GAO

United States
General Accounting Office
Washington, D.C. 20548

Office of the Chief Economist

B-277357

June 10, 1997

The Honorable Richard H. Baker
Chairman, Subcommittee on
Capital Markets, Securities and
Government-Sponsored Enterprises

Dear Mr. Chairman:

This letter includes our responses to the questions attached to your May 16th letter concerning the issue of mixing banking and commerce. We hope you find these answers responsive to your questions. If you have any additional questions or wish further clarification, please call me on (202) 512-6209.

Sincerely yours,

James Bothwell

James L. Bothwell
Chief Economist

Enclosures

158945

1. **The March 17th GAO report you wrote states that there is no "empirical support" for the benefits of eliminating the separation between banking and commerce, but says nothing about empirical support for maintaining those limits. In your literature search, did you find any empirical support--other than your own publications, which deal almost entirely with the failures of the regulators--for maintaining the separation of banking and commerce?**

In the literature that we reviewed, we found no mention of any economic efficiencies that are unique to maintaining the separation of banking and commerce. However, we found frequent references in the literature to the likelihood that maintaining the existing separation could be beneficial because it would mean less risk to the safety and soundness of insured depository institutions and to the financial system. Because of the existing separation of banking and commerce in the United States, the best empirical U.S. evidence that demonstrates the significance of such risks is found in the history of the Savings and Loan crisis of the 1980s. As stated in the report of the National Commission on Financial Institution Reform, Recovery and Enforcement, which was the congressionally sponsored commission charged with examining the evidence about the origins and causes of the crisis:

> "During the early 1980s, the S&L industry was swept up in a movement to deregulate American business. But "deregulating" S&Ls was not like that of, say, airlines or trucking in which power was given to market forces in the interest of economic efficiency. In the case of S&Ls, the process was not balanced. The industry obtained substantial new investment powers, and it was subjected to less supervision; but government-backed deposit insurance was retained and even increased. Shielded from the market discipline of depositors at risk, and with strong incentives to enter risky new areas, the industry was doomed and the insurance system set on a course that would involve huge claims on it.
>
> The S&Ls' asset and liability powers were expanded sharply, and they were allowed to move rapidly into risky new areas of business in which they lacked expertise. ... New policies allowed entry into the industry of individuals with serious conflicts of interest. These government policies created powerful incentives and opportunities for insolvent and weakly capitalized S&Ls to use insured deposits to grow rapidly and engage in speculative, imprudent, and sometimes fraudulent activities."[1]

---

[1]National Commission on Financial Institution Reform, Recovery and Enforcement, Origins and Causes of the S&L Debacle: A Blueprint for Reform (Washington,

In addition to this U.S. experience, industry analysts have pointed out that some countries that have permitted the mixing of banking and commerce to a greater degree than does the United States, have been reconsidering their policies and, in some cases, have recently taken actions to impose greater separation to limit risks. Further, it is important to note that some of the risks we identified, such as the risk associated with an increased concentration of economic power, may not arise until the industry has achieved a greater degree of consolidation--which may occur if current trends continue.

2. **Please furnish a bibliography or other list of the works or articles you consulted in your literature search or in the preparation of your report.**

A bibliography is attached as enclosure II. Please note that some of the articles listed in the bibliography are reviews of the literature and reference more articles than are listed in our bibliography.

3. **You state that there is a danger that the safety net will be extended to the commercial affiliates of banks. However, Chairman Greenspan has testified that the holding company structure prevents this from occurring. Do you disagree with him, and why?**

In his May 22 statement before the House Banking Committee, Chairman Greenspan stated that "H. R. 10 would continue the holding company framework for nonbank activities, which the Board believes is important to *limit* the direct risk of new financial activities to banks and the safety net" [italics added]. We agree with Chairman Greenspan and the Board of Governors of the Federal Reserve System that the holding company framework limits, but does not necessarily prevent, the risk of new financial activities to banks and the safety net.

4. **Banks are permitted to affiliate with mortgage banking companies, leasing companies, and securities firms under current law. Why don't these firms pose the same problem of expanding the safety net as commercial firms?**

Bank affiliations with mortgage banking firms, leasing companies, and securities firms *do* expand the federal safety net to some degree, and various statutory and regulatory firewalls and limits currently exist to reduce the risks posed by such activities to the safety net. In addition, the Federal Reserve has regulatory authority over these bank affiliates through the bank holding company structure.

D.C.: July 1993), p. 2.

Specifically, banks are permitted by the Board of Governors to affiliate with these types of holding company subsidiaries where the Board determines that the subsidiary's activity satisfies the requirements of section 4(c)(8) of the Bank Holding Company Act; i.e., that, among other things, the activity is properly incident to banking or managing or controlling banks and the public benefits of the activity can be expected to outweigh possible adverse effects. Among other things, such affiliates and their holding companies are subject to examination by the Board and must comply with applicable Board regulations. In addition, the Board has authority to require termination of the activity or divestiture of the subsidiary.

5. **Your report does not mention the role of Sections 23A and 23B of the Federal Reserve Act in preventing banks from providing financial assistance to their commercial affiliates. Why aren't these sections sufficient protection against the misuse of bank funds?**

Sections 23A and 23B may or may not be sufficient protection against the misuse of bank funds. We know from our work on insider lending that an activity deemed illegal or improper may not be detected.[2] Further, we know from our work on implementation of the prompt corrective action provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) that even when violations are detected, effective action may not be forthcoming by the regulator--either to ensure that the bank corrects the problem or to begin enforcement action.[3] In part, this can arise because examiners may not be sufficiently trained in certain areas. For example, determining whether transactions were conducted according to arm's-length standards can be a difficult process and may require both technical skills and experience that take time to develop. Examiners also need to learn how to detect issues that arise across affiliates, which may change as the type of affiliation changes. This was one of a set of reasons why the Federal Reserve put into place a comprehensive set of firewalls to govern the activities of Section 20 securities affiliates. They knew that their examiners needed time to learn about the interaction of securities underwriting activities and banking. During that learning period, stricter limits and even bans on certain activities were deemed necessary.

[2]Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies (GAO/GGD-94-88, Mar. 30, 1994).

[3]Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions (GAO/GGD-97-18, Nov. 21, 1996).

6. **The Fed has recently determined to eliminate most of the firewalls between banks and affiliated Section 20 companies, and to rely on Sections 23A and 23B. If the Fed thinks these sections are sufficient protection, why don't you?**

The Federal Reserve has suggested that certain regulatory firewalls may no longer be necessary, at least in part due to the presence of the firewall provisions contained in Sections 23A and 23B of the Federal Reserve Act. However, the Federal Reserve, in its request for comments on its proposal, asked for guidance on whether the firewalls in Sections 23A and 23B are sufficient in a number of particular instances. For example, the proposal contains a discussion of the firewall that prevents a parent or non-Section 20 affiliate from extending credit directly or indirectly secured by or for the purpose of purchasing any ineligible security that the Section 20 affiliate underwrites during the underwriting period or for 30 days thereafter; or to purchase from the Section 20 affiliate any ineligible security in which it makes a market. As part of that discussion, the Federal Reserve stated that this type of situation represents the most fundamental potential conflict between banking and securities underwriting and that it wanted commenters to assure it that Sections 23A and 23B, along with the Securities Exchange Act, would provide sufficient protection. These proposed changes appear to be based on the Federal Reserve's belief that it may have had sufficient experience with Section 20 affiliates to allow it to move to this less restrictive mode. In our work on Section 20 affiliates, we found that the Federal Reserve did a reasonably thorough job of checking compliance with firewalls. However, the approach the Federal Reserve is taking is clearly in the nature of an experiment. The Federal Reserve is making a judgment that Sections 23A and 23B, along with other regulatory guidance and changes in the operating rules for Section 20 affiliates, will provide a sufficient level of protection against potential conflicts of interest or the spread of any deposit insurance subsidy. Only time will tell if that judgment was well founded.

7. **If you mean by "conflicts of interest" that commercial firms will cause banks to make imprudent loans to their affiliates, have you taken account of the restrictions in Sections 23A and 23B?**

As we stated in our answer to question 5, it can be very difficult to determine whether a loan was made or credit extended in accordance with arm's length standards. Without examining loan files in great detail, it may not be possible to determine whether the interest rate or repayment terms properly reflect the degree of risk involved in the extension of credit. Periodic examinations or inspections cannot detect all potential issues, and our experience shows that, even when problems are detected, they may not be raised either to bank management or to supervisory officials. In addition, when examiners do raise concerns, their supervisors may or may not be willing to require corrective actions. Our recent report on regulatory implementation of the prompt corrective action provisions of FDICIA found that, although bank regulators were complying with the capital tripwires provisions, it was not clear that they were acting quickly enough to correct problems before they reduced bank capital.

8. **If you mean that commercial firms will cause their affiliated banks not to lend to competitors of the commercial affiliates, have you considered that there is no shortage of credit in today's economy--and that, if one bank won't lend, many other banks (as well as commercial finance companies and leasing companies) would be happy to do so?**

While currently there does not appear to be any general shortage of available credit in the economy, our concern is with the potential difficulties that might arise if banks and commercial firms were allowed to merge, or that might exist in the future if current trends toward consolidation continue.

9. **If you are suggesting that banks and their managements will violate the law in order to make these loans at the direction of their affiliated commercial firms, are you aware of the severe penalties (up to $1 million per day in some cases) that may be imposed personally on the directors and officers of banks that violate the banking laws, or of the regulations or orders of bank regulators?**

While firewalls and sanctions provide some level of protection against improper transactions, our work has shown that firewalls may not work in times of stress, or where managers are determined to evade them, and that violations have occurred despite the potential for enforcement actions and substantial penalties. For example, in our report on insider activities,[4] we reviewed Federal Deposit Insurance Corporation (FDIC) investigations of 286 bank failures that occurred in calendar years 1990 and 1991. We found that investigators cited evidence of insider problems, such as fraud or losses on loans to insiders, in 175, or 61 percent, of the failed banks. We also found that enforcement actions were generally not forceful or timely enough to prevent the problems cited from contributing to bank failures, and few sanctions, including civil money penalties, were imposed. However, the authority to impose such sanctions was known to

[4]Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies (GAO/GGD-94-88, Mar. 30, 1994).

bankers and may have contributed to some banks adopting a policy prohibiting any insider lending.

10. Would affiliation with a commercial firm pose a greater risk of "contagion" than affiliation with a leasing company, mortgage banking firm, or securities firm--all of which are permitted under current law?

The risk of contagion effects potentially applies to all affiliates of a financial services holding company. Thus, financial services holding companies should be regulated on a consolidated, comprehensive basis, with appropriate firewall provisions to protect both consumers and taxpayers against possible conflicts of interest and to prevent the spread of the federal safety net provided to banks, and any associated subsidy, to nonbanking activities. If the current separation between banking related activities and commerce were eliminated, having such an umbrella supervisory authority would thus imply an extension of some regulatory supervision to commercial firms.

11. Do you have any examples of contagion--in which a bank failed because of affiliation with a commercial firm?

We are unaware of any such examples in the United States in recent decades, in part, because of the current separation of banking and commerce. The concern is that contagion risks could arise if the current separation were relaxed or eliminated.

12. During the thrift crisis, S&Ls that were known to be themselves insolvent remained open and doing business. Presumably, this was because the public believed that their deposits were insured. What makes you think that there would be a run on a bank because one of its affiliates was in financial difficulty?

The existence of deposit insurance reduces, but does not eliminate, the likelihood of a run on the deposits of a bank. Even holders of insured deposits may attempt to withdraw their funds from a bank they believe might soon fail, just to ensure ready access to their funds. Holders of uninsured deposits have even more incentive to withdraw their funds if a bank is perceived as being in trouble. In 1991, 2.6 percent of all deposits held by banks <u>at time of failure</u> were uninsured. During the period approaching the time of failure, it is likely that a significantly larger percentage of deposits were uninsured and subsequently withdrawn. In addition, recent legislative changes have subjected uninsured deposits to greater risk. Specifically, uninsured deposits in a sound bank that is affiliated with a failed bank are now at greater risk because of the cross-guarantee provision--which could be executed by FDIC during resolution of the failed bank. This provision of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 allows FDIC to offset potential losses to the insurance fund by assessing the commonly controlled institutions for the expected losses suffered by FDIC.[5] The cross-guarantee provision was imposed by FDIC in two notable bank failures--Bank of New England, and First City Bancorporation of Texas.[6] In addition, although uninsured deposits often were effectively extended coverage in the past, the least-cost resolution provisions contained in FDICIA allow FDIC much less discretion in providing protection for uninsured depositors. Our work has shown, in fact, that, during 1992, FDIC more frequently chose resolution methods that resulted in uninsured depositors experiencing some losses.

13. Unless a bank has economic power, how can it add economic power to a conglomerate? In today's highly competitive financial economy--where banks are losing market share year after year--how can any bank be said to have market power?

According to some analysts, it is unclear that U.S. banks have been losing ground in terms of a relevant measure of market share. Although aggregated balance sheet data show that the banking sector's share of overall assets of U.S. financial intermediaries has declined since 1980, other changes in the marketplace, including the growth of credit related activities that do not appear on balance sheets, may have an offsetting effect on the banking industry's position in the overall U.S. credit market.[7]

Nonetheless, by combining, banks can attain a greater degree of market power than they would attain without combining. In addition, there may be specific situations, such as in the provision of banking services to rural areas or inner cities, or in the provision of certain unique services, where some banks might achieve some degree

---

[5]See 1992 Bank Resolutions: FDIC Chose Methods Determined Least Costly, but Needs to Improve Process (GAO/GGD-94-107, May 10, 1994).

[6]See Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991), and Failing Banks: Lessons Learned From Resolving First City Bancorporation of Texas (GAO/GGD-95-37, Mar. 15, 1995).

[7]See Edward C. Ettin, The Evolution of the North American Banking System, Board of Governors of the Federal Reserve System, July 1994, and John H. Boyd and Mark Gertler, Are Banks Dead? Or Are The Reports Greatly Exaggerated, Federal Reserve Bank of Minneapolis, Quarterly Review, Summer 1994.

of market power on their own. Further, the opportunities for banks to add to their market power could increase in the future as a result of greater industry consolidation, which has been ongoing for some time.[8]

14. Can you give an example of a bank that has market power--by which I mean the ability to injure a potential borrower by withholding funds?

While we do not have specific examples, insurance agents, securities firms, rural development officials, and academic experts have all expressed concerns that certain specific markets may still be susceptible to the exercise of market power--specifically, as concerns the availability of credit to small businesses in certain geographic areas.[9]

[8]See Bank Oversight: Few Cases of Tying Have Been Detected (GAO/GGD-97-58, May 8, 1997), and Interstate Banking: Experiences in Three Western States (GAO/GGD-95-35, Dec. 30, 1994).

[9]See GAO/GGD-97-58 and GAO/GGD-95-35.

Bibliography: Mixing Banking and Commerce

Aguilar, L. (1990), "Still Toe-to-Toe: Banks and Nonbanks at the End of the '80's," Economic Perspectives, Federal Reserve Bank of Chicago, January/February, 12-23.

Amel, D.F. (1996), "Trends in the Structure of Federally Insured Depository Institutions, 1984-94," Federal Reserve Bulletin, 82, 1, January, 1-15.

Ang, J.S., and T. Richardson (1994), "The Underwriting Experience of Commercial Bank Affiliates Prior to the Glass-Steagall Act: A Re-examination of Evidence for Passage of the Act," Journal of Banking and Finance, 18, 351-395.

Bentson, G., G. Hanweck, and D. Humphrey (1982), "Scale Economies in Banking: A Restructuring and Reassessment," Journal of Money Credit and Banking, 14, 435-456.

Berlin, M. (1988), "Banking Reform: An Overview of the Restructuring Debate," Business Review, Federal Reserve Bank of Philadelphia, July/August, 3-14.

Corrigan, E. G. (1987), "Keep Banking Apart," Challenge, November-December, 28-35.

Corrigan, E.G. (1990), "Reforming the U.S. Financial System: An International Perspective," Quarterly Review, Federal Reserve Bank of New York, Spring, 1-14.

Corrigan, E.G. (1991), "The Banking-Commerce Controversy Revisited," Quarterly Review, Federal Reserve Bank of New York, Spring, 1-13.

Corrigan, E. G. (1991), "Balancing Progressive Change and Caution in Reforming the Financial System," Quarterly Review, Federal Reserve Bank of New York, Summer, 1-12.

Edwards, F.R., and F.S. Mishkin (1995), "The Decline of Traditional Banking: Implications for Financial Stability and Regulatory Policy," National Bureau of Economic Research Working Paper No. 4993, January.

The FDIC Quarterly Banking Profile: Commercial Banking Performance-Third Quarter 1996, Federal Deposit Insurance Corporation, p. 5.

Federal Reserve Bank of San Fransisco (1997), "Efficiency of U.S. Banking Firms -- An Overview," Economic Letter, Federal Reserve Bank of San Francisco, 97-06, February 28, 1997.

Greenspan, Alan, (1997), Statement before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services, U.S. House of Representatives, Feb. 13, 1997.

Isimbabi, M.J. (1994), "The Stock Market Perception of Industry Risk and the Separation of Banking and Commerce," Journal of Banking and Finance, 18, 325-349.

John, K., T.A. John, and A. Saunders (1994), "Universal Banking and Firm Risk-taking." Journal of Banking and Finance, 18, 307-323.

Kareken, J.H. (1986), "Federal Bank Regulatory Policy: A Description and Some Observations," Journal of Business, 59, 1, 3-48.

Kaufman, H. (1991), "How Treasury's Reform Could Hurt Free Enterprise," Challenge, May-June, 4-10.

Mester, L. (1987) , "Efficient Product of Financial Services: Scale and Scope Economies," Business Review, Federal Reserve Bank of Philadelphia January/February, 15-25.

Pavel, C., and H. Rosenblum (1985), "Banks and Nonbanks: The Horse Race Continues," Economic Perspectives, Federal Reserve Bank of Chicago, May/June, 3-17.

Puri, M. (1994), "The Long-Term Default Performance of Bank Underwritten Security Issues," Journal of Banking and Finance, 18, 397-418.

Saunders, A. (1988), "Bank Holding Companies: Structure, Performance, and Reform," in W.S. Haraf and R.M. Kushmeider, (eds.), Restructuring Banking and Financial Services in America, Washington, D.C., American Enterprise Institute for Public Policy Research, 156-202.

Saunders, A. (1994), "Banking and Commerce: An Overview of the Public Policy Issues," Journal of Banking and Finance, 18, 231-254.

Saunders, A., and P. Yourougou (1990) , "Are Banks Special: The Separation of Banking from Commerce and Interest Rate Risk," Journal of Economics and Business, 42, 171-182.

Shaffer, S. (1988), "A Revenue-Restricted Cost Study of 100 Large Banks," mimeo, Federal Reserve Bank of New York.

Shull, B. (1994), "Banking and Commerce in the United States," Journal of Banking and Finance, 18, 255-270.

Spellman, L.J. (1982), The Depository Firm and Industry: Theory, History, and Regulation, New York, Academic Press.

Steinherr, A., and C. Huveneers, (1994), "On the Performance of Differently Regulated Financial Institutions: Some Empirical Evidence," Journal of Banking and Finance, 18, 271-306.

United States General Accounting Office (1988), Bank Powers: Issues Related to Repeal of the Glass-Steagall Act (GAO/GGD-88-37, Jan. 22, 1988).

United States General Accounting Office (1988), Using Firewalls in a Post Glass-Steagall Banking Environment, (GAO/T-GGD-88-25, Apr. 13, 1988).

United States General Accounting Office (1989), Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

United States General Accounting Office (1991), Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991).

United States General Accounting Office (1994), Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies (GAO/GGD-94-88, Mar. 30, 1994).

United States General Accounting Office, (1995), Financial Regulation: Modernization of the Financial Services Regulatory System (GAO/T-GGD-95-121, Mar. 15, 1995).

United States General Accounting Office (1996), Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure (GAO/T-GGD-96-117, May 2, 1996).

United States General Accounting Office (1996), Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure (GAO/GGD-97-23, Nov. 20, 1996).

United States General Accounting Office (1996), Bank and Thrift Regulation: Implementation of FIDICIA's Prompt Regulatory Action Provisions (GAO/GGD-97-18, Nov. 21, 1996), p. 28.

Volker, Paul A. (1997), Statement before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services, U.S. House of Representatives, Feb. 25, 1997.

(972631)

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

United States
General Accounting Office
Washington, D.C. 20548-0001

Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100

Official Business
Penalty for Private Use $300

Address Correction Requested