritten by the underwriting subsidiary would deprive the bank from participating in the project and, consequently, may reflect poorly on the bank's reputation in the community.

In conclusion, the ABA appreciates the opportunity to review and comment on the GAO's draft report. If you have any questions, please do not hesitate to contact our office.

Sincerely,

James D. McLaughlin /SDM

James D. McLaughlin

The following are GAO's comments on the American Bankers Association's letter dated January 8, 1990.

GAO Comments

1. The report reflects our discussions with securities industry officials. Views of the Securities Industry Association on the draft report are contained in appendix XVI.

2. We clarified our report to show that U.S. securities firms generally cannot own U.S. banks without themselves becoming bank holding companies. However, we pointed out that securities firms own some nonbank banks and do have opportunities to be affiliated with banks located outside the U.S. See pages 18 and 19.

3. Our discussion of the regulatory burden of firewalls has been expanded. (See pp. 15 to 17.) Also, the points made by the ABA have been incorporated into relevant portions of appendix III.

Comments From the Bank Capital Markets Association

Note GAO comments supplementing those in the report text appear at the end of this appendix

BANK CAPITAL MARKETS ASSOCIATION

NATIONAL PRESS BUILDING, SUITE 200, WASHINGTON, DC [illegible] (202) [illegible]

THOMAS P. [illegible]
EXECUTIVE DIRECTOR

December 27, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

We appreciate the opportunity to comment on the GAO draft report entitled Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies. We believe the report provides useful background information on the so-called Section 20 securities affiliates authorized by the Federal Reserve Board in 1987 and 1989. With regard to the continuing debate over the need to repeal or reform the Glass-Steagall Act, we also believe it is noteworthy that the GAO did not uncover any evidence of abuse or threats to the Federal Deposit Insurance Fund on the part of Section 20 affiliates although to us, these results are not surprising.

See comment 1

Most of the information developed by the GAO is summarized in the eight appendices to the report. We have no particular quarrel with the information presented although the discussion does focus exclusively on the commercial banking industry. We think the report would be more useful for public policy purposes if it included comparable information on the securities industry where appropriate.

See comment 2

Towards that end, we suggest an additional appendix that would review levels of concentration in securities underwriting and analyze the extent to which these concentration ratios could be diminished if banking organizations were permitted to compete. Certainly the high levels of concentration in securities underwriting was a major public policy concern on the part of the House and Senate Banking Committees in 1988 when both Committees approved legislation to modernize the Glass-Steagall Act.

See comment 3

Another appendix should be included to describe the current financial structure of securities holding companies and in particular, the degree of double-leveraging between the parent and its broker-dealer subsidiaries. The amount of double-leveraging allowed securities firms is clearly relevant to the debate over many of the restraints the securities industry seeks to impose on bank holding companies in the name of competitive equity. For example, the requirement that bank holding companies must deduct their capital investment in their securities subsidiaries from their own capital base is often justified on the theory that it keeps bank-affiliated securities firms from gaining a competitive advantage over unaffiliated securities firms. We believe a careful review of the financial structure of non-bank affiliated securities firms will lead to precisely the opposite conclusion -- the FED's current capital rules place bank affiliated securities firms at a competitive disadvantage.

See comment 4

Although the report reaches no specific conclusions, it does spell out seven areas that the regulators and the Congress should consider in determining financial restructuring policy. We would suggest an eighth point whose theme is implicit in much of the material in the appendices but is nowhere made explicit. The point is this: <u>At some level, firewalls have a perverse effect. Rather than reducing risk, they actually increase risk.</u>

As examples, we would cite many of the operational firewalls that require separate staffs and prevent banking organizations from utilizing their most experienced personnel to oversee the combined banking/securities activities. Another example is the absolute prohibition on a bank making loans to its securities affiliate. This prohibition could weaken the overall structure of the banking organization during a liquidity crisis such as we experienced in October of 1987. Also, the requirement that securities activities be conducted in separate affiliates (as opposed to a subsidiary of the bank) can actually weaken the bank by moving profitable activities from its balance sheet. The assets of the securities affiliate are also placed beyond the reach of the FDIC in the event the bank itself fails.

See comment 4

On a more general level, we would argue that excessive firewalls will discourage many banking organizations from diversifying their activities, thereby incurring more risk. If banks are not allowed to follow the natural evolution of the banking business into the securities markets, they will be compelled into making riskier loans to marginal borrowers in order to recapture their lost profits. This is a formula for <u>more</u> risk, not <u>less</u> risk.

After the debacle of the thrift industry, it is clear that the Congress and the regulators need to look at financial legislation in the light of its risk to the tax-payers. It does not follow, however, that the most cautious policy is necessarily the safest. Indeed, there are cases where doing nothing can be the riskiest of all policies. We think Glass-Steagall reform is clearly one of those cases. Relaxing most of the Federal Reserve Board's fire-walls imposed on Section 20 securities affiliates will strengthen and not weaken our financial system and provide less risk to the nation's tax-payers.

See comment 5

Now pp. 10-20

Point 2 in the draft is now point 3, and begins on p. 14

We also have some observations on two of your seven points listed on pages 19 through 24. Point 2 starts with the unassailable proposition that "It is important to be as clear as possible about the purpose of firewalls." It then goes on to discuss the prohibition against a bank issuing guarantees on issues underwritten by its securities affiliate. The report correctly states that "On risk grounds, the need for the firewall can be questioned. If the guarantee is priced correctly, the bank would be no more exposed to risk by the guarantee than if the bank simply made a loan to the company." The report then suggests that on competitive grounds the case for the firewall may be stronger and that its removal may place securities firms at a competitive disadvantage. It is hard to follow this logic. If the guarantee is competitively priced (as would be required under Section 23B of the Federal Reserve Act), it does not afford the bank's securities affiliate any competitive advantage over a securities firm not affiliated with a bank.

See comment 6

We suggest this point be dropped. The conclusion is not supported by the example cited. More importantly, the notion that competitive equity arguments should be given major weight in imposing firewall restrictions on an entire industry is suspect, especially when raised by a rival industry seeking to insulate itself from outside competition. If safety conditions are satisfied, public policy ought to act on the presumption that more competition is in the public interest. Restricting competition in the name of competitive equity is a dangerous game that is bound end in a weaker and less productive financial system.

Now pp. 15-17

Point number 4 on page 22 refers to a prior GAO report concluding that institutional abuses or conflicts of interest were not a widespread problem in the banking industry. We certainly agree. The report goes on, however, to state that "given the harm that could result to consumers and, ultimately, to banking safety and soundness from abuses, the potential for future abuses warrants close attention if banking institutions were granted expanded securities powers."

See comment 7

We believe this sentence is unduly alarmist and not justified by GAO's own evidence. Certainly the Congress and the regulators should think about potential abuses, but they should also think about potential benefits from expanded competition, especially when the probability of gain far exceeds the possibility of any loss. Considering only the possibility of potential abuse is a formula for enacting excessive and counter-productive firewalls. We urge that point four be dropped or at the very least be rewritten to include a more balanced treatment of the likely gains resulting from expanded bank securities powers.

We appreciate the opportunity to comment on your draft report.

Sincerely,

Thomas P. Rideout
Executive Director

The following are GAO's comments on the Bank Capital Markets Association's letter dated December 27, 1989.

GAO Comments

1. Given the nature of the request, most of the information in the report is concerned with the operations of Section 20 firms and bank holding companies. We agree that additional information about the securities industry would be useful; however, in order to meet our requester's information needs in a timely manner, we were unable to develop this information. Nevertheless, at various points, the report does discuss the nature of risks in the securities industry, market share, and capital adequacy regulation in the securities industry.

2. On the basis of data availability, we have included information on the levels of concentration in the securities markets in which Section 20 firms have initiated underwriting activities. (See app. I.) Since Section 20 firms have been operating for a relatively short time, it is still too early to determine the impact they could have on the securities market. The discussion in appendix I also points out that it is not necessarily the case that expanding the securities powers of banks over the long run will reduce market concentration in underwriting markets. See pages 31 and 32.

3. Our work did not include an analysis of the financial structure of securities holding companies. However, at several places in the report we do point out that the holding companies of securities firms are not subject to the same capital regulation as bank holding companies. See page 78.

4. Our draft report recognized banking officials' concerns about the regulatory burden imposed by the firewalls and that it would be useful to examine individual firewalls from the perspective of what can and cannot be accomplished under the current regulatory structure.

The report has, however, been modified to include an expanded discussion of regulatory burden and the possibility that firewalls could increase risk. (See pp. 15-17.) As noted, we agree that the prohibition on a bank making loans to its securities affiliates could weaken the overall structure of a banking organization during a liquidity crisis. See page 17.

5. Our discussion is intended to help focus attention on the purpose of the firewalls, and we think that competitive aspects are of concern to

many people. We have modified the discussion to take account of Section 23B of the Federal Reserve Act, but the existence of this provision does not necessarily take care of all competitive considerations, in part because the provision may be ignored if the firm experiences financial stress. In addition there may be economies of combining banking and securities activities that would benefit the banking organization. See pages 18 and 19.

6. The report was modified to include a discussion of whether it was appropriate to consider competitive equality. See pages 18 and 19.

7. We agree that potential benefits should be considered in determining the appropriateness of firewalls. However, we also believe that it is reasonable to be cautious in phasing in powers in new areas where the potential exists for conflicts of interest or abuses such as insider trading. The discussion of this point has been modified to clarify our view. See pages 15 to 17.

Comments From the Association of Bank Holding Companies

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

ASSOCIATION of BANK HOLDING COMPANIES

RICHARD M. WHITING
GENERAL COUNSEL & SECRETARY

730 FIFTEENTH STREET N.W. WASHINGTON D.C. 20005
(202) 393-1158

January 5, 1990

Mr. Richard L. Fozel
Assistant Comptroller General
General Government Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Fozel:

Thank you for the opportunity to review and comment upon your draft report on bank ineligible securities activities carried out by wholly-owned subsidiaries of bank holding companies.

As you know, although the authority for bank holding companies to engage in such activities was granted only recently, this development provides a significant opportunity for bank holding companies to serve their customers, diversify their product base and business risks, and compete more effectively in the financial services sector. Accordingly, we commend you for addressing this important topic and for noting that such activities have not "damaged the financial condition of a bank or bank holding company." We hope that your conclusions will quell the criticism from opponents to the conduct of ineligible securities activities by subsidiaries of bank holding companies.

See comment 1

Now p. 8

In general, we agree with your report and the conclusions therein. We do have, however, a few comments. First, on page 12, we would suggest that you insert the phrase "without limitation or regulation" after the word "dealing" in the second line after the subheading "Risks Associated With Section 20 and Bank Holding Company Activities." Without this addition, the sentence seems to imply that such risks cannot be managed and can be counter-balanced only by the opportunities or benefits from the conduct of such activities by subsidiaries of bank holding companies.

See comment 2

Now pp. 2 and 3

Second, the background discussion on pages 2-5 of the report should make clear that the limitations on gross revenues from ineligible activities were imposed as a result of the Federal Reserve Board's interpretation of the "engaged principally" language of section 20 of the Glass-Steagall Act. Further, it should be noted that that language is subject to different interpretations, including authorization to allow Section 20 subsidiaries of bank holding companies to contribute to over twenty-five percent of the organization's revenues. It is possible that the Federal Reserve Board's current interpretation could change over time.

ASSOCIATION of BANK HOLDING COMPANIES

Mr. Richard L. Fozel -2- January 5, 1990

See comment 3
Now on 10-20

Finally, recognizing that the section 20 language could accommodate a greater volume of ineligible activities, we believe your list of additional area that should be considered by the Congress (see pp. 19-24) should include wh... r greater ineligible securities activities, when subject to appropriate regulatio.., in fact would result in any increased risks to the banking system.

In conclusion, we appreciate the chance to comment on your study. You and y... r staff are to be commended on a job well d... .

Sincerely,

Richard M. Whiting

Richard M. Whiting

The following are GAO's comments on the Association of Bank Holding Companies' letter dated January 5, 1990.

GAO Comments

1. We do not believe the wording of the report implies that such risks cannot be managed. We have modified the discussion in the report to make it clear that although there have been benefits associated with using the holding company structure, having independent bank holding company subsidiaries is not necessarily the only way to structure the expanded securities activities for banking organizations in the long run. See pages 12 to 14.

2. We think the report is clear on this point. Although the question of whether to raise the revenue limit further is not an issue currently before the Board, we recognize the Board's continuing authority to reexamine limitations established on Section 20 subsidiaries.

3. Our discussion of regulatory burden on pages 15 to 17 has been modified to recognize that expanded securities activities is one of the restrictions that, like revenue limits and some of the firewalls, might be modified in the future.

Comments From the Coalition for Regional Ba˜nks

Note GAO comments supplementing those in the report text appear at the end of this appendix

Coalition for Regional Banks

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January 18, 1990

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

The Coalition for Regional Banks appreciates the opportunity to comment on th draft GAO Report entitled "Bank Powers: Activities of .ecurities Subsidiaries of Bank Holding Companies."

The Report provides a useful and objective discussion of the regulatory framework applicable to section 20 subsidiaries of bank holding companies and the ef t of the so-called "firewall" restrictions impos y the Federal Reserve Board on such activities. We be ve that the Report would provide a more complete view i greater emphasis were given to the di proportionate impact of the firewalls on regional banking organizations and we have enclosed specific comments in this regard.

W. appreciated the opportunity to meet with the GAO staff in the formulation of the Report. On behalf of the Coalition for Regional Banks, I am submit ing the enclosed comments on specific points made in the Report.

Sincerely,

Melanie Fein

Melanie L. Fein
Arnold & Porter
Counsel to The Coalition
For Regional Banks

Enclosure

cc: Stephen C. Swaim
Edward Wroblewski

See comment 1

Comments on the GAO Report Entitled
"Bank Powers: Activities of Securities
Subsidiaries of Bank Holding Companies"

1. The Coalition for Regional Banks believes that the Report should emphasize more clearly the disproportionate effect on regional bank holding companies of the gross revenue limit applicable to section 20 subsidiaries.

As a result of the ten percent gross revenue limit, a section 20 subsidiary must have a substantial volume of revenue from bank-eligible activities in order to engage in any significant volume of ineligible underwriting and dealing activity. T only major source of eligible revenues is from underwriting and dealing in U.S. government securities. The structure of the U.S. government securities market, howev , generally precludes bank holding companies from major involvement in this market unless they qualify as primary dealers, which most re ional bank holding companies do not.[1]

[1] The Federal Reserve Bank of New York designates certain large banks and securities firms as primary dealers. There are currently approximately 43 primary dealers, of which seven are domestic banks and several more are nonbank subsidiaries of bank holding companies. Each primary dealer is required to maintain at least a minimum one percent share of the total primary dealer transactions with customers, to submit competitive bids at every Treasury auction, and to maintain capital of at least $50 million. The Federal Reserve Bank of New York
[Footnote continued on next page]

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Regional bank holding companies that are not affiliated with primary dealers in U.S. government securities operate und r a severe competitive disadvantage relative to section 20 subsidiaries that are primary dealers because they lack the large base of eligible revenues from underwriting government securities. For example, as shown in the attached chart, a section 20 subsidiary of a regional bank holding compa y with gross eligible revenues of $15 million per year could generate ineligible revenues of no more than approximately $1.67 million, resulting in a minuscul market share. Interest income on positions would account for a significant portion of this amount, thereby limiting even further the ability of a section 20 subsidiary to engage in underwriting activities. Depending on the size of each issue, the gross revenue limit would permit a regional section 20

[Footnote continued from previous page]
has limited the number of primary deale to a maximu of approximately 50 firms. See Federal Reserve Bank of New York, "Criteria and Procedures Applied to Firms Interested in Becoming and Remaining Primary Dealers," Press Release of November 17, 1988. Primary dealers control 75 percent of the market in government securities with 200-300 secondary dealers accounting for the remaining 25 percent. The combined a. rage daily trading volume of all primary dealers in August, 1988, was $100.1 billion for immediate delivery. 75 Fed. Res. Bull. A31 (1989). This figure does not include a large volume of activity consisting of securities sold under repurchase agreements.

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subsidiary to engage in only a very few underwriting transactions.

In order to hold itself out as a creditable underwriter and dealer in ineligible securities, a section 20 subsidiary must be able to respond to requests for bids on underwriting deals and to participate regularly in the underwriting and dealing markets. Under a ten percent limit, a regional section 20 subsidiary may quickly exhaust its quota for ineligible underwriting revenue and be unable to participate in underwritings of local municipal projects of major regional importance.

The ten percent gross revenue limit thus makes it difficult or impossible for many regional bank holding companies to participate meaningfully or competitively in the ineligible securities underwriting markets. A 25 to 49 percent gross revenue limit would be more realistic. The U.S. Department of Justice and the Comptroller of the Currency have stated their legal opinions that the Glass-Steagall Act permits such a latitude of underwriting and dealing activities.

More meaningful participation by regional bank holding companies also would be possible if the Board applied the gross revenue limit based on bank holding company's total consolidated revenues rather than revenues of the section 20 subsidiary only. Such an

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approach would be consistent with the Glass-Steagall Act as well as previous interpretations by the Board.

See comment 1

2. The Coalition for Regional Banks also believes that the Report should place greater emphasis on the disproportionate effect of the firewalls generally on regional banking organizations. This disproportionate effect is evidenced by the percentage of regional banking firms that have actually activated their section 20 subsidiaries. Of the nine multinational banking firms with section 20 approval, seven, or 77 percent of the total, have begun their bank-ineligible activities. In contrast, of the ten regional banking firms with section 20 approval, only five, or 50% of the total, have begun their bank-ineligible activities (Tables IV.1 and IV.2 of the Report).

Because of their smaller size, regional companies are less able to absorb the additional organizational and operational costs required to comply with the firewalls. The prohibition on officer and director interlocks, for example, typically means that regional bank holding companies engaged in underwriting activities must either hire duplicative management personnel or dilute existing management. Moreover, because of their "relationship banking" approach to customers, the cross-marketing restrictions may have a more significant adverse impact on regional banking organizations and their customers. In "relationship banking", the customer has the conve[illegible]ence of looking to his individual relationship manager for all of his financing needs, a benefit that is not possible under the firewall restrictions.

See comment 1
Now p. 8

3. On page 14, the Report states that regional bank holding company officials stated that

> it is necessary to transfer into a Section 20 subsidiary some activities that may not fit well together from a business perspective in order to provide a large enough subsidiary rev[illegible]ue base to make doing ineligible business wort[illegible]while.

We would point out that, in addition to incompatibility, it is unfeasible to locate most non-securities related activities in a section 20 su[illegible]diary due to the net capital rule of the Securities and Exchange Commission. Moreover, the Federal Reserve Board requires a bank holding co[illegible]pany to deduct from its regulatory capital any capital supporting the section 20 subsidiary and imposes other restrictions, such as cross-marketing and interlocks prohibitions, that make the conduct of activities through the section 20 subsidiary expe[illegible]sive and im[illegible]actical from a business point of view. This point is made in Appendix III (p. 59) but should be emphasized in the body of the Report. We would note that the SEC's net capital rule provides an adequate

Now p. 44.

See comment 2

See comment 3
Now p. 46

- 6 -

safeguard to ensure the solvency of a section 20 subsidiary and thus the Board's capital deduction is unnecessary and costly.

4. The Coalition for Regional Banks believes that banks should be permitted to establish and fund section 20 subsidiaries in the same manner that the Board has permitted foreign banks to do so. See Board Order dated January 4, 1990, approving se ion 20 applications by Canadian Imperial Bank of Commerce, The Royal Bank of Canada, and Barclays Bank PLC. The FD 's regulations permit insured state nonm er banks to establish subsidiaries to engage in underwriting and dealing activities. 12 C.F.R. 337.4. Such activities should not become impermissible simply because a bank is owned by a bank holdi company. The Board's authority to regulate the activities of subsidiaries of holding company banks is doubtful in any e nt. Allowing banks to operate separate section 20 subsidiaries would afford domestic ban competitive parity with foreign banks and would enable dor tic banks to diversify their income and risks on a consolidated basis.

5. On pages 59-60, the Report cites a security industry official's c ents that "the e. ire investment industry's revenues from un writing were only about eight percen of gross reve s in the first half of 1989" and therefore a bank holding company could acquire

See comment 1.
Now p. 8

- 7 -

a large existing securities firm and still be within the ten percent gross revenue limit. This statement may be misleading because the Board's gross revenue limit is applicabl not only to underwriting activities but dealing as well. It would be useful for the GAO to ascertain and report the percentage of the investment industry's revenues that are derived from dealing activities in addition to underwriting activities.

In any event, regional bank holding companies generally are not interested in acq iring existing securiti firms given th poor condition of such firms generally.

6. On page 13, the draft Report states that

> bank holding company officials and some regulatory officials h e said that the regulatory structure r hamper the ability of the holding company as a whole to manage its exposure to a single customer or market se nt and, thus, the risks that may resu from such exposure.

We would note that, while the separate subsidiary require nt, interlocks restrictic , and other firewalls may interfere with management's ability to most efficiently monitor and control risk exposure, bank holding companies are not undertaking undue risks as a result of the firewalls but rather are managing such risks through burdensome policies and procedures that

- 8 -

otherwise would be unnecessary in the absence of certain of the firewalls.

7. In a number of places, the Report refers to concerns by securities industry officials that bank holding company section 20 activities will enable bank holding companies to compete unfairly with securities firms (e.g., p. 15). The Report states that, while th need for the firewalls may be legitimately questioned, elimination of the firewalls may place securities firms at a competitive disadvantage:

> [o]n competitive grounds, however, the case for the firewall may be much stronger. Securities firms competing with Section 20 firms are not affiliated with a bank and therefore could be placed at a competitive disadvantage if the firewalls were eliminated. (p. 21).

The Coalition for Regional Banks believes that competition between securities firms and banking organizations is not a valid Glass-Steagall concern. The Glass-Steagall Act was not intended as a device to insulate the securities industry from competition. Even if bank holding company section 20 subsidiaries did have a competitive advantage over securities firms (which they do not), public policy would not dictate that inefficient and burdensome restraints be imposed on section 20 subsidiaries.

See comment 6.
Now pp. 9, 18, 46, and 52.

8. In several instances (pp. 15-16, 24, and 73), the Report quotes securities industry officials as objecting to the section 20 subsidiaries' access to low cost funds in the form of insured deposits from their affiliated banks. The securities industry position is misleading for two reasons. First, under the Board's most recent firewalls, banks may not provide any funds to their section 20 affiliates. Even if they could, a bank loan to an affiliate must comply with the quantitative limitations and collateral requirements of section 23A of the Federal Reserve Act. A section 20 subsidiary must seek bank borrowings from unaffiliated banks. Second, securities firms have access to these so-called "low cost funds." They are permitted to borrow from banks and are not subject to section 23A limits. From a parity perspective, a non-bank-affiliated securities firm enjoys the same access to "low cost funds" as does a bank-affiliated section 20 affiliate. The Board itself has rejected the argument that section 20 subsidiaries have access to lower cost funds than their securities industry competitors, as noted in Appendix III (p. 66).

Now pp. 46 and 47.

Moreover, banking organizations operate subject to numerous regulatory restrictions that impose a "regulatory tax" on their operations. In addition to the section 20 firewalls that impose costly inefficiencies, ban s are subject to disadvantages resulting from the cost of deposit insurance premiums, foregone interest on required reserves, and capital requirements higher than would be maintained in the absence of regulation and deposit insurance. See "Regulatory Burden Handicaps Low-Risk Banking," Federal Reserve Bank of Chicago, Chicago Fed Letter, January, 1988, No. 5.

We also would note that a number of securities firms do in fact have bank affiliates and are not subject to the full range of firewalls applicable to section 20 subsidiaries.

See comment 7.
Now p. 18.

9. The Report on page 23 refers to potential customer confusion about whether investment products are insured or not. We w ld point out that customer confusion may be avoided by appropriate disclosures. Banks are not exempt from the anti-fraud provisions of the securities laws and the Securities and Exchange Commission recently has initiated a program to aggres ively monitor bank compliance with such laws.

See comment 8.
Now p. 50.

10. On page 70, the Report states that bank holding company officials stated that so foreign banks operating in the United States are permitted to provide credit enhancements for securities underwritten by their affiliat . We are unaware of any such activities or authority for such activities by foreign banks. It

- 11 -

would be useful for the Report to identify under what authority such foreign banks are pu:,ortedly providing credit enhancements.

(Appendix A)

MAXIMUM PERMISSIBLE UNDERWRITTEN AMOUNTS IN BANK INELIGIBLE MUNICIPAL
BONDS, OR CORPORATE DEBT OR COMMON STOCK, BASED UPON 5%, 10% AND 25% GROSS REVENUE LIMIT

(In Millions of Dollars)

	Gross Revenue Limit %	Permissible[A] Ineligible Gross Revenues	÷	Typical[B] Underwriting Spread	=	Maximum Annual Underwritten Amount	÷	Total[C] Issuances (1988)	=	Market Share
Bank Ineligible Municipal Bonds	5%	$0.79		1.2%		$ 65.8		$ 75,000		[illegible]
	10%	$1.67				$139.2				0.19%
	25%	$5.00				$416.7				0.56%
OR										
Corporate Debt	5%	$0.79		0.7%		$112.9		$236,460		0.05%
	10%	$1.67				$238.1				0.10%
	25%	$5.00				$714.3				0.30%
OR										
Common Stock	5%	$0.79		5%		$ 15.8		$ 29,600		0.05%
	10%	$1.67				$ 33.4				0.11%
	25%	$5.00				$100.0				0.34%

[A] Based on projections by regional bank holding companies of reasonably anticipated eligible gross revenues of $15 million.

[B] Municipal bond spread based upon gross spreads provided by Public Securities Association. Municipal bond spread for competitive issues is somewhat lower. Corporate underwriting figures estimated from a review of numerous public offering prospectuses.

[C] Issuance Amounts derived from "The 1989 Corporate Sweepstakes" Institutional Investor, Feb. 1989, at 128; Letter from Andy Nybo, Public Securities Association, to David F. Freeman, May 4, 1989; and Securities Industry Association, Trends, Vol. XV, No. 1 (Jan. 6, 1989).

The following are GAO's comments on the Coalition for Regional Banks' letter dated January 18, 1990.

GAO Comments

1. In appendix III of the report, we discuss the practical impact the firewall requirements have on banking organizations, including regional bank holding companies. We believe the report reflects the concerns and perspectives that regional banking organizations have concerning the firewalls.

2. The Board's approval of foreign banking organizations' applications to establish Section 20 subsidiaries occurred after we completed our audit; therefore, we did not have the opportunity to study the Board's approval in any detail. However, as noted in the report letter (see pages 12 through 14), we believe that the appropriate long-run structure to accommodate expanded activities authorized for banking organizations is a topic that should be studied further.

3. We did not obtain information on securities industry revenues generated from dealing activities, since the Section 20 firms that have initiated the new activities have primarily conducted underwriting activities. However, a banking organization's decision to acquire an existing securities firm would be affected not only by the amount of revenue generated from bank-ineligible activities but by other business considerations, such as the firm's profitability and how well the firm would fit into the banking organization's strategic business plans.

4. The text has been modified to better illustrate the need for determining the purpose served by each firewall.

5. We agree that while provisions contained in the Glass-Steagall Act generally tend to establish a degree of separation between the banking and securities industries, it does not appear that the act was intended to blunt competition among providers of financial services.

6. We agree that under either the firewall requirements or provisions contained in the Federal Reserve Act, loans made by a bank to an affiliate are required to be on essentially the same terms as those that exist in the markets for similar transactions. Therefore, it appears that the Federal Reserve's objective is to assure that a Section 20 subsidiary does not unduly benefit from being affiliated with an insured institution. Additionally, securities firms affiliated with a bank holding company, as

defined in the Board's regulations, would also be required to comply with the Board's firewalls.

7. We agree that adequate and appropriate disclosure, properly regulated, would be an effective mechanism to assure that a customer can clearly distinguish between federally insured and uninsured products and services that may be available from a federally insured institution.

8. The Bank Holding Company Act, as amended, defined a bank holding company as a company, including a foreign banking organization, that has direct or indirect control of a bank. Under Section 4(a)(2) of the act, certain foreign banking organizations qualify for grandfathered privileges under Section 8 of the International Banking Act of 1978 (IBA). Under Section 8 of the IBA, any foreign bank that controls a bank that operates in the United States shall be subject to the Bank Holding Company Act of 1956 and subsequent amendments in the same manner and to the same extent as if it were a bank holding company. The purpose of this provision was to bring the permissible nonbanking activities of foreign banks more in line with those of domestic bank holding companies. However, a foreign bank could continue to engage in nonbanking activities in the United States in which it was lawfully engaged before enactment of the IBA.

Appendix XVI

Comments From the Securities Industry Association

SECURITIES INDUSTRY ASSOCIATION
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January 8, 1990

Mr. Richard L. Fogel
Assistant Comptroller General
United States
General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Let me begin by thanking you for providing us with a copy of your draft report "Banking Powers: Activities of Securities Subsidiaries of Bank Holding Companies". This is a very difficult subject to analyze because there are no readily available data sources on specific securities products, and there has been little experience with the Section 20 Subsidiaries. You have done a superb job in consolidating the available information in the appendices.

The basic information concerning the industry comes from the SEC Focus Report. This basic regulatory document has not been changed since the mid-1970's, and contains a simple one page income statement. Obviously, the industry has changed substantially since that time, and continues to change. The industry and the regulators would be able to get a better picture if revenues and profitability were reported by product line. The Commission does little analysis of the industry, and frankly, that analysis is left to this association. Changes in the Focus Report could provide significantly better information, and make industry and product line analysis more meaningful.

Given the limited data and experience we certainly agree that it is too early to draw conclusions as to the competitive impact of the Section 20 Subsidiaries, or how real or necessary the firewalls are. SIA has long supported a legislative solution to intersection between investment and commerical banking. Your report raises the issues that need to be analyzed before the Congress can undertake a redefinition of national policy in the banking and securities industries. We look forward to working with you and the Congress towards that redefinition.

Sincerely,

Donald J. Crawford
Senior Vice President and
Director of Government Relations

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Related GAO Products

Commercial Banking

Banking: Conflict of Interest Abuses in Commercial Banking Institutions (GAO/GGD-89-35, Jan. 27, 1989).

Bank Powers: Issues Related to Repeal of the Glass-Steagall Act (GAO/GGD-88-37, Jan. 22, 1988).

Issues Related to Repeal of the Glass-Steagall Act (GAO/T-GGD-88-9, Feb. 10, 1988).

Using "Firewalls" in a Post Glass-Steagall Banking Environment (GAO/T-GGD-88-25, Apr. 13, 1988).

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

Safeguards That Need to Accompany Changes to Glass-Steagall Laws (GAO/T-GGD-88-51, Sept. 13, 1988).

Commercial Banking: Lending to Troubled Sectors (GAO/GGD-88-126BR, Sept. 26, 1988).

Bank Powers: Insulating Banks From the Potential Risks of Expanded Activities (GAO/GGD-87-35, Apr. 14, 1987).

The Securities Industry

Financial Markets: Preliminary Observation on the October 1987 Crash (GAO/GGD-88-38, Jan. 26, 1988).

Securities and Futures: How the Markets Developed and How They Are Regulated (GAO/GGD-86-26, May 15, 1986).

Securities Regulation: Securities and Exchange Commission Oversight of Self-Regulation (GAO/GGD-86-83, Sept. 30, 1986).

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Transition Series: Financial Service Industry Issues (GAO/OCG-89-4TR, Nov. 1988).

Financial Services Information on Nonbank Banks (GAO/GGD-86-46FS, Mar. 21, 1986).