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Statement No. 56

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Statement of the Shadow Financial Regulatory Committee

on

**The Elimination of Restrictions
on Bank Securities Activities and Affiliations**

May 7, 1990

Issues of liberalized banking powers and affiliations between banking organizations and others are receiving increasing attention. While the range of securities services authorized for banking organizations is relatively extensive, two kinds of restrictions inhibit banks -- percentage-of-revenue limitations on individual activities and the requirement that many functions be conducted in separate nonbank entities. Similarly, nonbank entities are constrained from owning banks by the restrictions on permissible powers contained in the Bank Holding Company Act.

The Shadow Financial Regulatory Committee maintains as a basic principle that safety and soundness

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considerations do not justify restrictions on bank powers or affiliations between banks and other entities once a rigorous economic capital program is in place. Specifically, the Committee has repeatedly called for three steps to assure strong economic capital at banks: the definition of capital in terms of current market valuations; measures to require sufficiency of such capital; and timely recapitalization and reorganization of entities facing economic insolvency. These actions would impose discipline on bank regulators and bank managers alike to sustain adequate economic capital in banks. The balance of this Statement elaborates on the applications of this position to affiliations and securities activities of banks.

Background. The current attention to bank powers reflects a variety of forces, including: (1) regulatory actions gradually widening the scope of banking powers; (2) reviews of the role and structure of federal insurance and guarantee programs; (3) uncertainties about the connections (if any) between the extent of powers and risk; (4) losses incurred in recent bank and thrift failures; and (5) greater recourse by nonfinancial business to unintermediated services in financial markets.

The attached table summarizes the current status of domestic securities powers of banks and bank holding companies.

Securities Powers. Current restrictions on bank securities activities curtail innovation and efficiency and impose higher costs on users of these services and, therefore, should be liberalized. A rigorous bank capital program of the kind proposed by the Committee should resolve concerns about broader powers. The chief prerequisite for new activities should be the ability of bank supervisors to evaluate and monitor the effects of such activity on total risk.

Institutional structures for undertaking securities activities. In recent years most newly authorized bank securities powers have had to be exercised through a holding company's nonbank affiliates. Legal stipulations (e.g., the requirement under the Banking Act of 1933 that bank affiliates not be "principally engaged" in securities underwriting) and political expediency are responsible for this form of evolution. This separation imposes unnecessary operational inefficiencies. In addition, current regulatory limitations discriminate against smaller banking organizations because of the high costs of establishing separate securities affiliates.

Removal of cross-ownership constraints. A counterpart to expanded securities powers for banks is authorization for securities firms to establish or acquire banks.

Avoidance of conflicts of interest and abuses. Authorization to engage in securities activities within a bank need not increase risks of conflicts of interest and potential abuses. Furthermore, Sections 23A and 23B of the Federal Reserve Act and other Federal banking and securities laws already deal with these matters.

Functional oversight. "Functional regulation" (the promulgation of applicable rules governing the provision of a particular kind of activity) is a term often used by agencies (and their constituents) engaged in struggles over turf. But this debate does not distinguish between the desirability of functional regulation and the enforcement of rules. Placing securities activities in separate affiliates or subsidiaries is not necessary to regulate or supervise those activities. In fact, it may be more economical to delegate supervision of particular activities to the relevant depository institution oversight agency, to be undertaken during the course of their regular supervision. Furthermore, the degree of substitutability among financial activities has risen in recent years and now appears to be relatively high.

Consequently, there are unlikely to be discrete groups of services where a functional approach to supervisory oversight would lead to material supervisory efficiencies. Thus, assuming the organization of supervisory agencies will be designed to achieve regulatory objectives with maximum operating efficiency -- as it should be -- functional supervision will not be a useful organizational guide.

Bank securities powers in the absence of fundamental capital reform. The attached table shows that some functions (generally involving underwriting and dealing) are not permitted for banks themselves but are allowed to holding company nonbank affiliates. Even without the discipline of economic capital that is the central element of reform, however, the Committee has argued previously (see Statement No. 13) that relaxation of Glass-Steagall restrictions on securities activities is warranted.

Attachment

It is the Committee's policy that members abstain from participation on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard Aspinwall and Roger Mehle abstained from voting on this statement.

STATUS OF MAJOR DOMESTIC SECURITIES ACTIVITIES FOR BANKS AND BANK AFFILIATES

	<u>Banks or Bank Subsidiaries¹</u>		<u>Investment</u>	<u>Nonbank Holding Company Affiliates</u>	
	<u>Underwriting and Dealing²</u>	<u>Yes</u>		<u>Underwriting and Dealing</u>	<u>Revenue Limits (if any)</u>
1. U.S. Government securities and securities of agencies guaranteed by the U.S. Government	Yes	Yes	Yes	Yes	None
2. General-obligation securities issued by state and municipal entities	Yes	Yes	Yes	Yes	None
3. Other securities issued by state and municipal entities	No ³	Yes ⁴	Yes ⁴	Yes	10% of gross revenues
4. Corporate debt a. Commercial paper b. Other debt	No	Yes ⁴	Yes ⁴	Yes	10% of gross revenues
5. Mortgage-backed securities a. Secured by federally insured mortgages b. Secured by other mortgages	No ⁵	Yes ⁴	Yes ⁴	Yes	10% of gross revenues

¹ This table generally refers to the powers of national and state member banks of the Federal Reserve System. State nonmember banks may have broader powers under state law.

² Nonmember banks may engage in underwriting through a bona fide subsidiary pursuant to FDIC regulations (12 C.F.R. 337.4).

³ National banks may underwrite certain state housing, hospital, and dormitory securities.

⁴ Subject to limitation of ten percent of the bank's capital and surplus.

⁵ National banks may underwrite their own securitized assets.

	<u>Banks or Bank Subsidiaries</u>		<u>Nonbank Holding Company Affiliates</u>	
	<u>Underwriting and Dealing</u>	<u>Investment</u>	<u>Underwriting and Dealing</u>	<u>Revenue Limits (if any)</u>
6. Securities backed by nonmortgage securities	No ⁵	Yes ⁴	Yes	10% of gross revenues
7. Corporate equities	No	No	Yes (subject to infrastructure review)	10% of gross revenues

	<u>Permitted for Banks or Bank Subsidiaries</u>		<u>Permitted for Nonbank Holding Company Affiliates</u>	
9. Mutual funds				
a. Underwriting and distribution	No ²		No	
b. Investment adviser	Yes		Yes	
c. Brokerage	Yes		Yes	
10. Futures, options, and swaps (brokerage and advice)	Yes		Yes	
11. Brokerage				
a. Discount	Yes		Yes	
b. Full-service	Yes		Yes	
12. Private placements	Yes		Yes	
13. Advisory services	Yes		Yes	

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Statement of the
Shadow Financial Regulatory Committee

on

Current Bank Holding Company Applications
for Increased Securities Activities

November 17, 1986

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The Federal Reserve Board presently has before it applications by four bank holding companies -- Chase, Chemical, Citicorp and Morgan Guaranty -- which, if approved, would expand the securities activities which are permissible for bank holding companies. If approved, bank holding companies would, for the first time, be permitted through a wholly-owned subsidiary to engage domestically in underwriting and dealing in municipal revenue bonds, mortgage-related securities, and consumer receivable-related securities, as well as commercial paper.

The Committee believes that these applications should be approved. The proposed activities are closely related to banking and a proper incident of banking, do not pose an unacceptable risk to the soundness of bank holding companies, do not compromise the interest of either the company's subsidiary bank customers or its affiliates' customers, and would promote competition in the relevant securities markets.

More broadly, the pending applications are part of a general trend towards expanding the securities activities which are permissible for bank holding companies under both the Glass-Steagall Act and the Bank Holding Company Act. The Committee believes that this trend is a constructive development that promises to improve the quality of financial services and to provide greater economic stability for financial institutions and markets.

With respect to the specific applications, the Committee would go further than the Federal Reserve Board would if it were to approve the applications as submitted. Section 20 of the Glass-Steagall Act requires that the proposed securities affiliates not be "engaged principally" (emphasis added) in the underwriting and/or dealing in the new securities activities that are proposed in the application. To adhere to this standard, the applicants have agreed to restrict their new activities in two ways. First, they would impose on their new activities an internal limit of 10% of the gross sales of both their

presently permissible activities and their newly proposed activities. In addition, the applicants have agreed to limit their proposed activities to specified percentages of the total market value of all underwriting and/or dealing in the market for the securities activities in question.

The Committee believes that, although there is no authoritative judicial interpretation of the Section 20 "engaged principally" test, the Federal Reserve Board should give maximum reasonable latitude to this limitation. In addition, the Committee sees no constructive purpose in the specified limits on total market value. These limits are not necessary to meet the "engaged principally" test, and would needlessly restrict competition. The Committee believes that no such restriction should be imposed on the applicants.

Finally, the Committee recognizes that the legislative barrier between banking and securities activities erected by the Glass-Steagall Act is being eroded in a piecemeal and haphazard fashion and that the applications at issue are part of this larger drama that is being played out. The Committee, therefore, strongly believes that new legislation be enacted that is more consistent both with current market forces and present economic theory and fact. Until that is done, however, the Federal Reserve Board, by approving the proposed applications, has the opportunity to move us forward toward the desired goal.

It is the Committee's policy that members abstain from voting on policy statements in instances in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Messrs. Aspinwall, Kaufman and Scott abstained from voting on this statement.