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LUDWIG STRESSES SUPERVISION AS KEY TO GLASS-STEAGALL REFORM

Comptroller of the Currency Eugene A. Ludwig today urged Congress to eliminate artificial barriers that restrict competition for financial services as it considers reform of the Glass-Steagall Act. In testimony before the House Committee on Banking and Financial Services, Ludwig urged increased reliance on regulatory supervision to assure safety and soundness rather than artificial restrictions and rigid structures that limit competition.

"Artificial limits and segregation of non-traditional and innovative products and services do not further safety and soundness in our complex and increasingly competitive financial system," said Mr. Ludwig. Specifically addressing the bill sponsored by Rep. Leach (H.R. 18), he said his fundamental concern is that it puts insufficient emphasis on supervision and relies too heavily on organizational structure and transactional firewalls to shield institutions from the perceived risks of expanded financial services activities.

Mr. Ludwig pointed to two aspects of the bill:

It allows broader securities activities to be conducted by banking organizations, but only through a bank holding company affiliate.

It contains extensive firewalls that separate a bank and its securities affiliate to such an extent that it impairs reasonable opportunities for synergies.

Mr. Ludwig said these devices do not deliver the safety and soundness benefits that are needed. "We cannot depend on them to protect the bank in moments of crisis," he said. "We have a better alternative. The combination of effective supervision and flexible firewalls can deliver safety and soundness we need without excessive costs." Mr. Ludwig said that a balance between prudential safeguards and enhanced activities flexibility, coupled with sound supervision, is one key principle of modernization.

"Today, artificial and antiquated barriers and restrictions impede the ability of banks, securities, firms, and other financial companies to operate efficiently, to provide the range of products and services their customers desire, and to fuel economic growth," said Ludwig. "Financial services modernization is more than just an interesting idea. It will result in better customer service, more efficient businesses, and a more vital financial services section for the nation's economy."

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TESTIMONY OF
EUGENE A. LUDWIG
COMPTROLLER OF THE CURRENCY
Before the
COMMITTEE ON BANKING AND FINANCIAL SERVICES
of the
U. S. HOUSE OF REPRESENTATIVES

February 28, 1995

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Mr. Chairman and members of the Committee, I welcome this opportunity to discuss H.R. 18, the Financial Services Competitiveness Act of 1995. I commend you for so quickly offering an initiative to modernize our financial services system. I also applaud Representative Baker for his thoughtful proposal. Today, artificial and antiquated barriers and restrictions impede the ability of banks, securities firms, and other financial companies to operate efficiently, to provide the range of products and services their customers desire, and to fuel economic growth. Financial services modernization is more than just an interesting idea. It will result in better customer service, more efficient businesses, and a more vital financial services sector for the Nation's economy.

For banks, activities diversification is an essential complement to the geographic diversification authorized by Congress last year. Together, they form the necessary cornerstones for a vigorous banking system. Both types of diversification are needed to ensure that our banks can meet the needs of their local customers and communities as well as remain competitive in international financial markets.

The Secretary of the Treasury has announced several concepts directed toward legislation in this area. He will testify further in this regard shortly. I support the Secretary's

approach.

There is much about H.R. 18 that I support. I nonetheless have a number of serious concerns, particularly about those provisions that force banking organizations into rigid structures that will make them less efficient competitors and less effective at meeting the needs of their customers.

I. Maximizing Competition

Mr. Chairman, we agree on the fundamental reason to reform our financial services industry. Allowing banking organizations to expand their activities will lead to improved, more convenient, and less costly services for consumers of financial services-- individuals as well as small and large businesses. Competitive financial services markets are the most efficient financial services markets, and thus the best able to serve and benefit all customers.

The benefits of allowing banks to engage in investment banking activities will likely show up most clearly on "Main Street America." A small- or medium- sized business seeking to grow may need to move from traditional bank loans to more sophisticated means of financing, such as the public debt or equity markets. Such a business typically develops a close working relationship with its commercial banker, who may be able to offer useful perspectives as the business seeks to graduate to a middle market. Yet, today, the ability of banks to facilitate a customer's changing financial needs is limited. Restrictions on the activities of commercial banks deprive that customer of the option to continue to work with a lender knowledgeable about its business when the customer seeks to access the capital markets. The customer is also deprived of the benefits of price and product competition from banks that would otherwise seek its business. The lack of price competition translates into increased financing costs. The lack of product competition limits the availability of innovative financing approaches for businesses.

A more troubling result for a business occurs if its commercial lender cannot serve its evolving financing needs, and no one else will. Small businesses often need amounts or types of financing that nonbank financial institutions have no interest in providing. In these situations, the inability of banks to offer a more comprehensive selection of financing forces some small- and medium-sized firms to perpetuate inappropriate financing arrangements. By harnessing the credit knowledge of the banking system, financial modernization promises these businesses broader access to capital markets.

Increased competition could have benefits for states and municipalities as well. At a time when all levels of government are trying to save money yet preserve essential services, we should offer state and local authorities the benefits of more effective price competition. We have known of these benefits for many years. A 1968 study issued by the Office of the Comptroller of the Currency demonstrated this point clearly. {Wm Paul Smith,

Commercial Bank Entry Into Revenue Bond Underwriting: Competitive Impact and Public Benefits (Washington, D.C.: U. S. Treasury Department, Office of the Comptroller of the Currency, 1968).] H.R. 18 recognizes this benefit in its provisions allowing greater authority for national banks to underwrite revenue bonds. But I would urge more flexibility in this matter than H.R. 18 provides. Specifically, I would allow national banks to underwrite municipal revenue bonds--as they are today allowed to underwrite municipal general obligation bonds--regardless of whether the bank has a securities affiliate.

In addition, the increased competition provided by banks in these markets will both lower costs to customers and increase (or in some instances create) access to the capital markets for larger businesses. [Samuel L. Hayes III, A. Michael Spence, and David Van Praag Mark, *Competition in the Investment Banking Industry* (Cambridge, MA: John Wiley & Sons, 1985), pp. 57-58, 274; Richard M. Levich, "A View From the International Capital Markets," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, edited by Ingo Walter (New York: John Wiley & Sons, 1985), p. 274; *Modernization of the Financial Services Industry: A Plan for Capital Mobility Within a Framework for Safe and Sound Banking*, Report 100-324, U.S. House of Representatives, Committee on Government Operations, 100th Cong., 1st Sess. (USGPO, 1987), Appendix, "Supplementary Data on Underwriting Concentration," Exhibits C-1 and G-1, pp. 85, 88; David Neustadt, "Investment Banking Party Ends As Commercial Banks Get Invite," *American Banker*, April 11, 1988, pp. 1, 38-39; Jed Horowitz, "There's Life After Glass- Steagall For Wall Street, Report Says," *American Banker*, December 2, 1987, pp. 3, 8; Thomas A. Pugel and Lawrence J. White, "An Analysis of the Competitive Effects of Allowing Commercial Bank Affiliates to Underwrite Corporate Securities," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, edited by Ingo Walter (New York: John Wiley & Sons, 1985), p. 209; and David S. Kidwell, M. Wayne Marr, and G. Rodney Thompson, "Shelf Registration: Competition and Market Flexibility," *Journal of Law and Economics*, vol. 30 (April 1987), pp. 181-206.]

Market access--whether by way of securitization, access to the commercial paper market, or underwriting revenue bonds--will spur economic development. The economic boost that competition in this area provides will translate into increased jobs and will deepen and strengthen our capital markets.

However, I say all of this with one important caveat. None of these benefits will materialize unless new entrants can compete effectively. It is not enough to allow a bank to undertake new activities if, in so doing, we impose so many unnecessary regulatory burdens that we lose the benefits of diversification. If we dismantle the Glass-Steagall wall, we must not leave so much regulatory barbed wire in its place that we defeat our objectives.

This leads me to two fundamental concerns about H.R. 18. First, the bill rigidly compartmentalizes new activities to

address safety and soundness concerns. I believe effective safety and soundness oversight requires a more flexible supervisory approach. While any new financial activity entails risk, we must recognize that safety and soundness can increase when banks realize efficiencies from affiliations with other financial services firms.

Second, H.R. 18 shifts new financial services activities--and even some traditional ones--from banks and their subsidiaries to holding company affiliates. Safety and soundness considerations do not require this surgery. It will leave banks atrophied, dependent on affiliate life-support systems. The long-term health of the economy and the banking system depends on banks' ability to remain strong and innovative financial services providers in their own right.

II. Preserving Safety and Soundness

My first concern with H.R. 18 is that the bill relies too heavily on organizational structure and transactional firewalls as supervisory devices to shield institutions from the perceived risks of expanded financial services activities. The bill allows broader securities activities to be conducted by banking organizations, but (with one exception) only through a bank holding company affiliate. It prohibits other structural options, potentially more efficient or better suited to a particular banking organization, such as the use of bank subsidiaries.

In addition, if banks wish to take advantage of this new opportunity to engage in broader securities activities, they must discontinue activities that are customary, profitable, and that have not been the basis for safety and soundness concerns. For example, a bank could no longer securitize and sell its loans. It could no longer participate in financial market innovations because it would be barred from underwriting and dealing in any securities other than those listed by statute. And banks would have to discontinue their private placement services for institutional customers.

H.R. 18 also contains extensive firewalls that would separate a bank and its securities affiliate to such an extent that it may preclude reasonable opportunities for synergies. These restrictions in many cases would disadvantage a bank securities affiliate relative to an unrelated third party securities firm, placing banking organizations at a competitive disadvantage.

Let me make two further points about relying on organizational structure to limit risk and protect bank customers. First, these devices, as contemplated in H.R. 18, will not deliver the safety and soundness benefits that we need. We cannot depend on them to protect the bank in moments of crisis. In fact, because they are a source of unnecessary costs, they may actually detract from safety and soundness. Second, we have a materially better alternative. A combination of effective supervision and adaptable firewalls can deliver the safety and

soundness we need, without excessive costs.

Proponents of the corporate structure approach argue that it promises safety and soundness by insulating the bank from risk. But corporate structure may fail to deliver the insulation from risk that it promises in theory. Experience teaches that the location of an entity in a banking organization's corporate structure, i.e., whether it is a subsidiary of the holding company or of the bank, does not matter when a banking organization decides whether to support its affiliates and maintain its public reputation. For example, where customers or creditors are aware of the relationship between a holding company subsidiary and a bank--and it is highly unlikely sophisticated customers would not be--it is questionable whether a holding company will feel free to walk away from a troubled affiliate, since doing so could hurt the reputation of the bank itself. In the 1970s several large bank holding companies bailed out their failing real estate investment trust affiliates. Just last year, several holding companies came to the rescue of troubled affiliated money market mutual funds.

Proponents of firewalls also contend they are necessary to prevent affiliates from making unlimited draws on the bank's capital and from taking advantage of their affiliates' customers. When applied to certain kinds of activities, these firewalls, along the lines of Sections 23A and 23B of the Federal Reserve Act, and separate capital requirements can play a useful role in reducing a bank's exposure to risk, protecting against conflicts of interest, and preventing consumer abuses. But we must be realistic about their shortcomings.

By far the most crucial shortcoming concerns the effects of overly rigid firewalls on the potential benefits of permitting banking organizations to engage in nontraditional activities. Unduly stringent restrictions could eliminate many of the incentives that motivate banks to enter new activities. Therefore, it would be a mistake to legislatively mandate extensive, detailed, and inflexible firewalls, particularly to broad categories of activities. Rather, supervisors need authority to adapt firewalls to specific activities the conduct of which entail the greatest risks.

For example, it would not, in our view, be appropriate to apply substantial new restrictions because a bank, bank subsidiary, or bank affiliate begins to underwrite state and municipal revenue bonds. Banks have underwritten state and municipal general obligation bonds for years, without ill effects. Why then, should substantial new restrictions be applied when those activities are expanded to include revenue bond underwriting? On the other hand, regulators should be able to provide meaningful firewalls for other activities, such as some or all aspects of property and casualty insurance underwriting.

In contrast to a careful and targeted use of firewalls, the structure H.R. 18 mandates for conducting new activities and operational restrictions are blunt instruments that I fear would

undermine key benefits of financial services modernization. If we want a healthy, modern banking system, regulators must have the flexibility to adopt modern approaches to supervision.

Given the widespread doubts regarding the efficacy of structural separateness and the costs involved in establishing a holding company structure, proponents of restricting new activities to holding company affiliates should bear the burden of demonstrating that the holding company structure is the most effective approach to safety and soundness. Otherwise, the market should be free to make its own structural choices to maximize operational efficiency and minimize risk.

Fortunately, we need not depend upon statutorily mandated structural devices to protect against risk. Let me describe the supervisory alternative. In determining whether a banking organization should conduct a particular new activity, the bank regulator must focus not only on the specific activity but also on the nature of the bank's current activities and on how the bank intends to integrate the new business into its operations. We must be certain the activity is appropriately supervised both by the bank and by its regulator. Relying on supervision, combined with corporate restrictions that fit the specific situations, is superior to relying on mere structural constraints. It allows regulators to tailor the risk management, in light of economic conditions, to the peculiar risks presented by new activities as they are conducted by a particular bank. One-size-fits-all structural constraints and rigid firewalls add nothing to such supervision, and they add little protection in crises.

Placing the emphasis on a combination of supervision and appropriate corporate safeguards is important because it allows us to adopt the kind of management that is necessary for a particular activity conducted in a particular manner. Moreover, supervision and risk control systems, including modeling and stress testing, have improved and become more sophisticated over time and have adapted to the constantly changing ways in which even the same activities are conducted. As banks develop new products, and new ways to synthesize risks, the regulator can adapt its supervisory practices to marketplace developments.

Therefore, safety and soundness depends on more than just risk insulation, and is independent of corporate structure. It is fundamentally determined by how an activity is conducted, how risks are managed, and how an institution is supervised. No matter what corporate structure is in place, strong and effective supervision--which includes appropriate treatment of capital to limit the exposure of the insured institution, and hands-on examination--is crucial to keeping risk in check and protecting the safety and soundness of the banking system and the deposit insurance fund.

III. Structural Choices and Safety and Soundness

My second concern is that H.R. 18's imbalance in favor of activities conducted in holding company affiliates instead of in

bank subsidiaries could increase risk and sap the vitality of our banking system. Limiting activities can make banks riskier for several reasons.

First, limiting activities deprives banks of the safety and soundness benefits of diversification. By putting all of their eggs in one basket, it leaves them prey to the vagaries of one market, one set of risks.

Second, limiting activities will prevent banks from evolving beyond a narrow market segment, impairing their ability to continue to do a safe and profitable business. External market forces such as the advent of diverse debt markets and increased competition from non-bank providers have dramatically shortened the reach and profitability of traditional banking activities, chiefly lending, over the past thirty years.

Third, limiting activities will cause banks to continue to lose their better customers, making even their traditional activities less safe. As competitors rush to develop new products, to learn about the risks of these offerings, and to compete aggressively for bank customers, banks and their subsidiaries will need the ability to provide products to respond to market demands. Accordingly, there should be a strong presumption in favor of allowing new activities to be conducted by bank subsidiaries as well as holding company affiliates where the particular activities do not materially increase the risk of the bank.

The long-term viability of our banking system depends upon the ability of banks (directly and through their own subsidiaries) to be strong and competitive financial services providers in their own right. Key to that result is that banking organizations have reasonable choices regarding the most efficient corporate structure for conducting business. Unless compelled by reasons of safety and soundness--which I do not believe is the case for securities, insurance, and many other financial activities--banking organizations should be allowed to innovate, either through holding company affiliates or bank subsidiaries, as they and the market--not the government--deem appropriate.

Artificial limits and segregation of non-traditional and innovative products and services do not further safety and soundness in our complex and increasingly competitive financial system. Forcing innovation and new product development to occur outside of a bank and its subsidiaries, restricting banks to a very narrow range of familiar activities, would ill-serve the banking system and the Nation's consumers.

Empirical evidence suggests that non-traditional financial activities need not threaten bank safety and soundness. In this regard, let me offer several observations. First, U.S. banks, through foreign branches and subsidiaries, as well as holding company affiliates, have successfully engaged in a variety of non-traditional activities abroad for many years. The authority for this is longstanding.

Second, banks in most G-10 countries have been engaging in a broad range of financial services activities, including the activities specifically referred to in H.R. 18, for many years. Again, no empirical evidence indicates that engaging in these activities has threatened the safety and soundness of these institutions. [The failure of Barings over the past weekend arose from unauthorized derivatives activities. Derivatives activities are within the scope of activities currently permissible for both U.S. and foreign banks and accordingly are not the kind of new activity at issue in Glass-Steagall reform.] On the contrary, foreign bank supervisors have told me that income from non-traditional activities has been a key support to the safety and soundness of certain banks during periods of financial stress.

Third, there is no support for the premise that a bank would bear more risk holding municipal revenue bonds (or other types of securities), for a matter of hours, as part of an underwriting, than it does today when it holds government securities or municipal general obligation bonds, for a matter of hours, in connection with currently permissible bank underwriting activities. Common sense suggests that neither of those market risks is necessarily greater than making and holding a long-term commercial loan.

Finally, the risks to banks from insurance activities are generally no greater than those presented by commercial lending. U.S. banks have offered a variety of insurance services to their customers for many years. They already sell all types of insurance in towns with populations of less than 5,000. They underwrite and sell municipal bond, credit life, accident, and health insurance nationwide.

Recent research also lends support to the conclusion that commercial and investment banking can be combined safely. Scholars have found that the Glass-Steagall Act's separation of commercial and investment banking was not justified either on safety and soundness grounds or as a response to documented problems. In fact, banks with securities affiliates failed less frequently than other banks. A path-breaking 1986 study by Eugene White of Rutgers University found no convincing historical evidence that any of the 9,000 banks that failed between 1930 and 1933 did so as a result of their investment banking activities. [E. White, "Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks." *Explorations in Economic History* (January 1986).] It seems the separation between commercial and investment banking largely reflected the continued faith of legislators and regulators in the now-discredited Real Bills Doctrine, which held that making short-term loans for productive purposes and secured by real goods was the only appropriate lending activity for commercial banks. The immediate impetus for passage of the Act came from a serious misdiagnosis of the causes of the banking collapse in the 1930s, together with widespread public resentment toward bankers involved in underwriting and distributing corporate securities.

Another recent study found that the securities underwritten by commercial banks in the years 1921-1933, far from being unduly speculative, tended to be higher in quality than those underwritten by investment banks. [Randall Kroszner and Raghuram Rajan, "Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933." American Economic Review. 84 (September 1994).] A detailed study of the hearings preceding passage of the Glass-Steagall Act by George Benston of Emory University found little concrete evidence of the alleged abuses by commercial banks' securities affiliates. [George J. Benston, The Separation of Commercial and Investment Banking. (New York: Oxford University Press, 1990).]

In sum, H.R. 18 represents an opportunity to enhance the safety and soundness of banks. But the ability of banks to seize that opportunity will depend upon the extent to which they can diversify without inefficient and costly structural and supervisory impediments.

IV. Banking and Commerce

You have asked me to comment on the issues involved in permitting commercial firms to own banks. The line between banking and commerce is unclear. Various products and services have attributes of both commerce and banking. Changes in the economy, particularly in the field of technology will further blur the line between banking and commerce. For example, computer programming and information management are now widely acknowledged to be integral to the provision of financial services, even though twenty-five years ago they seemed to be more like pure commercial activities.

Concerns about the consequences of combining banking with pure commercial activities date back to the establishment of the Bank of England, and have included worries about conflicts of interest, excessive market power, and undue risk-taking that might adversely affect depositors, or further threaten the stability and efficiency of the financial system. In the United States, state bank charters have traditionally restricted the powers of banks to engage in such commercial activities. The National Bank Act and the Bank Holding Company Act continue these restrictions for national banks and nonbank affiliates.

Nonetheless, American financial history contains many examples of banks owned by, or otherwise affiliated with, commercial and manufacturing enterprises. The Bank Holding Company Act Amendments of 1970, ended many, but not all, of all those affiliations. Those combinations of banking and commerce did not occasion particular problems or abuses, although many of them involved highly specialized circumstances.

Clearly, the health and competitiveness of U.S. banking may at some time come to depend on our willingness to modify or dismantle this separation. But further expansion by banking organizations into financial activities offers benefits that are greater and more immediate, and poses risks that are better understood than those associated with combining banking and

commerce. At this time, therefore, I would urge that we focus our attention on the universe of financial activities.

V. Conclusion

Any reform proposal must embody three key principles if we are to achieve the full benefits of financial services modernization. First, any new approach must maintain the safety and soundness of the banking system. This requires a balance between prudential safeguards and enhanced activities flexibility, coupled with sound supervision. It does not require presumptions or prohibitions against bank entry into new activities.

Second, a new system should encourage healthy competition and efficient business operations to benefit all consumers of financial services--in all of our communities--and thereby facilitate economic growth. The elimination of artificial barriers to entry and antiquated restrictions on corporate structures is essential to this goal. Like other businesses, banks should have substantial freedom to choose the organizational form that best enables them to respond to marketplace demands, absent compelling public policy reasons to limit that freedom.

Third, regulation--and regulators--must be both effective and efficient. They must not impose unnecessary burdens. In other words, we should not limit the efficiencies resulting from modernization by placing constraints on what activities banks may conduct and how they may conduct them, unless those constraints are clearly necessary to assure safety and soundness or to protect consumers or investors.

In conclusion, I would like to emphasize the importance of these hearings and once again commend your leadership in this area. Absent reform, increasingly competitive world financial markets would imperil the long-term profitability and stability of our banks. Facing up to these issues by reconsidering archaic and counterproductive product restrictions, by removing unnecessary impediments on corporate structure, and by relying on strong supervision of diversified financial firms is, I am convinced, both a wise and necessary course of action.