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Statement of the Shadow Financial Regulatory Committee

on

Recent Fed and OCC Rulings on Permissible Bank Activities

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In recent months, the Comptroller of the Currency and the Federal Reserve Board have each offered changes in their regulations to expand opportunities for banks and bank holding companies to innovate. The changes focus on activities that previous regulations constrained, or even precluded. We applaud the actions of both agencies, but want to make clear that many more steps are needed to modernize the financial system.

Because the rules adopted by the Comptroller appear more dramatic than the proposals advanced by the Fed, they have received commensurately more attention in the press. But the Fed's action is noteworthy because it embodies a change in its approach to deregulation and reform.

The Comptroller's new rules would permit national banks to establish operating subsidiaries in any activity which the Comptroller deems incidental to banking. These activities could include traditional financial services, such as underwriting securities or selling insurance; but they could also include areas of activity, such as telecommunications, that have not been associated traditionally with the business of banking. To prevent unfair competition and threats to the bank's financial health, the Comptroller would impose a number of prudential restrictions on the operating subsidiaries of banks. These include limiting the amount that a bank can invest in or lend to a subsidiary and deducting the capital investment in the subsidiary from the capital of the bank.

These new rules offer a way for banks, through subsidiaries, to compete in a broader range of activities. Entry into new activities should enhance the competitiveness of the financial system also, benefiting users of financial services. Within the comptroller's supervisory safeguards, greater freedom to enter profitable activities should also strengthen the parent banks, and better protect the Bank Insurance Fund and taxpayers.

The strategy of expanding bank powers through subsidiaries is one which the Fed has used with great success under its Regulation K. For many years, the Fed has permitted Edge Act subsidiaries of banks to conduct activities abroad which are considered banking activities in foreign markets. This has proven to be a safe way to permit U.S. banks to meet foreign competition without endangering the parent bank.

The Federal Reserve has proposed to liberalize the rules under which bank holding companies may engage, through subsidiaries, in activities that it permits as "closely related to banking." The most prominent of these is a proposal to further increase, from 10 to 25 percent, the proportion of total revenue that a Section 20 subsidiary may derive from underwriting and dealing in corporate debt and equity securities. This, together with other more technical changes, will increase the competitiveness of these entities and enable a broader range of banks to form Section 20 subsidiaries.

In a separate proposal, the Fed has indicated that it will be more open to expanding activities permissible to bank holding companies on its "laundry list" of activities considered closely related to banking. The Fed also stated that it would no longer follow some burdensome regulatory policies, such as applying to bank holding companies the anti-tying rules that statute law applies only to banks, or seeking to enforce its supervisory policies through rulings in the unrelated process by which bank holding companies apply for new activities.

These are important reforms. But both agencies are moving closer to the limits of their statutory authority. More liberalization is necessary for a fully competitive financial system. The next steps must be taken by Congress.

The Comptroller's new rules are particularly significant, because they are not burdened by the misplaced idea that all nonfinancial activities must be forbidden to banks. If the Comptroller follows through by allowing national bank subsidiaries to engage in a variety of nonfinancial activities that are incidental to the business of banking, national banks will have the freedom to compete in many more sectors of the economy.

If the Comptroller authorizes activities for bank subsidiaries which the Fed does not authorize for bank holding companies, however, competitive inequities may emerge. National banks may be permitted to enter new areas of activity in the economy while other firms engaged in these same activities are prohibited, by the Fed's construction of the Bank Holding Company Act, from acquiring or chartering a bank. A two-way street would permit banks to get into a variety of other activities and permit nonbanking firms to acquire banks without meeting the draconian activity restrictions imposed by the Bank Holding Company Act.

In our view, there is no meaningful difference between permitting a bank to engage in an activity through a subsidiary and permitting the same activity to be carried on by the parent of the bank or by an affiliate of the bank that is a subsidiary of the bank's holding company. The Comptroller's action opens the door to significant expansion of bank powers. It is now up to Congress to finish the job by creating the two-way street through which nonbanking firms can get into the banking business.

It is the Committee's policy that members abstain from voting on policy statements if they have direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Robert Litan abstained from voting on this statement.