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General Government Division

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June 6, 1995

The Honorable Ron Wyden
Ranking Minority Member
Subcommittee on Oversight and Investigations
Committee on Commerce
House of Representatives

Dear Mr. Wyden:

In your letter to us, you expressed concern that, with the possible passage of Glass-Steagall reform legislation, U.S. securities firms might become more attractive takeover targets for large banks, most of which are foreign-owned. To aid you in your forthcoming consideration of the Glass-Steagall reform legislation, you asked us a series of questions regarding the current supervisory structure for foreign banks that own U.S. broker-dealers, how that structure might change with the passage of the proposed Glass-Steagall legislation, and whether acquisition of a broker-dealer by a foreign entity would impede U.S. regulators' ability to supervise the acquired firm.

In addition to these questions on supervision, you asked whether such an acquisition would affect (1) the ability of acquired firms to innovate or (2) the cost of capital in the United States. Additional questions concerned trends in concentration in the U.S. banking and securities industries and the potential effects on bank concentration of the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Finally, you asked a series of questions about other countries' restrictions on foreign ownership of financial institutions and about the effect of the absence of Glass-Steagall-like provisions in other countries. In this letter, we briefly answer your main questions. The enclosure has a more detailed and complete response to your questions.

In general, a process broadly similar to that currently used to supervise foreign banks with subsidiaries, branches, and agencies in the United States would be used under the Glass-Steagall reform bill recently approved by the House Committee on Banking and Financial Services to supervise the U.S. operations of foreign banks that own U.S. broker-dealers. The overall U.S. presence, including any

securities affiliate, would be supervised--either as a financial services holding company or as an investment banking holding company--by the Federal Reserve. Any bank operation would be directly regulated by the relevant bank regulator: the Office of the Comptroller of the Currency (OCC) in the case of a national bank, the Federal Reserve Board and the state regulator in the case of a state bank that is a member of the Federal Reserve System, and the Federal Deposit Insurance Corporation (FDIC) and the relevant state regulator in the case of a state nonmember bank. The securities affiliate itself would be regulated by the Securities and Exchange Commission, and therefore required to be a member of a self regulatory organization (SRO) such as the National Association of Securities Dealers (NASD).

Available data show that there has been an increase in concentration in both the banking and securities industries over the past 5 years, at least as measured by the portion of industry assets or capital owned by the largest institutions. In our 1993 report on interstate banking, we stated that the relaxation of interstate banking and branching provisions was likely to increase banking concentration at the national and regional levels, although the effect at the state and local level was less clear.[1]

While many of our major trading partners allow universal banking--a system in which securities and even insurance activities are considered part of banking--not all do, and many impose restrictions, such as confining insurance activities to a bank affiliate. In addition, the ability of foreigners to own financial institutions in these countries varies from substantial freedom to do so to substantial restrictions on foreign ownership.

Much of our work on interstate banking and branching and bank concentration has already been reported in our interstate banking report. We have also issued reports on the bank regulatory systems of the Federal Republic of Germany and the United Kingdom.[2] Our answers draw on that work and on ongoing work on bank and securities regulation in the United States and abroad. We have also recently testified on the Glass-Steagall reform legislation before the House Committee on Banking and Financial

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[1] Interstate Banking: Benefits and Risks of Removing Regulatory Restrictions (GAO/GGD-94-26, Nov. 2, 1993)

[2] Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994) and Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994).

Services.[3] In that statement, we suggested that, while it may be an opportune time to restructure the financial services regulatory framework, any legislation needs to include certain safeguards to avoid undue risk to the safety and soundness of the financial system, the deposit insurance funds, and consumers and taxpayers. We suggested that

-- financial services holding companies should be subject to comprehensive regulation on both a functional and a consolidated basis;

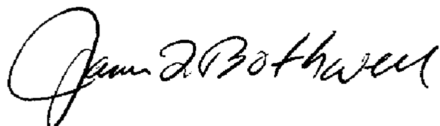
-- capital standards for insured banks and financial services holding companies should reflect all risks;

-- clear rulemaking and supervisory authority should be established, including requirements for cooperation and coordination among functional regulators; and

-- mechanisms should exist to prevent excessive concentration of economic power and assure free entry into financial services markets, so that small businesses and consumers can be assured of receiving the benefits of modernization efforts.

Because you are receiving similar responses from the relevant regulators, we did not request comments from the regulators on this response. 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) 512-8678.

Sincerely yours,



James L. Bothwell
Director, Financial Institutions
and Markets Issues

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[3]Financial Regulation: Modernization of the Financial Services Regulatory System (GAO/T-GGD-95-121, March 15, 1995)

1. How are foreign banks that own U.S. broker-dealers currently supervised? How will this change if Glass-Steagall reform legislation is enacted?

Foreign banks with operations in the United States are currently supervised according to the concept of national treatment. The purpose of national treatment is to allow foreign banks to operate in the United States without incurring either a significant advantage or disadvantage compared with U.S. banks. Accordingly, foreign banks with commercial banking operations in the United States that also own U.S. broker-dealers eligible to underwrite and deal in corporate debt and equity securities are to be supervised in a way that duplicates, as closely as possible, the supervision of U.S. bank holding companies that own such broker-dealers.

There are two exceptions to the general rule. The securities activities of some foreign banks operate under a grandfathering arrangement. In addition, a foreign bank may own a U.S. securities firm without engaging in banking in the United States.

The proposed Financial Services Competitiveness Act of 1995, recently approved by the House Banking and Financial Services Committee, would essentially maintain the current regulatory structure for foreign banks that own U.S. broker-dealers. However, certain regulatory restrictions would become statutory in the case of financial services holding companies, while remaining regulatory for wholesale financial institutions.[4] Another difference would be that previously grandfathered firms would be regulated like everyone else, rather than be subject to separate rules.

HOW U.S. BANK HOLDING COMPANIES ARE SUPERVISED

Under the Bank Holding Company Act, a U.S. banking company that owns a broker-dealer authorized to underwrite and deal in corporate debt and equity generally must structure its securities firm as a separately capitalized subsidiary of the holding company. The entire holding company, including the securities firm, is supervised by the Federal Reserve. The Federal Reserve must approve the establishment of the affiliate, and in so doing ensure that the securities affiliate will not weaken the capital of the bank or the holding company.

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[4]Financial services holding companies will take the place of bank holding companies that contain insured banks and securities affiliates that underwrite securities. Wholesale financial institutions are holding companies whose bank subsidiary does not have retail deposits or deposit insurance.

Under the bank holding company structure, banking companies that own securities firms are subject to a number of restrictions on transactions involving the securities firm, the bank, and other affiliates. In the case of a securities firm that is authorized to underwrite corporate stocks and bonds (the so-called section 20 companies), the Federal Reserve applies a number of special restrictions, known as firewalls, that are designed to protect the safety and soundness of the bank from the activities of the securities affiliate as well as to protect against potential conflicts of interest.

In addition to Federal Reserve supervision of the bank holding company, the individual banks in the holding company are supervised by the appropriate federal banking agency: OCC examines national banks, the Federal Reserve examines state banks that are members of the Federal Reserve System, and FDIC examines state banks that are not members of the Federal Reserve System. State banks are also examined by state regulators. In practice, the Federal Reserve holding company examination is usually coordinated with that of other federal or state bank examinations, and each of the relevant bank regulators has an opportunity to ensure that improper transactions do not take place between the bank and the securities affiliates.

Finally, like all other securities firms, the securities affiliate of a bank holding company must register with the SEC and comply with its requirements for regulatory reporting, minimum capital, and examinations. The firms must also comply with the requirements of the various exchanges and industry associations, such as the New York Stock Exchange and NASD, which have been granted self-regulatory responsibilities under the Securities Exchange Act of 1934. The Market Reform Act of 1990 authorized the SEC to collect information from holding companies and other unregulated, material affiliates of the securities firms it regulates.

MOST FOREIGN BANKS THAT OWN U.S. BROKER-DEALERS ARE SUPERVISED UNDER AN ADAPTATION OF ARRANGEMENTS APPLICABLE TO U.S. BANKS

Applying the national treatment concept to foreign banks that operate both banking and securities businesses in the United States requires some adaptation of the bank holding company arrangement. Of the world's largest 50 foreign banks, all 47 that have a banking presence in the United States operate either a branch or an agency, organizational forms that do not require a

separately capitalized U.S. bank.[4] In addition, 20 of the 47 largest foreign banks with a U.S. presence also operate separately capitalized bank subsidiaries. These subsidiaries are able to offer insured deposits and therefore to conduct retail banking operations.

The adaptation that has been made for foreign banks operating in the U.S. market is to consider the home country bank to be the equivalent of a holding company parent, and the U.S. bank, branch, or agency and the securities affiliate to be the equivalent of holding company subsidiaries. The Federal Reserve is responsible for providing umbrella supervision of all of a foreign bank's U.S. operations, but because much of a foreign bank's activity takes place outside the United States, no U.S. regulator is in a position to provide consolidated supervision for the company as a whole.

The Federal Reserve must approve the establishment of the U.S. bank or branch and any acquisition of a securities firm. In making such a determination, the Federal Reserve procedures are to look to the adequacy of capital and determine whether the bank as a whole is subject to adequate comprehensive consolidated supervision by the home country regulator. The foreign-owned securities firm must register with the SEC, meet all of the capital and other requirements for securities firms, and join an SRO. In addition, all of the individual U.S. subsidiary banks, branches, or agencies are to be examined by OCC (in the case of federally licensed entities) or by state banking departments (in the more common case of state-licensed entities).

In approving a foreign bank's acquisition of a securities firm that can underwrite corporate debt and equity securities, the Federal Reserve imposes restrictions on transactions between the U.S. bank or branch and the U.S. securities firm similar to those applicable to U.S. banking organizations. Securities firms with underwriting powers are expected to operate as section 20 companies and are subject to the same types of firewalls. The firewalls that apply to the arrangements between the U.S. bank or branch and the securities firm are the same for U.S. and foreign banks. Because the Federal Reserve can only regulate entities that operate in the United States, firewalls that apply to arrangements between the securities firm and the home country

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[4]Branches and agencies are legal and operational extensions of the foreign parent bank. Branches and agencies are preferred by foreign banks operating in the United States for the same reason that they are often used by U.S. banks that operate overseas--i.e., they can make use of the capital of the bank as a whole when dealing with large corporate customers. One important difference is that an agency cannot accept deposits.

bank take the form of conditions that must be met by the securities firm.

WHAT IS LIKELY TO CHANGE IF GLASS-STEAGALL IS REFORMED?

Any change in regulation would depend on the reform adopted. In principle, if Glass-Steagall legislation were to be enacted, there would not necessarily be any need to change the way foreign banks or their securities affiliates are regulated.

However, specific provisions of reform legislation could have an effect on some of the regulatory provisions applicable to foreign banks. For example, the proposed Financial Services Competitiveness Act of 1995 has no statutory firewalls for wholesale banks (those that have no insured deposits), but would allow the Federal Reserve to establish whatever regulatory firewalls it deems necessary. The proposed act specifies a set of statutory firewalls between retail banks and their securities affiliates. These firewall changes could have a differential impact on foreign banks compared to domestic commercial banks. Those 27 large foreign banks that operate only as branches or agencies have no insured deposits in the United States (although they would have insured deposit bases in their home countries). On the other hand, virtually all U.S. commercial banks have insured deposits, and there are only a few in which insured deposits play a relatively insignificant role in the bank's funding.

Grandfathered Firms

As of May 1995, there were 13 foreign banks that owned securities firms that operated under a special grandfather provision. These banks operated securities firms in the United States prior to the International Banking Act of 1978, which incorporated the national treatment concept for bank regulation. With one exception, the growth of these grandfathered firms through merger or acquisition has been constrained by law, and their securities activities are relatively small. (The exception involves CS First Boston.) The proposed Financial Services Competitiveness Act of 1995 would repeal the grandfathering provision.

FOREIGN BANKS OWNING U.S. SECURITIES FIRMS THAT DO NOT OPERATE BANKS IN THE UNITED STATES

Foreign banks may own a U.S. securities firm without operating a bank subsidiary, branch, or agency in the United States and, as a result, would not be subject to bank holding company-like regulation and all of its restrictions. In such a case, the securities firm is subject to SEC regulation, and the bank is subject to supervision by the home country regulator. This

option could continue even if Glass-Steagall were to be reformed. To operate in this way, the foreign bank has to be willing to have no access to the U.S. payments system. So far as we are aware, only 1 of the top 50 foreign banks in the world (ING of the Netherlands) operates a U.S. securities firm but has no U.S. bank subsidiary, branch, or agency.[5]

2. **Will the acquisition of a U.S. broker-dealer by a foreign bank impede U.S. regulators' ability to supervise the acquired entity?**

Such an acquisition should not impede the regulator's ability to supervise either under current law or under the proposed legislation. In particular, under the proposed Financial Services Competitiveness Act of 1995, the Federal Reserve would retain its authority to regulate and supervise foreign banks in the same way that it now regulates the section 20 arrangements. About one-third of the existing section 20 companies are foreign-owned.

An acquired broker-dealer would also be subject to regulation by the SEC and appropriate self-regulatory organizations. The SEC has a great deal of experience in supervising foreign securities firms since 2 of the top 15 securities firms ranked by capital, and about a quarter of the top 50, are foreign-owned firms.

3. **If the legislation is enacted, will a foreign-owned broker-dealer have the same freedom to innovate as a U.S.-owned broker-dealer?**

There are no special limits on the ability of a foreign-owned broker-dealer to innovate in U.S. markets. The degree to which innovation occurs depends on the business plan and capability of the firm.

4. **If the legislation is enacted, how will the acquisition of broker-dealers by foreign banks affect the cost of raising capital to corporations? Will the returns to investors be affected?**

Unless such acquisitions lead to substantial consolidation and increased concentration in the market, there is no reason to expect such acquisitions to adversely affect those raising capital in the United States. In general, so long as U.S. capital markets retain their characteristic competitiveness, depth, and liquidity, the cost of capital should not increase and, if acquisition of broker-dealers by foreign banks results in

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[5]ING chose to forgo owning a bank because it has a U.S. insurance subsidiary and was not allowed to affiliate the two.

an increase in the amount of capital in the market, the acquisition could reduce somewhat the cost of raising capital. The introduction of additional capital could also introduce competitive factors that might result in some reduction in the returns to investors in securities firms that were not able to become more efficient.

5. What is the trend of concentration within the banking and securities industries during the past 10 years?

In our 1993 report on interstate banking,[6] we discussed trends toward consolidation in the banking industry. We found that the number of banks and banking companies were declining and that measures of concentration at the national level were increasing. The information contained in that report concerning the concentration of banking assets among the nation's bank holding companies, updated for 1994 as well, is as follows:

Table 1: Concentration Ratio of the Banking Assets of the Largest U.S. Banking Companies

	1986	1992	1994
Top 3	12.8%	14.4%	15.5%
Top 10	26.3	29.4	33.0
Top 50	53.0	59.5	64.1

Source: GAO analysis of call report data

We also found that concentration at regional and state levels was a mixed picture. At the local level, however, there was no increase in concentration from 1980 through 1991.[7]

The U.S. securities industry is more concentrated than banking. According to information available from the Securities Industry Association Yearbook, the industry has also become more

[6]Interstate Banking: Benefits and Risks of Removing Regulatory Restrictions (GAO/GGD-94-26, Nov. 2, 1993)

[7]For a more detailed discussion, see pages 60-67 in our report on interstate banking (GAO/GGD-94-26).

concentrated over the past 5 years. Ranking them by capital,[8] the Yearbook shows the following degree of concentration among association members for January 1, 1989, and January 1, 1994.

Table 2: Percentage of Capital of Securities Industry Association Members, 1989 and 1994

	January 1, 1989	January 1, 1994
Top 3	31.6%	46.2%
Top 10	61.4	76.6

Source: Securities Industry Association.

6. Does GAO expect bank concentration to change in light of the enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994?

In our interstate banking report, we concluded that increased competition resulting from removing federal restrictions on interstate banking and branching will likely add to the consolidation trend in banking. Although it is not possible to determine the precise effects of such liberalization, we believe it is reasonable to expect the following:[9]

-- Nationwide banking and branching is likely to encourage the growth of larger, more geographically diversified banking companies, some with a nationwide presence and others with a regional focus.

-- Concentration may rise in some markets and fall in others but, on the whole, is likely to remain more stable than at the nationwide level.

-- Although the number of medium and smaller banks is likely to decrease, their share of the market may not decline substantially.

[8]Capital, as defined by the Securities Industry Association in its Yearbook, is the regulatory definition of capital, i.e., the sum of ownership equity and subordinated liabilities.

[9]For a more detailed discussion of the effects of interstate banking and branching, see pages 48 through 62 of our interstate banking report (GAO/GGD-94-26).

7. What has been the result of the lack of Glass-Steagall-type restrictions in other jurisdictions (e.g., Canada, France, Japan, and Mexico) in terms of bank ownership of securities firms and concentration of financial institutions?

It is difficult to compare the banking and securities markets in different countries because of differences in the structures of the markets, in their relative sizes, and in the data that are available. From Treasury's 1994 National Treatment Study, our ongoing work on foreign regulatory structures, and other sources, we compiled the following information on selected countries that relates to this question and the two that follow.

Canada

The six largest Canadian banks accounted for 90 percent of the total banking system assets at the end of 1993.

Before 1987, Canada did not permit affiliation between banks and securities firms. Since Canada began permitting such affiliation, the largest securities firms have been acquired by Canada's largest banks. Of the major full-service securities firms in Canada, six are owned by the six largest banks, and four are independent. It is estimated that the eight largest Canadian firms account for slightly over 50 percent of the regulatory capital of the securities sector and that they typically earn about two-thirds of the sector's total revenue.

Mexico

The three largest Mexican commercial banks account for about 50 percent of total banking system assets. As of March 1994, 21 of the 28 brokerage houses in the country were part of various financial groups or holding companies, many of which include banks.

Japan

The Japanese banking industry consists of many different types of banks, including city banks, long-term credit banks, trust banks, regional banks, and various specialized institutions. The largest Japanese banks are the 11 "city banks," which are similar to U.S. money center banks and account for 35 percent of the total market. Long-term credit banks provide long-term loans to private industry. There are three of these banks, and they account for an 8-percent share of the total market. There are 129 regional banks in Japan, which account for 28 percent of the market. (Market share percentages are as of year-end 1993.)

Japan does not allow universal banking. According to the U.S. Treasury study, as of 1993, Japanese banks can engage in the securities business through separate subsidiaries. However, the Ministry of Finance has permitted new bank subsidiaries to engage in only a limited range of securities activities. Thus, securities firms continue to have exclusive rights to broker equities and convertible bonds, and to underwrite equities.

France

As of the end of 1993, France had 425 banks, the 5 largest of which held an estimated 60 percent of total loans and other credits.

French banks conduct a universal banking business. There are also securities houses in France that specialize in the investment and management of transferable securities and negotiable instruments. As of December 31, 1993, one-third of the 156 securities houses in France were subsidiaries of foreign financial institutions, such as American investment banks.

Federal Republic of Germany

Any bank licensed in Germany may conduct a universal banking business. As of December 1993, there were 328 commercial banks in Germany that made up 28 percent of total bank assets, with the largest 3 banks in Germany sharing 11 percent of bank assets.

Many securities firms are owned by universal banks.

United Kingdom

As of February 28, 1994, there were 518 banks in the United Kingdom, with over 1.2 trillion pounds in assets. Approximately half of these assets (593 billion pounds) were held by 8 of the larger British banks.[10] Any authorized bank in the United Kingdom--including subsidiaries of foreign-owned banks--may conduct securities and insurance activities, as long as the latter are carried out in bank subsidiaries. This, in effect, permits banks to conduct a universal banking business. We have no information on the concentration of securities firms.

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[10]These eight banks are not the eight largest banks in the United Kingdom since technically that number would include a former building society now converted to a bank.

8. What types of restrictions are there in other countries on foreign ownership of financial institutions?

Canada

No group or individual (Canadian or foreign) can own more than 10 percent of a major Canadian bank. Total holdings in Canadian banks by foreigners (other than U.S. entities) cannot exceed 25 percent, with no foreign entity owning more than 10 percent of any one Canadian bank. Total holdings in Canadian banks by U.S. companies can exceed 25 percent, but they are also limited to no more than 10 percent of any one Canadian bank.

Foreign securities firms were allowed to enter the Canadian market in 1987. They can acquire full ownership of Canadian securities firms.

Mexico

In general, Mexico limits foreign ownership of banks. U.S. banks can acquire Mexican banks but there are capital limitations--the capital of the acquired bank plus the capital of an existing subsidiary of the U.S. bank in Mexico cannot exceed a specified market share limit that is to be phased out by the year 2000.

Foreign firms are limited to minority holdings of Mexican securities firms. NAFTA has opened up the securities market for U.S. and Canadian firms, as long as the firms establish subsidiaries and hold at least 99 percent of the shares of the subsidiaries; otherwise they are subject to the same restrictions as other foreign investors.

Japan

According to the Treasury study, foreign banks are only minor participants in the Japanese banking system, partly because of exclusionary business practices and partly because of the regulatory environment. There are 90 foreign commercial banks in Japan, of which 20 are U.S. owned (as of year-end 1993). The acquisition of a Japanese bank by a foreign bank has never occurred, although such an event is possible according to the Japanese government.

Foreign banking entities are able to enter the Japanese securities market through branches of offshore subsidiaries, provided that their equity stake in their branches is no more than 50 percent (according to the Treasury study). Currently, all foreign security firms are established as branches of offshore subsidiaries of the banking or

nonbanking parent firm. The total number of foreign securities firms with branches in Japan was 48 as of 1994, of which 18 were U.S. firms.

France

France has no formal restrictions on the foreign ownership of financial institutions.

Federal Republic of Germany

Germany has no special restrictions on the foreign ownership of financial institutions. However, domestic and foreign purchasers of participating interests must be able to demonstrate their trustworthiness to the Federal Banking Supervisory Office and the Deutsche Bundesbank.

United Kingdom

Foreign-owned financial institutions can acquire existing financial institutions (banks and securities firms) with few restrictions. Mergers and buyouts of well-established but weakly capitalized British firms have been common. According to the Treasury study, the British Banking Act of 1987 does give the Bank of England the power to control changes of ownership of authorized institutions incorporated in the United Kingdom, on the basis of prudential grounds.

9. **Is a U.S. bank or securities firm permitted to acquire a major financial institution in other jurisdictions (e.g., Canada, France, Japan, and Mexico)?**

Canada

U.S. banks or securities firms can acquire up to 10 percent of a Canadian bank and 100 percent of a Canadian securities firm.

Mexico

The capital and market share limitations (see answer to question 8) on ownership of Mexican banks precludes the acquisition of Mexico's largest banks by foreign investors.

Japan

The Japanese government says that an acquisition of a Japanese bank by a U.S. bank is possible. As of the end of 1993, 17 Japanese banking companies had more assets than the largest U.S. banking company.

U.S. securities firms have limited ability to operate in the Japanese securities market, according to the Treasury study.

France

According to the French government, a U.S. bank or securities firm is permitted to acquire a major financial institution in France. The Treasury study suggests that firms outside of the European Union might be subject to more rigorous regulatory review. As of the end of 1993, 5 French banking companies had more assets than the largest U.S. banking company. The securities industry in France is dominated by banks.

Federal Republic of Germany

As of the end of 1993, 2 German banking companies had more assets than the largest U.S. banking company. The securities business in Germany is dominated by universal banks.

United Kingdom

There are few restrictions on foreign ownership of financial institutions in the United Kingdom. As of the end of 1993, 3 banking companies in the United Kingdom had more assets than the largest U.S. banking company.

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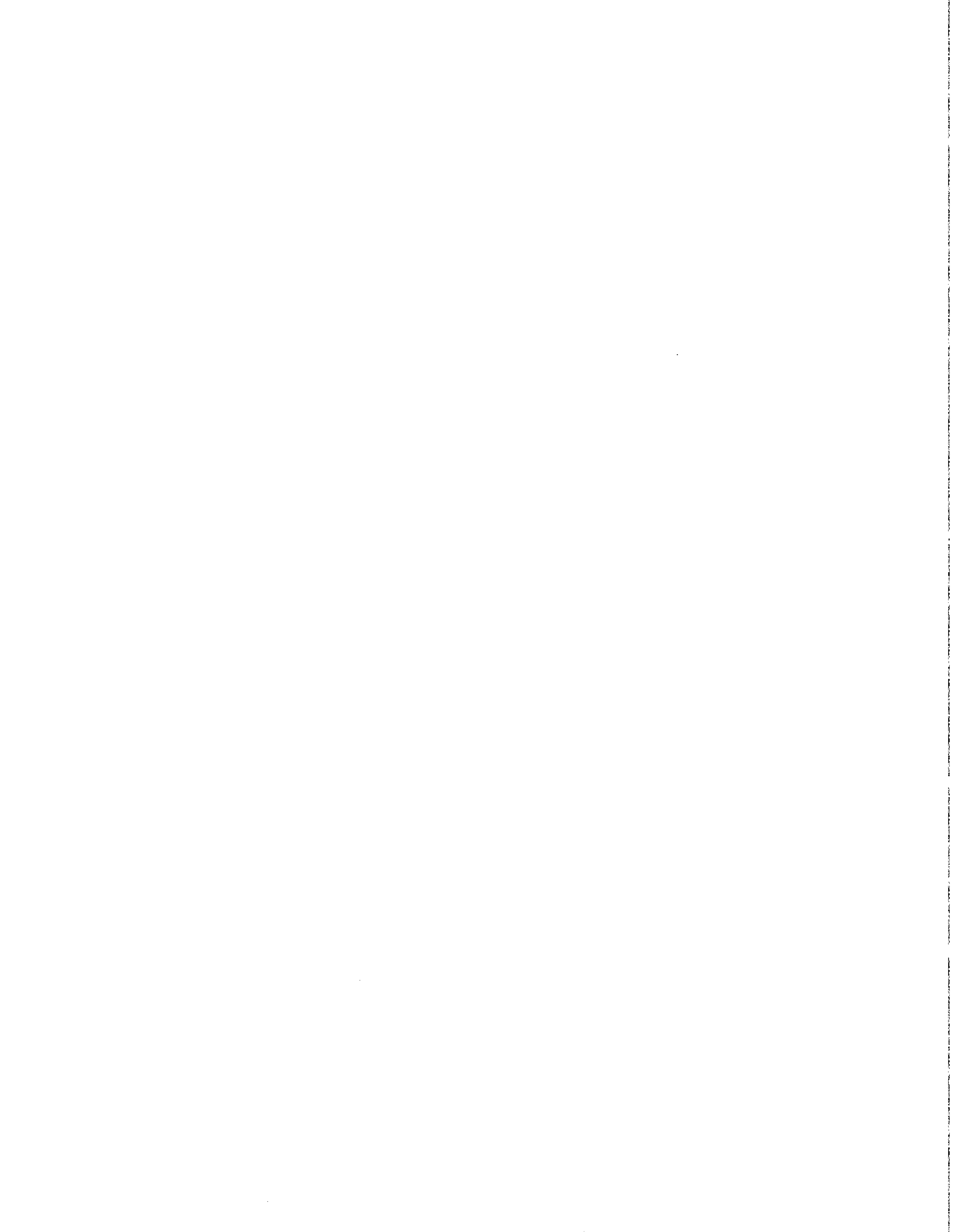

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