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IN SEARCH OF A NEW SAFETY NET FOR THE FINANCIAL SERVICES INDUSTRY

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In Search of a New Safety Net
for the Financial Services Industry*

I want to talk with you, today, about interdependence within the financial services industry and some of its possible consequences, which seem to call for a re-examination of the way in which that industry is regulated. By "financial services", I mean to embrace financial intermediaries of the depository-type, the insurance-type and the investment-type, including broker-dealers and futures commission merchants.

This subject should be of interest to the New York Regional Group of the American Society of Corporate Secretaries. After all, New York is the financial capital of the world. And, although there may be a few of you left who are not yet affiliated with one or more firms in the financial services industry, conglomeration may change that before long. In any event, if you are not part of the industry, you and your company are bound to be dependent on it in many ways.

The financial services industry deals with other people's money. Regulation of that industry has sought to protect that money, and that which it buys -- be it securities, insurance policies or whatever -- from loss due to failure of the financial intermediary. As Representative Steagall said in 1933, with reference to banks and the Glass-Steagall Act:

> "The purpose of this legislation is to protect the people of the United States in the right to have banks in which their deposits will be safe. They have the right to expect of Congress the establishment and maintenance of a system of banks in the United States where citizens may place their hard earnings with reasonable expectation of being able to get them out again on demand."

The regulatory approaches vary somewhat, depending upon the type of financial intermediary. But the common themes are to assure soundness (which is the avoidance of illiquidity

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* The views expressed in this speech are my own and do not necessarily represent those of the Commission, my fellow Commissioners or the staff.

or insolvency) and to provide mechanisms to protect customers should failure occur.

Soundness regulation includes restrictions on the competitive environment in which financial intermediaries operate, portfolio restrictions on both the asset and liability side, prohibitions against self-dealing and regulation of conflicts of interest.

Post-failure mechanisms include such federal entities as the Federal Deposit Insurance Corporation for bank customers, the Securities Investor Protection Corporation for broker-dealer customers, and the Pension Benefit Guarantee Corporation for pension plan beneficiaries under ERISA, as well as the state-established guaranty funds for insurance policyholders.

While disasters like the Great Depression can readily explain the present regulatory thicket, justification remains elusive. Professor Robert C. Clark of Harvard Law School, an expert on financial intermediaries, observes that "an extraordinary percentage of failures of financial intermediaries has been ascribed to fraud, self-dealing, and other forms of unsavory behavior on the part of managements."* Yet, as he notes, the measures employed to promote soundness go far beyond anything necessary to deal with dishonesty.

The justification offered by Congressman Steagall rings of paternalism -- to protect the public suppliers of capital, without regard to how foolish they may be in selecting an intermediary with which to entrust their funds. This goal, of course, could be achieved by insurance without necessarily having the many restrictions we now employ to limit risk.

Increasingly, voices critical of our traditional regulatory system are being heard. Some advocate placing greater, and perhaps even exclusive, reliance on regulation of the reactive, post-failure type. And the apostles of deregulation would substitute disclosure and market discipline for the heavy-handed restrictions that soundness regulation has traditionally imposed. In fact, deregulation, today, is much in vogue; pressures are building for greater reliance on disclosure and market discipline to assure soundness. In a time of budgetary restraints and overall disillusionment

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* Clark, The Soundness of Financial Intermediaries, 86 Yale L. J. 1, 12 (1976). This article will reward anyone seeking to understand past rationales for soundness regulation and how policy should be developed for the future.

with government intervention, marketplace forces offer a seductive solution to secure soundness. Yet, the growing interdependence of financial intermediaries should give pause to policymakers tempted by the siren song of Adam Smith.

It is my thesis that:

- market discipline can only assure soundness in an environment where institutions are permitted to fail;
- the linkages among financial intermediaries often are too extensive (and growing stronger and more numerous) to prevent one failure from triggering others;
- therefore, the collateral consequences of failures often pose unacceptable costs to our financial system; and
- accordingly, to assure soundness a new system of direct regulation is needed -- a system broad enough to encompass all financial intermediaries and flexible enough to enable the forces of full disclosure and market discipline to do their share of the job.

Let me try now to develop this thesis.

I. The Interdependency Phenomenon

Anchovies

In 1972, the Humboldt Current moved away from the coast of Peru, leaving the waters too warm for energetic breeding among anchovies. Faced with this dilemma, Peruvian fishermen, who supply to the world some two million tons of this protein-rich fishmeal per year, equipped their boats with electronic fish-finders and gathered in all the fish they could find -- consuming their aquatic "seed corn". Thus it was that in the following year, the anchovy crop failed. In that same year two other major sources of protein were afflicted with natural disasters. In the United States, 75 million bushels of soybeans rotted, while in West Africa and India, the peanut crops were savaged by drought. Through world-wide linkages, these disparate events conspired to increase substantially the world price for cattlefeed, chickenfeed, and hogwash. And, of course, the price of food at markets throughout the world sharply increased. The lesson here was that the world's economic structure was strikingly fragile, subject to large disruptions from small, seemingly isolated events.

Foreign Debt

Those who missed the anchovy lesson, and who thought of the twin oil shocks of the 1970's only in terms of an increase in the price of gasoline, were rudely awakened in recent months to find that those shocks have now contributed to a global lending problem of profound, and yet uncertain, dimensions. As stated by Treasury Secretary Donald Regan in recent testimony on Capitol Hill, "[t]he world faces extremely difficult economic and financial problems, essentially without precedent in the postwar period." And last week, Chairman Paul A. Volcker of the Federal Reserve Board told the House Committee on Banking, Finance and Urban Affairs:

> "We are talking about dealing with a threat to the recovery, the jobs, and the prosperity of our own country, a threat essentially without parallel in the postwar period."

A succession of near defaults on foreign loan payments by Poland, Mexico and Brazil brought about a startling realization of the vast size of lesser developed country debt and of the corresponding vulnerability of Western banks. From 1973 to 1982 the external public and private debt of LDCs rose from $110 billion to an estimated $550 billion, as banks recycled funds deposited by the petroleum producing countries. As of June 1982, $268 billion of this debt was owed to private Western banks, which had served as risk-taking intermediaries between OPEC and the borrowing countries.

It was expected that the money lent to developing countries would be used for capital investment which, in turn, would generate economic growth, exports and ultimately the hard currency necessary to service the debt. Worldwide recession, falling commodity prices and, in some cases, political mismanagement dashed this hope. By mid-1982, even before the problems in Mexico and Brazil became public, 20 countries had rescheduled debt due in 1982.

The complexity of the global lending situation is reinforced by the probable impact of oil price declines in recent weeks. These declines, if permanent, should alleviate financial strains somewhat for many developing countries. In oil producing countries such as Mexico, Venezuela, Nigeria, and Indonesia, however, existing problems are likely to be exacerbated.

As Chairman Volcker pointed out in his recent testimony, "[t]he international financial system is not separable from our domestic banking and credit system." Of the $268 billion in outstanding loans by private banks to the developing countries as of June 1982, over 36 percent, or $98.6 billion, were claims of U.S. banks. Nor is the exposure of U.S. banks confined to the multi-national banking institutions; over 1500 U.S. banks have loans outstanding to Latin America alone.

The troubled international situation is not merely a problem for the banks. Almost 20 percent of our Nation's industrial output is produced for export. Approximately 40 percent of U.S. agricultural production is sold overseas. Thus, the health of the U.S. economy is vitally dependent on the health of the world economy.

Evidence of growing economic interdependence, however, is not confined to the international scene. In recent years, examples have surfaced in the domestic financial markets as well.

Drysdale

Last spring, Drysdale Government Securities went bankrupt. From a capital base of approximately $20 million on the date of its incorporation in January, 1982, the firm accumulated a gross long position in excess of $2 1/2 billion and a gross short position of about $4 billion in only four months through repo and reverse repo transactions involving government securities. When interest rates moved against its net short position, the firm collapsed. To avert the possibility that the Drysdale default would have system-wide repercussions, the Federal Reserve Board announced that its discount window was open to solve unusual liquidity problems. And it indicated a willingness to make more flexible the terms of its short-term loans of government securities to primary government securities dealers.

Bache

Two years earlier the so-called "Silver Crisis" occurred. Bache and several other large broker-dealers had extended credit to the Hunt brothers to finance spot silver and silver futures positions. When the price of silver collapsed in the spring of 1980, the Hunts were unable to meet margin calls on their net long positions. The ability of Bache to continue operations was severely threatened. Indeed, a net capital deficiency was averted only when the steep decline in silver prices fortuitously bottomed out. Bache's failure might have triggered serious collateral consequences for the banks extending credit to Bache and for other broker-dealers with whom huge inter-firm debits and credits customarily are maintained. For example, at one point in the Spring of 1980, Bache had inter-firm debits and credits of approximately $250 million and repo and reverse repo agreements with both banks and broker-dealers of almost $2 billion. As Paul Volcker stated in testimony before the Senate Banking, Housing and Urban Affairs Committee:

> "[S]ome of the institutions with the greatest exposure in the silver situation had farflung activities in many other markets. Had one of those institutions become insolvent, the problem would have quickly spread to other markets, many of which are far removed from silver."

To assist in alleviating the crisis, a consortium of banks extended a loan of $1.1 billion to the Hunts.

Paine Webber

At about the same time as the Silver Crisis, Paine Webber was experiencing operational problems for another reason. On December 31, 1979, Blyth Eastman Dillon & Co. was merged into Paine Webber. The attempt to integrate operations and customer accounts encountered substantial problems which threatened the continuing viability of the surviving firm. The problem was ultimately resolved, although at enormous expense to the firm. At the time, however, there was considerable concern that the firm might fail. Again, the ripple effect of a failure was recognized. At one point in the Spring of 1980, Paine Webber had inter-firm debits and credits totalling some $155 million -- as well as repo and reverse repo agreements with both banks and broker-dealers of some $3.6 billion. The size and complexity of the firm and its problems made it doubtful that the Securities Investor Protection Corporation could have handled a liquidation.

Examples of interdependence and fragility are found in banking as well.

Penn Square

Last Fall, Penn Square Bank failed, causing significant losses to several major banks, including Chase Manhattan and Continental Illinois, both of which had accumulated, apparently without close scrutiny, large positions in loan participations offered by Penn Square.

Three of the situations just described could be characterized as textbook examples of imprudent lending practices. The fourth, the Paine Webber situation, like the Penn Central merger 12 years before, can in large part be attributed to inadequate planning and preparation. In each situation the losses could have been avoided through the exercise of greater vigilance. But I think there are other, and more important, lessons to be drawn from these isolated incidents. They reflect a growing interdependency among financial institutions. They are examples of how, with increasing frequency, the difficulties of a single financial institution threaten to trigger a chain reaction, extending well beyond the entities immediately involved. And they suggest the need for a government safety net, at the ready and capable of moving swiftly, to supply liquidity and act in other ways necessary to protect the stability of our Nation's financial system.

One could argue that these incidents demonstrate -- perhaps brilliantly -- the adequacy of our present system. I see them as warning flags, however, pointing to the need for a more carefully constructed safety net to meet the crises of tomorrow.

II. Interdependency as an Obstacle to Disclosure

Because of the multiple linkages among the institutions comprising the financial community, it is often difficult to address problems involving a particular financial institution without consideration of the broader ramifications. We at the SEC seem to be facing this phenomenon with greater frequency. Consider, for example, our recent experience with Delaware Cash Management Fund, a money market mutual fund. In response to alarming rumors about the firm's solvency and an incipient run, the SEC staff immediately conducted an investigation, which showed the rumors to be false. The staff then published an announcement that the fund was sound. This was an extraordinary step, contrary to the SEC's traditional policy of not passing on the condition of a particular issuer or the merits of its securities. In so acting, the staff was not unmindful of the dangers that a single failure could have on public confidence in money market mutual funds generally.

Let's take another example. The SEC is commonly called upon to address the question of whether an issuer need disclose a particular fact. Generally, we have been able to resolve the question by reference solely to that issuer's special situation. After all, the purpose of the securities laws is to protect securityholders, and the application of those laws pivots on what is material to them. But increasingly we are met with arguments for accommodation -- for a bending of the dictates of our disclosure rules --

to avert what are predicted to be dire and widespread consequences extending well beyond the issuer and those it touches.

The present international banking crisis illustrates the point. In a recent speech, former Under Secretary of the Treasury for Monetary Affairs, Robert Roosa, was critical of a new SEC Staff Accounting Bulletin, the purpose of which is to clarify the disclosure obligations of bank holding companies with respect to foreign loans. Mr. Roosa warned of "arbitrary accounting criteria that can create a cloud of concern which might shake confidence in the American banking system". He urged that particular care be taken lest "the staff's well-motivated intention . . . produce a new wave of apprehension concerning the liquidity, or indeed the ultimate solvency, of those bank holding companies in the United States which have participated substantially in foreign lending."

The even-handed application of our disclosure rules becomes difficult when experts of Mr. Roosa's stature, both in and out of government, warn of nationwide or even worldwide catastrophe as a possible result of adhering to the rules. Should we reject these legitimate concerns, wrap ourselves in the securities laws and insist on disclosure, while pointing to Congress as the body to which the collateral effects problem should be addressed? Is it our duty to reject these concerns? Or should we bow to them and bend the rules of disclosure in special cases? These are important questions. But, I do not want them to divert us from the central topic -- that is, the regulatory implications of this growing interdependence and vulnerability within the financial services industry.

III. Technology -- The Root Cause of Interdependency

The growth of linkages among financial intermediaries is in large part a function of technological advances. Last week I saw in the Science Section of the New York Times a statistic regarding the capacity of computers that seems hard to comprehend. Apparently, over the past 25 years the raw speed of computers has doubled, on average, every year. Because electronic impulses travel at the speed of light, this increase could only be achieved by reducing the size of microelectronic chips and by arranging them within the computer in configurations designed to minimize the distances that the electronic impulses must travel between chips.

We are witnessing an explosive rate of change in technology, and with it, a transformation of society, from which the financial markets are not immune.

Computers have permitted high-speed, low-cost data processing, which has led to sophisticated money management techniques employed not only by financial institutions, but also by most corporations. No longer does cash sit overnight in non-interest bearing accounts. Prudent cash management requires that excess funds be invested in money market instruments on a daily basis. There are numerous examples of how adroit money management has contributed significantly to a firm's profit.

At the same time, the velocity with which funds can move contributes to the vulnerability of the financial system. When the objective is to achieve maximum investment over relatively short periods of time, the cushion of cash reserves is reduced, and the time available to respond to a fail is severely curtailed. The problem is sharpened if commitments to deliver are matched against expectations of receipt. System-wide liquidity problems can result.

Technology also has facilitated instantaneous global telecommunication. This has resulted in a growing internationalization of the financial markets and the integration of financial institutions on an international level.

To some extent technology also has been responsible for increased competition among financial institutions. For example, advances in telecommmunications and data-processing have enabled non-banking institutions to offer products and services that traditionally had been available only from banks. These include money market mutual funds and the cash management accounts offered by brokerage firms.

IV. Conglomeration and Concentration -- Contributing Factors

In addition, the vulnerability of our financial system is likely to be further exacerbated by what appears to be the emergence of a trend toward consolidation and growth in the size of financial intermediaries.

Across the broad spectrum of the economy, statistics for the decade of the 1970's do not show a general increase in concentration. As Lawrence J. White, Director of the Economic Policy Office of the Justice Department's Antitrust Division, concluded in the *Wall Street Journal* on December 11, 1981: "Despite the merger wave [throughout the 70's] and despite claims to the contrary, the relative size of the country's largest corporations has not been growing."

The 1980's, however, may prove to be a decade of consolidation in the financial service industry. Recent combinations such as Sears with Dean Witter, Prudential with Bache, and American Express with Shearson, are evidence of such a trend. And, many observers see rapid concentration within the banking industry as a likely result of the Garn-St.Germain Depository Institutions Act of 1982.

Of course, companies of greater size and diversification of business line may be better able to cross-subsidize their various activities, and thereby absorb reverses that would cause the demise of smaller-sized firms or firms limited to a single line of business. On the other hand, a multi-lined firm has more linkages that can cause its failure to impact adversely on others, as well as the failure of others to impact adversely on it. And like ships, whose size is measured by the water they displace, the larger the firm, the greater the displacement of those around it, when failure comes.

V. Pressure for a Free Market Model

One consequence of technological change is that it often renders obsolete regulatory structures developed in a preceding era, requiring new structures more in tune with the present environment. Recent developments in banking illustrate this point.

In pursuit of soundness, banks traditionally have been sheltered from the free operation of market forces -- the theory being that unrestricted competition is inimical to this goal. In recent years, this regulatory approach has grown increasingly ineffective, as technological innovation has eroded the banks' exclusive franchise. In response to competitive pressures, such regulatory restraints as interest rate ceilings on bank deposits are being removed. Geographic limitations and what's left of the Glass-Steagall barrier may well be the next two forms of anti-competitive banking regulation to fall.

In addition, banks have been permitted to diversify, on the theory that diversification is necessary to enable them to compete more effectively with non-bank financial service institutions. Recently, for example, banks or bank holding companies have received authorization to provide securities and commodity futures brokerage services, to underwrite commercial paper and to invest in export service corporations.

Deregulatory initiatives are not confined to banks. The 1982 Report of the Executive Advisory Commission of the State of New York on Insurance Industry Regulatory Reform recently concluded that "[i]n order for New York to continue to have a viable insurance industry, its companies must be able to compete in the broader environment of financial services." As part of a program to increase the flexibility of insurance companies doing business in New York, the Commission recommended that insurance companies be permitted to invest up to 10 percent of their assets in subsidiaries engaged "in any lawful business." This report reflects a massive change of view from that held by the Armstrong Committee, appointed in 1905 to investigate the life insurance industry in New York. Its conclusion was that the business of a life insurance company is -- and should remain -- life insurance.

Deregulatory initiatives within the financial service industry raise something of a paradox for regulators. As competitive restraints are relaxed, banks and other financial institutions necessarily become exposed to greater risks. Yet, deregulation often involves abandoning precisely those regulatory devices designed to promote soundness.

The way out of this dilemma, as seen by a number of regulators, is to substitute market forces for direct regulation. As C.T. Conover, the Comptroller of the Currency, has stated: "deregulation begins to shift some of the responsibility for discipline of banks from regulators to the marketplace." In order for the discipline of the marketplace to operate efficiently and to provide adequate safeguards against excessive risks, market participants must have all necessary information to conduct meaningful risk analysis. Disclosure, then, becomes an integral part of the free market model.

In fact, there has been an increase in the public dissemination of information concerning the financial condition of banks. A prime example is the recent revision of the quarterly Call Reports to collect additional information on non-performing loans and interest-rate sensitivity, and to make this information publicly available. In announcing this change in traditional bank regulatory policy, the Federal Financial Institutions Examination Counsel said that this information "should be of benefit to the depositing public and to other bank creditors and to bank investors", concluding that it was "in line with an increased emphasis on market discipline and bank deregulation." In addition, Mr. Conover recently raised the possibility of reversing traditional policy by releasing information on enforcement actions taken against banks.

VI. Problems with the Free Market Model

The recent efforts of bank regulators to increase the amount of information publicly available concerning the financial condition of banks should be applauded. Thinking of market discipline as a substitute for direct regulation, however, is an idea which should give us pause.

As a general proposition, accurate and timely disclosure of both favorable and adverse information facilitates the optimum allocation of capital among competing investments and deters risk-taking that is deemed excessive by the suppliers of capital. There is no reason why disclosure should not have the same salutary effect on financial institutions as it does in other sectors of the economy.

I would suggest, however, that exclusive, or even primary, reliance on market discipline may not be the answer. One of its principal deficiencies as a means to assure soundness is that, in order for market discipline to operate efficiently, financial institutions must be fully exposed to the risk of failure. As Mr. Conover states, in a deregulated environment "banks cannot take on increased risk without accepting ultimate responsibility for their own mistakes." William M. Isaac, Chairman of the Federal Deposit Insurance Corporation put it even more bluntly: "Deregulation carries with it greater freedom to make mistakes, and some of those mistakes will no doubt be serious enough to cause failure." Indeed, if market discipline is to operate efficiently, financial intermediaries <u>must</u> be permitted to fail. But the growing interdependence among financial institutions and their resulting vulnerability, as noted earlier, makes a failure -- at least among the larger firms -- an unacceptable result. For many of our larger financial firms, the collateral repercussions of failure would be intolerable. In many cases, the costs of resuscitating a failing firm would be far less than the system-wide costs of letting it go.

The expectation that government would have to intervene prevents the marketplace from operating efficiently. The realization among large bank depositors and creditors that they would not be required to absorb the full consequences of a bank failure erodes the incentive necessary to conduct their money management activities in a manner designed to deter the bank from incurring excessive risk. Unrestrained, the firm would be free to adopt a risk preference greater than one compatible with soundness. This analysis suggests the necessity, as a matter of public policy, of continuing to rely on direct regulation to prevent financial intermediaries from becoming tempted to incur unacceptable risks.

The current international lending situation aptly illustrates the inadequacies of the free market model for regulating financial institutions. In focusing on short-term profits, and abandoning traditional standards of loan evaluation, banks miscalculated the long-term risks. But, to permit the banks to suffer the full consequences of their miscalculations could create intolerable collateral consequences. Let's examine this matter a bit more closely.

In the late 1970's, lending to lesser developed countries was a highly profitable enterprise. Their assets swelled by the influx of OPEC money, the international banks were able to lend in the Third World at very attractive rates. This profit-making opportunity also attracted regional banks eager to acquire participations in loans which the international banks collected substantial fees for arranging. As a consequence of this activity, many foreign countries have incurred debt-servicing obligations considerably in excess of their foreign exchange earnings.

Many bankers have sought to explain their lending practices by asserting that sovereign nations, unlike corporations, can not go bankrupt. Yet they fail to explain why, if the loans were so secure, the rates charged were so high. Even after the crisis had become obvious, some bankers continue to insist that the loans are not in jeopardy, suggesting that the problem is merely one of temporary illiquidity.

What now seems desirable is a comprehensive restructuring of these problem loans, built on realism and involving the principle that <u>all</u> parties must accept a fair share of the burden. Such a plan would seem, inevitably, to include the write-off of a portion of existing loans by the private lending institutions.

Whether a realistic write-off will occur remains to be seen. Of total U.S. bank claims on the developing countries in June, 1982, of some $100 billion, 60 percent were held by our nine largest banks, while the 15 next largest banks accounted for an additional 20 percent. For the big nine, claims on all developing countries by last June had grown to about twice their capital, and about half of those claims were concentrated in Argentina, Brazil and Mexico. Thus, a write-down of 50 percent , as recently suggested by George Champion, the former Chairman of Chase Manhattan Bank, implies a realistic capital base of zero for our largest banks. If the consequences of realism are that awesome, one can appreciate the apparent reluctance of all but a few commentators to embrace reality and its consequences.

I am not dwelling on this troubled area because I have a good idea, much less a better one, about how to solve the problems. My point simply is to illustrate the difficulty of substituting the free market model for direct regulation when failure poses unacceptable social and economic consequences.

VII. Construct for a New Safety Net

Last summer, in a speech on the international banking problem, Robert Roosa observed that new opportunities are often "forged in the crucible of crisis."

If we are to take full advantage of the current opportunity we must, he said, develop a regulatory structure that is based upon "the reinforcing of market processes through governmental action, and upon containing the apparent excesses to which imperfect freedom sometimes contributes."

Roosa's sketch of the desired structure is appealing. All that is needed are the details! Alas, I am not prepared, today, to fill them in. But I do want to return to the thesis I advanced at the outset. I have tried to show that:

- market discipline can only assure soundness in an environment where institutions are permitted to fail;

- the linkages among financial intermediaries often are too extensive (and growing stronger and more numerous) to prevent one failure from triggering others;

- therefore, the collateral consequences of failures often pose unacceptable costs to our financial system; and

- accordingly, to assure soundness a new system of direct regulation is needed -- a system broad enough to encompass <u>all</u> financial intermediaries and flexible enough to enable the forces of full disclosure and market discipline to do their share of the job.

The optimal techniques for assuring soundness can only be selected after the circle is drawn around those financial activities requiring regulatory protection against failure. Circle drawing is terribly difficult. In banking, for example, some would circle only the bank itself, others the bank and its subsidiaries, and still others the entire bank holding company structure. These differences are suggested by the various approaches to legislative reform proposed over the past year by Senator Garn, Secretary Regan and Chairman Volcker. As the <u>distinctness</u> of such activities as banking, investment banking and insurance continues to erode, placement of the circle becomes even more of a challenge.

I will leave you with one final thought. If direct regulation continues to be necessary to assure the soundness of at least some group of major financial intermediaries -- a proposition I have tried to support -- I urge the closest scrutiny of proposals that seek to protect those firms through legal structuring. Whether it be through subsidiary, holding company affiliate or whatever, I have serious reservations as to whether such legalities can adequately immunize the financial intermediary from the risks determined to be incompatable with soundness.