

# Statement No. 56

## 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 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.

Table 1 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.

Table 1. Status of Major Domestic Securities for Banks and Bank Affiliates

	Banks or bank subsidiaries <sup>1</sup>		Nonbank holding company affiliates	
	Underwriting and dealing <sup>2</sup>	Investment	Underwriting and dealing	Revenue limits (if any)
1. U.S. government securities and securities of agencies guaranteed by the U.S. government	Yes	Yes	Yes	None
2. General-obligation securities issued by state and municipal entities	Yes	Yes	Yes	None
3. Other securities issued by state and municipal entities	No <sup>3</sup>	Yes <sup>4</sup>	Yes	10% of gross revenues
4. Corporate debt	No	Yes <sup>4</sup>	Yes	10% of gross revenues
a. Commercial paper				
b. Other debt				
5. Mortgage-backed securities	No <sup>5</sup>	Yes <sup>4</sup>	Yes	10% of gross revenues
a. Secured by federally insured mortgages				
b. Secured by other mortgages				
6. Securities backed by nonmortgage securities	No <sup>5</sup>	Yes <sup>4</sup>	Yes	10% of gross revenues
7. Corporate equities	No	No	Yes (subject to infrastructure review)	10% of gross revenues
		Permitted for banks or bank subsidiaries		Permitted for nonbank holding company affiliates
9. Mutual funds	No <sup>2</sup>		No	
a. Underwriting and distribution				
b. Investment adviser	Yes		Yes	
c. Brokerage	Yes		Yes	
10. Futures, options, and swaps (brokerage and advice)	Yes		Yes	
11. Brokerage	Yes		Yes	
a. Discount				
b. Full-service	Yes		Yes	
12. Private placements	Yes		Yes	
13. Advisory services	Yes		Yes	

Source: Melanie Fein, Arnold & Porter.

<sup>1</sup>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.

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

<sup>3</sup>National banks may underwrite certain state housing, hospital, and dormitory securities.

<sup>4</sup>Subject to limitation of 10 percent of the bank's capital and surplus.

<sup>5</sup>National banks may underwrite their own securitized assets.

### 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 its 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**

Table 1 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, November 17, 1986) that relaxation of Glass-Steagall restrictions on securities activities is warranted.

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.