SHADOW
FINANCIAL
REGULATORY
COMMITTEE

COMMITTEE MEMBERS

LAWRENCE CONNELL
Co-Chair
Attorney-at-Law

GEORGE G. KAUFMAN
Co-Chair
Loyola University
of Chicago

RICHARD C. ASPINWALL
Chase Manhattan Bank

GEORGE J. BENSTON
Emory University

FRANKLIN R. EDWARDS
Columbia University

ROBERT A. EISENBEIS
University of North Carolina
at Chapel Hill

RICHARD J. HERRING
University of Pennsylvania

PAUL M. HORVITZ
University of Houston

EDWARD J. KANE
Boston College

FRANCO MODIGLIANI
Massachusetts Institute of
Technology

KENNETH E. SCOTT
Stanford Law School

PETER J. WALLISON
Gibson, Dunn & Crutcher

SUPPORTERS INCLUDE

LOYOLA UNIVERSITY
OF CHICAGO

SARAH SCAIFE
FOUNDATION

Administrative Office
c/o Professor George Kaufman
Loyola University of Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
TEL (312) 915-7075
FAX (312) 915-6118

Statement No. 130

For information contact:

Lawrence Connell
207-761-2638

Paul M. Horvitz
713-743-4765

Peter J. Wallison
202-955-8515

Statement of Shadow Financial Regulatory Committee

on

Expansion of Bank Powers by Regulation

February 12, 1996

During the ten years that the Shadow Financial Regulatory Committee has been in operation, there have been vast changes in technology and major innovations in financial markets and products. Banking law has evolved far more slowly. Most legislative attempts to deregulate banking have ended in failure--bogged down in disputes among various industry groups and efforts of the regulatory agencies to protect their turf.

A recent example of this is the effort over the past year to modify the Glass-Steagall Act to allow banks to offer expanded securities services. This legislation is now mired in Congress. In fact, the Leach Bill (H.R. 1062), although styled as deregulation, is now replete with an extensive array of regulatory restrictions, including a prohibition on further insurance activities by national banks (see Statement No. 120, May 22, 1995). It is clear that once again lobbying forces in Washington have frustrated legislative efforts to effect deregulation.

Experience in the U.S. with financial legislation suggests that legislation does not often lead the way to improved operations of the financial system, but rather lags changes in technology, market forces, and regulatory action. In view of these considerations, the Committee believes that the best opportunity for financial deregulation lies in the effective use of the discretionary authority of the regulatory agencies. The Committee urges the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC) to use their regulatory authority more boldly to remove needless and anticompetitive operating restrictions on banks and bank holding companies.

Three areas where such actions by the regulators can be most productive are securities activities, general operating powers of banks, and bank holding company activities.

Securities Activities

Section 20 of the Glass-Steagall Act (12 U.S.C. 377) prohibits a member bank from being affiliated with any company "engaged principally" in the underwriting of securities. The FRB has determined that a bank holding company subsidiary is "engaged principally" in underwriting securities if the revenue from this activity reaches 10 percent of its gross revenues (73 Fed. Res. Bulletin 473, 1987). This seems an unduly restrictive interpretation of the term.

A limit of 50 percent of gross revenue would be consistent with the common understanding of the term "engaged principally," as well as other FRB regulatory interpretations, such as Regulation K. Most banking organizations interested in securities underwriting could operate more effectively within this broader definition. In addition, using the same interpretation of the "engaged principally" clause, the OCC should use its authority to permit national banks to engage in securities activities through subsidiaries.

Even within the FRB's 10 percent limitation, there are significant opportunities to enhance the range of activities available to bank securities affiliates. For example, the courts and the OCC have permitted national banks to underwrite and deal directly in securities that are derivatives of or represent interests in pools of residential mortgages, consumer loans, credit card loans, and the like. The FRB should recognize this authority by exempting the revenues derived from these activities from the 10 percent revenue limitation.

General Operating Powers of Banks

A recent Supreme Court decision, the VALIC case (NationsBank of North Carolina v. Variable Annuity Life Insurance Company, 115 S. Ct. 810), and amendments to Part 5 of the OCC Regulations, have created opportunities for expanding the operating powers of national banks, directly or through operating subsidiaries. The OCC should continue this process of authorizing new operating powers for national banks (see Statement No. 121, May 22, 1995).

Under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), the FDIC has the power to veto activities of state chartered banks if these activities are not permitted to national banks. The FDIC should not use its veto authority over state banking powers to stifle healthy innovation under state law.

Bank Holding Company Activities

Under Section 4(c)(8) of the Bank Holding Company Act, (12 U.S.C.1843(c)(8)), the FRB may permit a bank holding company to engage directly or through subsidiaries in activities that are "so closely related to banking as to be a proper incident thereto." For more than 25 years, the FRB has interpreted this language too restrictively, hampering the ability of banking organizations to meet changing market needs.

Recently, Royal Bank of Canada was permitted to invest in a company that would engage in the development of home-banking software, dropping many of the restrictions the FRB has imposed in the past. This is a promising step. The Committee recommends that the FRB continue this approach, using its authority under the Bank Holding Company Act to enlarge the range of activities permitted to banking organizations. At a minimum, this should include the following steps:

1. The FRB should conduct a comprehensive review of the meaning of the statutory term "closely related to banking" in light of changes in the business of banking in recent years, and particularly the business of banking as it is conducted in other countries in which U.S. banks compete. The term "closely related to banking" encompasses more than banking activities alone. In addition, there is every reason to consider banking activities outside the United States in determining what is banking and what is closely related to banking.

2. The FRB should review its orders permitting individual bank holding companies to engage in particular activities, with an eye toward adding activities to the "laundry list" of permitted activities under the FRB's Regulation Y.

Although legislative action would be the preferable course, action by the regulators is necessary where legislative gridlock has prevented essential changes in law.