Discussion Paper

Presented to
International Securities Regulators' Group Meeting
The Stock Exchange
London, England

AN OVERVIEW OF THE INTEGRATION OF SECURITIES AND BANKING ACTIVITIES IN THE UNITED STATES

James C. Treadway, Jr.
Commissioner
United States Securities and Exchange Commission

September 13-14, 1984

Introduction

This gathering occurs at a propitious time. Technology, market forces, competitive zeal, and legal ingenuity have combined to blur substantially historical distinctions among the providers of financial services in the United States. In the United States banking today is not always called "banking." Furthermore, those who conduct that activity are not necessarily limited to entities formally chartered as banks, heretofore generally assumed a prerequisite. Instead, we have the "financial services industry," offering a sometimes baffling array of products, crossing traditional industry lines, and challenging established legal barriers. The confusion over products, providers, and barriers is all-too-well reflected by a recent report issued by the Committee on Government Operations of the United States House of Representatives. The report bears the apt title, "Confusion in the Legal Framework of the American Financial System and Services Industry." 1/

Development of a national policy for industries as vital as banking and securities today lacks overall direction. The two houses of our Congress have clashed over the future of our financial services industry, and various federal agencies with overlapping jurisdiction publicly disagree with one another. Our courts decide lawsuits brought by industry associations and various governmental agencies on a narrow, case-by-case basis. These narrow decisions provide little broad guidance and clearly set no broad policy, yet they have significant impact.

The result is confusion, overlap, and contradiction. Because of a lack of overall direction at the Congressional level, adversarial proceedings and judicial decisions are essentially setting policy. Non-depository institutions in our country, such as Merrill Lynch, will accept your funds and invest them for you in money market funds, insured savings accounts, insured certificates of deposit, and, even occasionally, traditional stocks and bonds. Merrill Lynch is not unique. American Express Company conducts international banking and issues credit cards and travelers' checks. Through Shearson/Lehman American Express Inc., American Express provides full-line investment banking, money management, securities brokerage, and commodities services. Sears, Roebuck & Co., a merchandiser of consumer goods, now offers consumer credit, insurance, real estate, securities brokerage, commodities, investment banking,

---

1/ House Comm. on Government Operations, Confusion in the Legal Framework of the American Financial System and Services Industry, H. Rep. No. 692, 98th Cong., 2d Sess. (1984) ("House Report").

various money management services, and *de facto* banking through Sears Savings Bank. Numerous money market mutual funds offer a deposit-like investment that allows an investor to earn a favorable interest rate and write checks on the investment almost as if it were a checking account at a bank.

These companies lack charters denominating them as "banks," they disclaim that they accept deposits, and they engage in traditional commercial activities. Yet, they undeniably perform banking-like activities, if not "banking," and they represent only a short list of non-banking companies that do so. A recent *Time* magazine cover story on Sears indicates:

> The Sears strategy for expansion into financial services is bold, and Sears is now aggressively going after this market . . . . [A]n internal Sears committee is looking into all sorts of new financial ventures. One plan would turn the company's credit card into a debit card that would automatically deduct the price of purchases from a savings account. [A finance professor speculates that] 'The Sears credit card overnight could be a major tool for collecting deposits, selling certificates of deposit and maintaining checking accounts.' Sears is also actively looking to buy more savings and loan associations to add to the one it already owns in California. It was a bidder in 1983 for Chicago's First Federal Savings and Loan, which was finally bought by Citicorp. 2/

Banks in the United States hardly have been idle as entities without formal bank charters have moved to conduct banking-like activities. In successful efforts to expand business activities beyond "traditional banking," banks have used aggressive legal interpretations, creativity, inconsistencies between federal and state laws defining the permissible range of activities of banks, interpretations as to the legally permissible range of activities of banks that differ among federal banking regulators, and differences between laws and regulations governing banks and those governing thrift institutions. Securities brokerage and underwriting, mutual fund sponsorship and share distribution, real estate activities, and insurance comprise a partial list. Our banking industry has publicly lobbied to obtain changes in the governing laws.

At work in the integration of our financial services industry are forces and concerns that are not unique to the United States. Competitive pressure is, of course, a principal force. Another is the need to form capital pools which are of sufficient size to meet the needs of capital users and which

---

2/ *Time*, Aug. 20, 1984, at 85.

can be distributed rapidly and efficiently. Yet another is the perception, correct or incorrect, that larger size and more diversified activities will result in economies of scale and lower costs to consumers.

But some see a dark side to these developments. They observe that the quest for size and the formation of larger and larger pools of capital inevitably means a concentration of power and more potential for conflicts of interest. In addition, if concentrated economic power becomes monolithic, the potential to suppress innovation exists.

Our Historical Path To The Present

Despite the blurring that has occurred, a dividing line nonetheless remains to some extent in the United States between depository institutions, principally represented by banks, and non-depository institutions, such as traditional securities brokerage firms and investment companies. Some refer to this division as a line between "banking" and "commerce." The precise twists and turns of that wavering line, however, are not always quickly perceived. To underscore the difficulty, consider that our federal laws which permit or bar functions (generally based upon the deposit-taking function) are embodied no less than twenty-two (22) federal statutes, 3/ administered or enforced by five (5) separate federal departments or

---

3/ (1) Bank Holding Company Act, 12 U.S.C. §§ 1841-1850; (2) Bank Merger Act, 12 U.S.C. § 1828(c); (3) Bank Service Corporation Act, 12 U.S.C. §§ 1861-1867; (4) Banking Act of 1933, 48 Stat. 162; (5) Banking Act of 1935, 49 Stat. 684; (6) Change in Bank Control Act of 1978, 12 U.S.C. § 1817(j); (7) Change in Savings and Loan Control Act, 12 U.S.C. § 1730(q); (8) Consumer Checking Account Equity Act of 1980, Title III, P.L. 96-221; (9) Deposit Insurance Flexibility Act, Title I, P.L. 97-320; (10) Depository Institutions Deregulation and Monetary Control Act of 1980, P.L. 96-221; (11) Douglas Amendment to the Bank Holding Company Act, 12 U.S.C. § 1842(d); (12) Federal Deposit Insurance Act, 12 U.S.C. §§ 1811-1832; (13) Federal Reserve Act, 12 U.S.C. §§ 221-552; (14) Federal Saving and Loan Insurance Corporation Act, 12 U.S.C. §§ 1724-1730(f); (15) Financial Institutions Regulatory and Interest Rate Control Act of 1978, P.L. 95-630; (16) Garn-St. Germain Depository Institutions Act of 1982, P.L. 97-320; (17) Glass-Steagall Act of 1933, 12 U.S.C. §§ 24, 377, 378, and 78; (18) Home Owners Loan Act of 1933, 12 U.S.C. §§ 1461-1470; (19) McFadden Act, 12 U.S.C. § 36; (20) National Bank Act, 12 U.S.C. §§ 21-215b; (21) Savings and Loan Holding Company Act, 12 U.S.C. § 1730a; and (22) Thrift Institutions Restructuring Act, Title III, P.L. 97-320.

agencies. 4/ Each department or agency is essentially independent, has differing statutory obligations, and even may operate at cross-purposes at times. For example, a primary objective of bank regulatory authorities is the preservation of public confidence in banks. Full disclosure is the primary objective of the Securities and Exchange Commission, even if the disclosure is negative and damages a particular entity. When publicly-owned banks become distressed, the potential for conflict between these objectives is readily apparent. 5/

Our existing legal framework is based on the assumption, held for fifty years, that commerical banking and investment banking should be clearly separated. This separation, or compartmentalization of functions, was a response to the 1929 Stock Market Crash and ensuing Depression and an effort to restore widespread confidence in the banking system. From 1913, when the Federal Reserve Act was enacted, to 1933, 13,502 banks in the United States failed. More bank failures occurred during that twenty year period than the number of banks existing in the United States today. From 1929 to 1933, more than 9,900 banks failed. 6/ I believe that this record of bank failures is an uniquely American experience.

4/ (1) Board of Governors of the Federal Reserve System; (2) Department of the Treasury, including the Office of the Comptroller of the Currency; (3) Federal Home Loan Bank Board and Federal Savings and Loan Insurance Corporation (same members); (4) Federal Deposit Insurance Corporation ("FDIC"); and (5) Securities and Exchange Commission ("SEC").

5/ Address by Commissioner Treadway, "A Seamless Web: Banks, New Activities and Disclosure" (Sept. 29, 1983) (*See* Attachment A).

6/ I do not mean to suggest that securities activities were the sole cause of bank failures. For example, the National City Bank, discussed *infra*, did not fail, notwithstanding its extensive securities business. Indeed, it has since become one of the largest banks in the world. Over the years, a number of economists and bankers have argued that most of the bank failures between 1921-1931 resulted from small, mismanaged, undercapitalized, poorly supervised rural banks. That argument is frequently voiced today as a justification for allowing banks to engage in broader activities, including underwriting equity securities issued by corporations.

During the 1920's, many large commercial banks set up securities affiliates. The banks indirectly financed the affiliates and bank employees frequently recruited public investors for issues of speculative corporate securities underwritten by the securities affiliates. These issues thus effectively were underwritten by the banks. The banks became even more closely linked financially to the issuers of such securities as banks made loans to such issuers, sometimes ill-advised, to shore up the prices of the securities underwritten. In 1929 the affiliates and the banks collapsed like houses of cards, triggering a nationwide run on bank deposits.

National City Bank is a prime example of the aggressive securities activities engaged in by banks. In 1911 the bank caused the incorporation of the National City Company, technically a legally separate securities investment company. All of National City's capital was advanced by the bank, however, and shareholders of the bank were urged to invest in the new firm. But this was not an exercise in corporate democracy, for a shareholders' agreement placed voting control in three senior officers of the National City Bank. In fact, bank shareholders could not even sell their nonvoting shares in National City without simultaneously selling their shares in the bank. One observer wrote that National City Bank and National City Company were "like one body with two heads." Another stated: "To consider an affiliated firm like the National City Company independent [of the bank] was 'a masterpiece of legal humor.'" 7/

In 1916 Charles E. Mitchell became President of National City Company and in 1929 Chairman of National City Bank, largely on the success of National City Company.

> In thirteen years Mitchell boosted a four-person office into the largest investment house in the country, complete with nineteen hundred employees, sixty-nine branch offices, a private wire stretching 11,300 miles, its own engineers, accountants, bookkeepers, policemen, and annual securities sales averaging over $1.5 billion per year. To accomplish this, Mitchell simply ignored time honored banking practices. 'Instead of waiting for investors to come,' an admiring business executive wrote, 'he took young men and women, gave them a course of training on the sale of securities, and sent them out to find the investors. Such methods, pursued with such vigor and on such a scale were revolutionary.' To lure investors, the National City Company advertised extensively in national magazines, had its salesmen selling bonds door to door like Fuller brushs or Hoover vaccum cleaners or

---

7/ Seligman, The Transformation of Wall Street 24 (1982).

> clerking in brightly lit downtown securities offices. 'To keep the salesmen on their toes,' Mitchell's headquarters sent out a daily stream of demands, pep talks, and inducements known as 'flashes.' The most welcome flashes offered cash prices to the salesman who earned the most points selling a list of hard-to-move securities. When sales lagged, Mitchell displayed a harsher side. 'I should hate to think,' he once telegraphed, 'there is any man in our sales crowd who would confess to his inability to sell at least some of any issue of either bonds or preferred stock that we think good enough to offer. In fact, this would be an impossible situation and in the interest of all concerned, one which we would not permit to continue.' 8/

The Banking Act of 1933 generally, and its Glass-Steagall provisions in particular, 9/ were designed to promote the safety and soundness of banks and to encourage depositor confidence. Banks simply were barred from activities perceived to

---

8/ *Id.* at 24-25.

9/ The Glass-Steagall Act substantially restricted the involvement of national banks in securities and investment banking activities, both directly or through affiliates. It also prohibited persons in the investment banking business from receiving deposits.

Section 16, 12 U.S.C. § 24(Seventh), limits the power of national banks to enter into securities transactions, as follows:

> The business of dealing in securities and stock by [banks] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the accounts of, customers, and in no case for [their] own account, and [banks] shall not underwrite any issue of securities of stock.

Section 16 also authorizes a national bank to purchase "investment securities," but not shares of stock, for its own account, subject to certain limitations and restrictions, but contains an important exception:

> The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States or general obligations of a State or of any political subdivision thereof . . . .

(footnote continued)

be too troublesome or risky. With certain minor exceptions, banks were forbidden to underwrite or deal in investment securities and generally were permitted to conduct only those activities necessarily incidental to banking. Interest was prohibited on demand deposits, interest rates on time deposits were regulated, federal bank examiners were given additional powers, and federal deposit insurance was created. In exchange, however, banks were given a virtual monopoly on certain activities, principally that of accepting demand deposits.

Potential depositors thus were assured that the likelihood of anything adverse happening to banks was remote and that deposits nevertheless were insured in the unlikely event that a bank failed. Whatever its merits or weaknesses, this approach has clear "protectionist" aspects. Yet, nothing in either the statutory provisions or legislative history of the Banking Act of 1933 suggests a concern for securities firms or an intent to confer upon them any special, protected status. The sole purpose of this regulatory scheme was to protect banks and depositors, not, as some have mistakenly assumed, to insulate securities firms from competition by banks.

The separation of "banking" and "commerce" was reaffirmed in 1956 when Congress enacted the Bank Holding Company Act, subsequently amended in 1966 and 1970. That Act allowed bank holding companies to diversify only into businesses the Federal Reserve Board deemed to be "closely related to banking," such as leasing, mortgage banking, and consumer finance. Even this leeway, however, preserves the concept that banks should be restricted in their business activities and should not engage in "commerce."

9/ (footnote continued)

Section 20, 12 U.S.C. § 377, prohibits banks from participating in securities transactions through affiliates. It provides that:

> No [national bank or member of the Federal Reserve System] shall be affiliated . . . with [any business entity] engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.

Section 21, 12 U.S.C. § 378, prohibits:

> [any organization] engaged in the business of issuing, underwriting, selling, or distributing . . . securities, [from engaging] at the same time to any extent whatever, in the business of receiving deposits. . . .

This mandated separation of functions has resulted in firms operating in prescribed niches. But compartmentalization also may be partially due to traditional patterns of conducting business and voluntary line-of-business preferences of the firms themselves, as well as customers who accepted the notion of acquiring different financial services from different purveyors. 10/

This division of functions resulted, at least until recent times, in the following:

- Commercial banks, regulated principally by the Federal Deposit Insurance Corporation, Federal Reserve Board, and Comptroller of the Currency, accepted demand, passbook, and time deposits and made loans to business and non-business consumers;

- Thrift institutions, comprised mostly of savings and loans and savings banks and regulated principally by the Federal Home Loan Bank Board and Federal Savings and Loan Insurance Corporation, accepted only passbook and time deposits, paid slightly higher interest rates than commercial banks, and principally made loans to finance the purchase of housing;

- Insurance companies, regulated almost exlusively by the states, received premiums and paid life, casualty, and property claims or met annuity needs; and

- Investment banking and securities brokerage firms, regulated principally by the Securities and Exchange Commission, underwrote all types of debt and equity securities, provided all manner of markets for the products they underwrote, and were the members of organized securities exchanges. 11/

In recent years, a variety of factors, including inflation, high interest rates, the need to acquire new sources of capital, deregulatory initiatives in other countries' financial markets, and technological advances in communications and computers have stimulated financial service providers to cross traditional boundaries. This has tested the limits of statutes and regulations as never before and rendered obsolete the once staid image of banking. One observer has remarked:

10/ *See* House Report at 6.

11/ *Id.*

> Banking [in the 1960's] was essentially risk-free, highly regulated, respectable and dull. Today it is risky, aggressive, innovative and exciting. In large part, this change is due to immense forces in world markets that fractured the international monetary system, sent energy costs, interest rates and prices soaring, put microchips and plastic cards in place of tellers and turned formerly docile passbook savers into floating-rate gymnasts. 12/

Permitted and Forbidden Bank Involvement in the Securities Industry 13/

General Scope of Bank Securities Activities

As a general proposition, in terms of securities activities, banks in the United States today can:

- organize and manage common and commingled trust funds, forms of pooled investment vehicles;
- engage in retail discount securities brokerage in an agency capacity, at least through a separate subsidiary of a bank holding company;
- arrange for the private placement of securities, render advice with respect to mergers and acquisitions, and conduct other investment banking type services; and

---

12/ Stabler, "Wriston Set Off an Avalanche in a Glacier-Like Industry," Wall St. J., Aug. 30, 1984, at 18.

13/ For a more complete treatment of these and other related issues, *see* Goelzer, Rosenblat and Schaffer, "The Wall That Fell Down Flat -- The Convergence of the Banking and Securities Industries," June 4, 1984, and Pitt and Williams, "The Unified Financial Services Industry: Statutory and Regulatory Framework and Current Issues in the Banking/Securities Arena" (Outline Prepared for Commerce Clearing House - Federal Bar Association Mutual Funds and Investment Management Conference, Palm Springs, California, March 20-24, 1983).

- by virtue of a recent administrative ruling by the Comptroller of the Currency, 14/ organize and manage pooled funds composed of the assets of individual retirement accounts. 15/

As a general proposition, in terms of securities activities that are forbidden, today U.S. banks cannot:

- underwrite or deal in corporate debt or equity securities;
- underwrite or deal in municipal revenue bonds (although they can underwrite and deal in general governmental obligations);
- sponsor and underwrite mutual funds; or
- engage in insurance activities, except to a very limited extent.

Underwriting Third Party Commercial Paper

In 1978 Bankers Trust Company, a state-chartered member bank of the Federal Reserve System, began marketing commercial paper issued by several of its corporate customers, acting only in an agency capacity. The Securities Industry Association ("SIA"), a trade association of securities broker-dealers, and a broker-dealer petitioned the Federal Reserve Board to rule that Bankers Trust's activities were unlawful. The petitioners focused on provisions of the Glass-Steagall Act which bar commercial banks from the "business of dealing in securities and stock" 16/ and prohibit any person "engaged in the business of issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes, or other securities" from receiving deposits. 17/

14/ Decision of the Comptroller of the Currency on the Application by Citibank, N.A., Pursuant to 12 C.F.R. § 9.18(c)(5) to Establish Common Trust Funds for the Collective Investment of Individual Retirement Account Trusts, [1982-1983] Fed. Banking L. Rep. (CCH) ¶ 99,339 at 86,363 (Oct. 12, 1982).

15/ A recent court decision has overruled the Comptroller's decision with respect to two banks' activities. See p. 19 infra.

16/ 12 U.S.C. § 24.

17/ 12 U.S.C. § 378.

In September, 1980 the Federal Reserve Board ruled that Bankers Trust's activity did not violate the Glass-Steagall Act, reasoning that commercial paper was not a "security" for purposes of the Glass-Steagall Act. The Board viewed commercial paper as functionally more similar to a traditional commercial bank loan than to an instrument issued in an investment transaction, notwithstanding that the Securities Act of 1933 expressly defines commercial paper as a security. 18/

The petitioners sued the Federal Reserve Board, seeking a reversal. The Securities and Exchange Commission participated in the case, _amicus curiae_, urging at the District Court level that the term "security" in the Glass-Steagall Act be construed to have the same meaning as the term "security" in the Securities Act of 1933 (which was enacted within twenty days of the Glass-Steagall Act and emanated from the same Senate Committee), which includes commercial paper. The District Court ruled that the Federal Reserve Board erred in deciding that commercial paper is not a "security" under the Glass-Steagall Act. 19/

In November, 1982 the Court of Appeals reversed the District Court's decision, 20/ essentially adopting the Federal Reserve Board's "functional analysis" which led it to conclude that the term "security" in the Glass-Steagall Act did not encompass commercial paper and that "security" in the Glass-Steagall Act does not mean the same as in the Securities Act. That left Bankers Trust free to continue its commercial paper activities.

On June 28, 1984 the Supreme Court reversed the decision of the Court of Appeals. 21/ The Court rejected the "functional analysis," which the Court found focused entirely on the nature of the financial instrument rather than the bank's role in the transaction. The Court concluded that such an analysis was erroneous in that it "misapprehends Congress' concerns with commercial bank involvement in marketing securities." 22/ The Court observed that Congress was concerned "that a bank's

---

18/ 15 U.S.C. § 77b(1).

19/ _A.G. Becker, Inc. v. Board of Governors of the Federal Reserve System_, 519 F. Supp. 602 (D.D.C. 1981).

20/ _A.G. Becker, Inc. v. Board of Governors of the Federal Reserve System_, (D.C. Cir., Nov. 2, 1982); [1982] Fed. Sec. L. Rep. (CCH) ¶ 98,850 at 94,381.

21/ _Securities Industry Association v. Board of Governors of the Federal Reserve System_, No. 82-1766 (June 28, 1984).

22/ Slip op. at 16.

'salesman's interest' in an offering 'might impair its ability to function as an impartial source of credit'" 23/ and that "banks might use their relationships with depositors to facilitate the distribution of securities in which the bank has an interest, and that the bank's depositors might lose confidence in the bank if the issuer should default on its obligations." 24/ In short, a commercial bank's underwriting of third party commercial paper raised all the concerns that led Congress to enact the Glass-Steagall Act.

> By giving banks a pecuniary incentive in the marketing of a particular security, commercial-bank dealing in commercial paper also seems to produce precisely the conflict of interest that Congress feared would impair a commercial bank's ability to act as a source of disinterested financial advice. 25/

While finding that commercial paper was a "security" under the Glass-Steagall Act, the Court declined to decide whether Bankers Trust's agency activity in marketing the commercial paper constituted "underwriting" prohibited by the Glass-Steagall Act. The Court remanded the case for a determination of this issue. Bankers Trust has publicly stated that it does not believe its commercial paper activities constitute "underwriting," and the SIA has vowed further litigation if the activity continues.

Bank Discount Brokerage Activities

BankAmerica Acquisition of Schwab

Also on June 28, 1984 the Supreme Court affirmed the Federal Reserve Board's decision to allow BankAmerica Corp., a bank holding company and the parent of Bank of America, to acquire Charles Schwab & Co., a retail discount broker registered with the Securities and Exchange Commission as a broker-dealer. 26/ The SIA alleged that the acquisition violated both the Bank Holding Company Act, which prohibits acquisitions by bank

---

23/ *Id.* at 17.

24/ *Id.*

25/ *Id.* at 18.

26/ *Securities Industry Association v. Board of Governors of the Federal Reserve System*, No. 83-614 (June 28, 1984).

holding companies of businesses not "closely related" to banking, and the Glass-Steagall Act, which prohibits a bank from being affiliated with companies "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities. 27/

The Federal Reserve Board determined that a discount brokerage business "essentially confined to the purchase and sale of securities for the account of third parties, and without the provision of investment advice to the purchaser or seller" was "closely related" to banking. 28/ Such an activity is thus permitted by the Bank Holding Company Act to subsidiaries of bank holding companies. The Board further determined that Schwab, which confines its business to retail discount securities brokerage and acts in an agency capacity only, is not principally engaged in activities forbidden under the Glass-Steagall Act to affiliates of banks (i.e., the issue, flotation, underwriting, public sale, or distribution of securities).

The Supreme Court found that the Federal Reserve Board had persuasively "articulated the ways in which the brokerage activities provided by Schwab were similar to banking [including the long history of banks providing] as an accommodation to their customers, brokerage services that are virtually identical to the services offered by Schwab." 29/ The Court also upheld the Board's determination that the public interest served by BankAmerica's acquisition of Schwab outweighed any possible adverse effects, noting that the public would benefit from increased competition and that the acquisition would not result in undue concentration of resources or have other unfavorable effects.

The Court noted that Congress sought, by adopting the Glass-Steagall Act, to limit commercial banks' securities activities, to ensure bank solvency, to protect bank depositors, and to maintain public confidence in banks. The Court found that Schwab's brokerage services did not present any of these dangers. Schwab trades only as an agent and thus lacks a salesmen's interest in the value of the security sold, deriving profit solely from the volume of sales.

27/ 12 U.S.C. § 377.

28/ Slip op. at 4-5.

29/ Slip op. at 4.

Securities and Exchange Commission Proposed Rule 3b-9

The Securities and Exchange Commission has also addressed bank discount brokerage activities from its regulatory perspective. On November 8, 1983 the Commission promulgated for public comment proposed Rule 3b-9, which may be one of the most controversial rules ever proposed by the Commission. The rule specifies certain bank securities activities that must be performed through broker-dealers registered with the Commission under the Securities Exchange Act of 1934. Thus, if a bank engages in the specified activities, it would have to register with the Securities and Exchange Commission as a broker-dealer or transfer those activities to a separate corporate subsidiary that would so register.

When the Securities Exchange Act of 1934 was passed, Congress excluded banks from the definitions of "broker" and "dealer." 30/ Yet, as the SEC observed in proposing Rule 3b-9, the services offered today by banks have significantly changed from the limited accommodation functions performed in 1934, including extensive advertising and the proposed offering

---

30/ Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 define the terms "broker" and "dealer." Section 3(a)(4) provides that:

> The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.

Section 3(a)(5) provides that:

> The term 'dealer' means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

However, the definitions in the Exchange Act are expressly qualified by the phrase "unless the context otherwise requires." Accordingly, this "exclusion" may be limited. For example, the Supreme Court, in construing another of the statute's defined terms, "security," has made clear that economic reality, not literalism, governs. *See*, *e.g.*, *Marine Bank v. Weaver*, 102 S.Ct. 1220 (1982); *United Housing Foundation v. Forman*, 421 U.S. 837 (1975).

of combined investment advice and brokerage services. 31/ The SEC questioned whether the bank exemption from broker-dealer registration was an absolute exemption or whether certain securities activities should be required to be performed through a broker-dealer registered with the SEC to assure adequate investor protection and reasonably complete and effective regulation of the securities markets.

Under the proposed rule, the activities that would require broker-dealer registration are:

(1) the public solicitation of brokerage business;

(2) receipt of transaction-related compensation for providing brokerage services for trust, managing agency, or other accounts for which the bank provides advice; or

(3) dealing in or underwriting securities other than exempted or municipal securities.

More than 200 commentators responded to this proposal. The great majority are banks, who uniformly oppose the rule. Bank regulators likewise are unenthusiastic, viewing this as unnecessary jurisdictional expansion on the part of the SEC. On the other hand, the Department of Justice, the Securities Industry Association, the Investment Company Institute, and a number of securities firms support the rule strongly. The Commission has not yet acted on the proposed rule.

The Comptroller of the Currency, on April 16, 1984, proposed a rule that would require national banks to conduct certain securities brokerage activities through operating subsidiaries registered with the Commission. The Comptroller's proposal would require that brokerage activities be conducted through a subsidiary if:

(1) a bank made margin loans to its brokerage customers; or

(2) a bank held customer securities other than as an introducing broker on a fully disclosed basis.

In addition, national banks providing retail customers with "individualized" investment advice together with brokerage services, for which a separate, transaction-related fee was charged, would be required to conduct such activities through a subsidiary.

31/ Securities Exchange Act Release No. 20357 (Nov. 8, 1983) ("This action is prompted by investor protection and other regulatory concerns raised by the recent expansion of bank securities activities.").

The virtue of a separate subsidiary, whether as proposed by the SEC or the Comptroller, is that it facilitates functional regulation, for all who act as broker-dealers would be regulated consistently and by the same regulatory body. The neatness of functional regulation does not resolve, however, the question of how much risk the separate subsidiary should undertake. Gerald Corrigan, President of the Federal Reserve Bank of Minneapolis (and soon-to-be President of the Federal Reserve Bank of New York), has been quite outspoken on the virtues of a continued separation of banking and commerce and has criticized those who argue that housing expanded activities in a separate legal entity insulates banks from risk.

> It does not follow . . . that we can be indifferent as to the degree of risk associated with such activities simply because they may be housed in a separately organized and separately capitalized subsidiary of a bank holding company. To the contrary, experience suggests rather clearly that in times of peril it may not be possible to insulate the bank from the problems of its sister organizations -- even when such problems arise in affiliated organizations, including subsidiaries of bank holding companies. 32/

"Non-bank" Banks

Another recent controversial development in the United States involves the acquisition of "limited purpose" banks by non-depository institutions. In recent years, commercial firms and traditional securities and advisory firms have increasingly viewed banking as a desirable activity, partly as a competitive response to the incursion by banks into areas perceived by many as the traditional securities business.

The most obvious way to compete was to acquire or form a bank subsidiary. But the Bank Holding Company Act was previously thought to be a practical barrier to such acquisitions. Bank holding companies are extensively regulated by the Federal Reserve Board and, as a general matter, are prohibited from engaging in non-banking activities or owning non-banking related subsidiaries. The Bank Holding Company Act thus generally prevents a non-banking company from acquiring a bank without relinquishing non-banking activities.

32/ Corrigan, "Are Banks Special?," Federal Reserve Bank of Minneapolis, 1982 Annual Report 18 (1982) (*See* Attachment B).

Several non-banking companies nonetheless recently have acquired banks but avoided registration under the Bank Holding Company Act. This seemingly odd result can occur because of legal ingenuity and the definition of "bank" under the Bank Holding Company Act. The Act defines a "bank" as "any institution . . . which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans." 33/ A "bank holding company" is any company that controls a "bank." If the acquiror causes the bank to divest its commercial loan portfolio simultaneously with the acquisition, the acquired bank no longer is a "bank" for purposes of the Bank Holding Company Act. Such banks are known euphemistically as "non-bank banks," for they can continue to perform many traditional banking functions, including accepting demand deposits.

Gulf & Western Corporation began this trend by acquiring the Fidelity National Bank. Others soon followed. In October, 1982 Dreyfus Corporation, a money management firm, announced its intention to acquire the Lincoln State Bank of New Jersey. The acquisition was subject to the regulatory approval of only the Federal Deposit Insurance Corporation, provided the acquisition did not cause Dreyfus to become a bank holding company. If it did, the Federal Reserve Board's approval also would be needed. Dreyfus structured the transaction so that Lincoln Bank would divest its commercial loan portfolio and cease making commercial loans immediately upon the acquisition. Dreyfus contended that Lincoln Bank no longer would be a "bank" under the Bank Holding Company Act; therefore, Dreyfus did not become a bank holding company. The FDIC approved the acquisition over strong objections by the Federal Reserve Board.

Dreyfus also applied in October, 1982 to the Comptroller of the Currency for permission to organize a new national bank to be known as "Dreyfus National Bank." Dreyfus plans to use this "bank" to facilitate its employee benefit and retirement plan business, but does not intend for the bank to accept demand deposits or make commercial loans. The Federal Reserve Board again protested that granting such a banking charter would violate the Glass-Steagall Act. The Comptroller rejected these contentions.

On April 5, 1983, however, the Comptroller, in a letter to the Chairmen of the House and Senate Banking Committees, announced a limited moratorium on the chartering of new national "non-bank" banks, in order to permit congressional debate on this subject. The moratorium expires at the end of the 1984 session of Congress.

33/ 12 U.S.C. § 1841(c).

The Federal Reserve Board has recently moved to eliminate "non-bank banks" by proposing to redefine "bank" under the Bank Holding Company Act. The proposed rule would define a "bank" as an institution that (1) accepts demand deposits, and (2) engages in the business of commercial loans, which the Federal Reserve Board defines as any loan other than a loan to an individual for personal, family, household, or charitable purposes. It includes the purchase of commercial paper, certificates of deposit, bankers' acceptances and similar money market instruments, the extension of broker call loans, the sale of federal funds, and the deposit of interest-bearing funds. The rule would effectively require otherwise exempt bank holding companies to register under the Bank Holding Company Act or divest themselves of the bank subsidiary. 34/

Common Trust Funds for the Collective Investment of Assets of IRAs

The Comptroller of the Currency has approved the applications of three national banks, Citibank, Wells Fargo Bank, and Bank of California, to establish common trust funds for the collective investment of individual retirement accounts ("IRAs"). Each bank proposed to act as trustee of the individual IRAs, and as trustee, to invest the IRA assets in a common trust fund or funds maintained by the bank. Each bank proposed to perform the functions of investment adviser, administrator, custodian, and transfer agent of the funds. The Comptroller found that the operation of such a common trust fund was a traditional and permissible fiduciary activity of banks entirely consistent with the Glass-Steagall Act. The Comptroller stated that such fiduciary services did not present the hazards and potential abuses Congress sought to eliminate by the Glass-Steagall Act. 35/

34/ Revisions to Reg. Y, 49 FR 794 (Jan. 5, 1984) (to be codified at 12 C.F.R. § 225.2). On September 24, 1984 a U.S. Court of Appeals set aside the rule and ordered the Board not to "attempt to enforce or implement" it. Dimension Financial Corp. v. Board of Governors of the Federal Reserve System, No. 83-2696, slip op. at 22 (10th Cir. Sept. 24, 1984).

35/ All of these funds have registered with the Commission under the Investment Company Act of 1140, and participations in the fund have been registered under the Securities Act of 1933. The Comptroller, however, took issue with the SEC's position that no exemption was available from registration under the Securities Act or the Investment Company Act.

In August, 1984, however, a federal judge overturned the Comptroller's ruling as it applies to Wells Fargo and Bank of California. 36/ The Court found that the funds are not operated for bona fide fiduciary purposes and that their operation could involve the hazards the Glass-Steagall Act is intended to prevent. Relying on ICI v. Camp, 37/ in which the Supreme Court invalidated the collective investment of managing agency funds held by a bank, the Court defined the issue to be whether the assets commingled in the IRA funds were offered for a "true fiduciary purpose rather than for investment." The Court concluded that the funds were offered for investment purposes. The Court also disagreed with the Comptroller's conclusion that the Glass-Steagall Act hazards were not present, finding that, as pooled vehicles designed to compete with mutual funds, the funds could tend to create a greater "salesman's stake" than traditional common trust funds, especially when the amount of the bank's fee depended on the net asset value of the funds.

The ultimate effect of this initial ruling is unclear, except that more litigation assuredly will follow.

Other Ways For Banks To Engage In Discount Brokerage

Banks also have created or acquired discount brokerage firms as direct subsidiaries. This approach contrasts structurally with the BankAmerica-Schwab transaction, in which Schwab became a subsidiary of the bank holding company and a sister corporation of the bank. For example, Union Planters National Bank of Memphis ("Union Planters") received approval from the Comptroller to acquire the stock of Brenner Steed and Associates, Inc. ("Brenner Steed"), a discount broker, and to offer discount brokerage services through Brenner Steed at certain branch offices of Union Planters and at certain

---

36/ Investment Company Institute v. C.T. Conover, No. 84-0742 (N.D.Cal. Aug. 28, 1984). A decision is pending in a similar case brought by the Investment Company Institute against the Comptroller over the Comptroller's decision to allow Citibank to operate a collective trust fund for IRAs. Investment Company Institute v. Conover, No. 83-0549 (D.D.C.).

37/ ICI v. Camp, 401 U.S. 617 (1971).

affiliated banks both in Tennessee and out-of-state. 38/ Union Planters' brokerage activities would be separate from its banking activities. Brenner Steed would continue as a separate entity and would continue to be registered as a broker-dealer, subject to SEC regulation and oversight. In addition, Brenner Steed would continue to use fully qualified registered representatives to conduct its brokerage activities.

In November, 1983 a federal District Court reversed the Comptroller's decision in Union Planters. 39/ The Court upheld the Comptroller's determination that the Glass-Steagall Act permits national banks to operate discount brokerage subsidiaries, but held that an office of a national bank conducting brokerage business is a "branch" of the bank. Under the McFadden Act, 40/ the bank is subject to state law restrictions on establishing branch offices. The decision effectively limits the operation of a national bank's brokerage business to its home state. (Bank holding companies, however, are not subject to the McFadden Act's restrictions.)

Yet another variation was created by Security Pacific National Bank ("Security Pacific"). Security Pacific received the Comptroller's permission to establish an "introducing" broker relationship with Fidelity Brokerage Services, Inc. ("Fidelity"), a registered broker-dealer. 41/ Security Pacific's brokerage business is limited to buying and selling securities as agent for its customers, without providing investment advice. The brokerage business is conducted by bank employees in a separate office of Security Pacific. Fidelity provides back-office services, including clearing and execution of trades, custody of securities, and margin financing. Fidelity pays Security Pacific based on the volume of transactions.

38/ See Decision of the Comptroller of the Currency, Sept. 20, 1982.

39/ Securities Industry Association v. Comptroller of the Currency, No. 82-2865 (D.D.C. Nov. 2, 1983).

40/ The McFadden Act, 12 U.S.C. § 36, passed in 1927, limits banks' ability to open branch offices across state lines (or outside home counties or cities, in some cases) unless permitted by state law.

41/ See Decision of the Comptroller of the Currency, Aug. 26, 1982.

"Networking" arrangements also have been used by depository institutions to enter the discount brokerage business. Under networking arrangements, a registered broker-dealer agrees to perform brokerage services in a physically segregated area of a bank or thrift institution. The operation and conduct of the brokerage services are fully subject to the securities laws.

A group of savings and loan associations pioneered the networking arrangement by forming a jointly-owned registered broker-dealer subsidiary, Savings Association Investment Securities, Inc., now known as Invest. SAIS/Invest acts as an "introducing" broker, effecting transactions in an agency capacity only and not carrying customer accounts or holding funds or securities for customers. SAIS/Invest does not purchase or sell securities for its own account or underwrite securities, although it will offer its customers advice, research materials, and recommendations. Association employees are qualified registered representatives of SAIS/Invest and work under the supervision of fully qualified SAIS/Invest principals. SAIS/Invest's activities are subject to SEC regulation and oversight. The SAIS/Invest proposal was approved by the Federal Home Loan Bank Board on May 6, 1982. Savings and loan associations with no ownership interest in SAIS/Invest can contract with SAIS/Invest to provide brokerage services on their premises.

The SIAS/Invest arrangement raised special issues under the securities laws. Savings and loan associations are not "banks" and thus do not qualify for the "bank exemption" from the definition of "broker" discussed previously in connection with proposed Rule 3b-9. 42/ An association thus is required to register as a broker-dealer if it engages in certain activities, such as advertising its brokerage service, sharing commissions, and assisting customers in opening brokerage accounts.

The SEC nonetheless authorized its Division of Market Regulation to issue SAIS/Invest a no-action letter 43/ to the effect that the savings and loan associations whose employees carry out brokerage functions as registered representatives of

---

42/ There is no separate exemption for savings and loan associations.

43/ A no-action letter is one in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated. In some instances, the staff will state in response to a no-action request that it is unable to assure the writer that it will not recommend enforcement action to the Commission if the transaction occurs in the manner proposed by the writer. *See* Securities Act Release No. 6253 (Oct. 28, 1980).

SAIS/Invest would not be required to register as broker-dealers under the Securities Exchange Act of 1934. The key elements of the SAIS/Invest arrangement upon which the Commission relied in issuing the no-action letter are:

- the brokerage services will be offered by a registered broker-dealer;
- the employees accepting orders and delivering securities will be registered representatives employed by the broker-dealer;
- the brokerage services will be physically segregated from other business activities of the savings and loan associations;
- the broker-dealer will have supervisory responsibility for the activities of the registered representatives and responsibility for regulatory compliance;
- locations of SAIS/Invest will be subject to SEC and self-regulatory organization inspection;
- bookkeeping and accounting for the brokerage services, including confirmations and account statements, will be the responsibility of SAIS/Invest; and
- advertising will be the responsibility of SIAS/Invest.

Practically, the direct involvement in and responsibility for the brokerage activities principally would be that of SAIS/Invest, and the associations' direct involvement in such activities accordingly would be limited.

Investment Adviser Subsidiaries of Banks

In September, 1983 the Comptroller authorized American National Bank of Austin, Texas to create an investment advisory subsidiary which will register as an "investment adviser" under the Investment Advisers Act of 1940. 44/ The Comptroller

---

44/ Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish An Operating Subsidiary to Provide Investment Advice, Sept. 2, 1983.

ruled that investment advisory activity, conducted through a bank subsidiary, does not contravene the Glass-Steagall Act.

Standing alone, that decision is not profound. Yet in March, 1983 the Comptroller authorized American National to establish a subsidiary to conduct discount brokerage activities. The investment adviser and discount broker subsidiaries will share the same name, be located at the same address, and coordinate other activities. The decision thus is significant in that it authorizes the combining of banking, brokerage, and investment advisory services under one corporate umbrella. Yet, one of the factors emphasized by both the Federal Reserve Board and the Supreme Court in the BankAmerica-Schwab case was that no investment advice was being offered.

As a result of the American National decision, major U.S. banks, including Citibank and First National Bank of Chicago, have begun providing investment advice to their discount brokerage customers through programs available from third-party research organizations such as Standard & Poor's and Value Line. First Chicago also is evaluating a system that flashes investment advice across a television screen that would be placed in bank lobbies. 45/

Political Implications Arising From Continental Illinois National Bank and Trust Company

Undeniably, the erosion of barriers between banking and securities has been substantial. Even if economic logic and legal ingenuity seem destined to continue the trend, political reality cannot be ignored. Looming over all these developments is the collapse of Continental Illinois Bank and Trust Company. The federal rescue package for Continental, the eighth largest commercial bank in the United States, has made abundantly clear the intention of our federal government to maintain confidence in the American banking system. The federal rescue, which guaranteed insurance of all deposits, including those over the $100,000 per account limit, gave the Federal Deposit Insurance Corporation the right to hire and fire management. That power subsequently was exercised.

In recent testimony before the House Banking Committee on the Continental rescue, C. Todd Conover, the Comptroller of the Currency, acknowledged that the federal government currently will not allow any of the nation's eleven largest banks to fail. Under the Comptroller's regulatory system, these eleven banks are supervised as a separate group. Predictably, some criticized

---

45/ 8 Bank Letter No. 33, at 1 (Aug. 20, 1984).

this apparent regulatory double-standard; some Congressmen remarked that the federal government had created a new species of bank: the "TBTF" bank, for "Too Big To Fail." Conover defended the concept as necessary to avert a national, if not an international, financial crisis. 46/

The long-term question is whether the Continental Illinois bailout, considered by many *de facto* nationalization of a major bank, will produce a political reaction that will erase some of the integration of the banking and securities industries which has occurred over the past several years and undermine banks' broader quests for more powers.

Insurance

The insurance industry also is a major provider of financial services in the United States. Inflation, high interest rates, and technological advances have subjected the insurance industry to the same competitive pressures that banks and securities firms face. The pace of change since has accelerated, as a recent cover story in *BusinessWeek* entitled "Upheaval in Life Insurance," illustrates. 47/ New, investment-oriented policies are replacing traditional whole-life insurance policies. Many insurance companies have added mutual funds, limited partnerships, and other securities to their product mix. Others have acquired money management firms and securities brokerage firms. The most significant acquisition is Prudential Insurance Co.'s 1981 purchase of Bache for $385 million. The day "is fast arriving when every insurance agent must have a personal computer and a license to sell securities." 48/ One insurance executive recently stated: "It is not the life insurance business anymore. It's the investment business." 49/

46/ Wall St. J., Sept. 20, 1984, at 2.

47/ *BusinessWeek*, June 25, 1984, at 58.

48/ *Id.* at 60.

49/ *Id.* at 59.

In stark contrast to the banking and securities industries, insurance industry regulation in the United States is left largely to the states. Under the McCarran Act, 50/ Congress declared that state regulation of insurance was in the public interest and that the business of insurance "and every person engaged therein" was subject to state law. There is no statutory barrier to insurance-securities firms combinations, such as that imposed by the Glass-Steagall Act between banks and securities firms. In order to sell some of the new products, however, an insurance agent must be licensed by the National Association of Securities Dealers and operate under the supervision of a registered broker-dealer. That is another reason why many insurance companies have sought links with stock brokerage houses, either through outright acquisition or joint ventures.

In an attempt to compete with banks, Metropolitan Life Insurance Co. has developed a set of "guaranteed" savings products competitively similar to federally insured bank accounts. These accounts include a "fully guaranteed" money market account and a "guaranteed interest certificate," similar to bank certificates of deposit. The guarantee of principal and interest is made by Metropolitan itself. Although insurance companies have traditionally offered guarantees of benefit payments on life insurance policies, annuities, and various pension products, the extension of the guarantee to savings accounts is new. In doing so, Metropolitan is trying to counter the banking industry's prime marketing tool, the aura of safety that emanates from federal deposit insurance provided by the FDIC and the Federal Savings and Loan Insurance Corporation. 51/

Recent Legislative Proposals Potentially Affecting the Glass-Steagall Line

S. 1609

S. 1609 (a revised version of an original Treasury Department proposal) would allow banks to underwrite and deal in municipal revenue bonds and to sponsor, advise, and distribute mutual funds. It would also:

- Allow thrift institutions to establish holding companies in the same manner as bank holding companies and engage in the same new activities as bank affiliates;

50/ 15 U.S.C. §§ 1011-1015.

51/ Wall St. J., Aug. 28, 1984, at 12.

- Effectly require all banks and thrift institutions to conduct such activities through affiliates that are the subsidiaries of a parent holding company;

- Add insurance underwriting and brokerage activities and real estate investment development and brokerage activities to the list of permitted activities of bank holding company affiliates; and

- Prohibit the acquisition or formation of "non-bank" banks, but "grandfather" previous acquisitions of "non-bank" banks.

S. 1720

S. 1720, introduced in October, 1981, would amend the Glass-Steagall Act to permit banks to underwrite municipal revenue bonds and to sponsor, underwrite, and advise mutual funds. Chairman John Shad of the Securities and Exchange Commission testified as follows on the bill in 1981:

- The Commission has reservations about a piecemeal approach to amendments to the Glass-Steagall Act.

- Any amendments to the Glass-Steagall Act should take into account the lessons of history regarding conflicts of interest that led to serious abuses.

- The Commission supports the proposal that all expanded bank securities activities be carried out by means of bank holding company affiliates registered and regulated under the Securities Exchange Act of 1934. The Commission would add to the list, for banks which expand their securities activities, present bank activities such as general obligation municipal bond underwriting, dividend investment, employee stock and customer stock purchase plans as well as customer transaction services.

- While the Commission continues to have concerns about possible adverse effects on small regional broker-dealers, and in turn upon the capital-raising abilities of the corporations they serve, the Commission does not oppose bank entry into the business of underwriting and dealing in municipal revenue bonds, if the tax advantages currently available to banks are addressed by requiring all municipal securities underwriting to be carried out through securities affiliates.

- The Commission does not oppose bank sponsorship and underwriting of mutual funds, if banks and bank personnel who sell such shares are subject to the same regulatory scheme as broker-dealers who engage in the same activity.

- Banks which act as advisers to mutual funds should be subject to the provisions of the Investment Advisers Act. 52/

S. 2851

In November, 1983 Senator Garn introduced his own omnibus banking bill, the "Financial Institutions Competitive Equity Act." This bill was unanimously approved by the Senate Banking Committee on June 27, 1984, and Senator Garn will continue his efforts to have the bill enacted this year. 53/ S. 2851 would permit bank and thrift holding companies to sponsor and underwrite municipal revenue bonds, mortgage-backed securities, and commercial paper, and to engage in discount brokerage activities. The bill also closes the so-called "South Dakota loophole," under which South Dakota has authorized state-chartered subsidiaries of bank holding companies to conduct insurance activities, but only outside the State of South Dakota. Under S. 2851 a state could authorize banks to offer only those activities permissible under the Bank Holding Company Act. 54/

House of Representatives Proposals

Two principal bills have been introduced in the House of Representatives dealing with the integration of the financial services industry. The House Banking Committee approved H.R. 5916 on June 26, 1984, which would close the "non-bank bank" loophole and redraw a more traditional separation between

---

52/ Hearings before the Committee on Banking, Housing and Urban Affairs, United States Senate, 97th Cong., 1st Sess. on S. 1686, S. 1720 and S. 1721, Oct. 31, 1981, at 888.

53/ 43 Wash. Fin. Rep. (BNA) No. 7, at 255 (Aug. 13, 1984). On September 13, 1984 the Senate passed S. 2851 by a vote of 89-5. It is unclear what success the measure will have in the House of Representatives.

54/ Id.

banking and other lines of commerce. 55/ The bill redefines the term "bank" under the Bank Holding Company Act and would subject all state-chartered nonmember banks and thrift associations to the Glass-Steagall Act prohibitions against affiliations with securities firms. 56/

H.R. 5881 also would eliminate the "non-bank bank" exemption by prohibiting non-banking institutions from acquiring limited purpose banks without complying with the Bank Holding Company Act. The bill would subject all banks and thrift institutions to the Glass-Steagall Act and impose a three-year moratorium on decisions by bank regulators to give new financial or commercial powers to banks. The bill also contains a prohibition on banks offering certain discount brokerage activities, a provision not contained in H.R. 5916. 57/

Conclusion

As my remarks have emphasized, many developments in the United States are occurring as a result of litigation and *ad hoc* administrative agency decisions. To date, Congress has failed to provide clear guidance or leadership. Legislative activity is not totally lacking, but any consensus on these issues at the legislative level is lacking. The lack of a consensus among the various federal administrative agencies as to the proper regulatory approach compounds problems. Without that consensus, the courts will continue to play the pivotal role. That result alone -- setting policy by litigation -- may distinguish the United States from other countries.

Achieving internal consensus in the United States is not the end of the process. Internationalization of the world's financial markets continues apace. Recent articles have predicted that a dozen or so large securities houses will come to dominate the industry. 58/ One major British merchant bank, S.G. Warburg & Co., has announced plans to merge with three London securities firms. 59/ Citicorp is acquiring two British stock brokerage houses, pursuing its goal to be a world-wide financial services organization. 60/

55/ 43 Wash. Fin. Rep. (BNA) No. 1, at 3 (July 2, 1984).

56/ *Id*.

57/ 43 Wash. Fin. Rep. (BNA) No. 5, at 181 (July 30, 1984).

58/ Wall St. J., Aug. 23, 1984, at 26.

59/ *Id*.

60/ Wall St. J., Sept. 4, 1984, at 33.

A Merrill Lynch official recently stated: "Depending on how the changes are taking place in the U.K. regulatory environment, I could see a time when Merrill Lynch would be a member of the London Stock Exchange and a primary dealer in gilts [British government debt]." 61/ In addition, while American financial institutions are moving into the British market, some U.K. firms are looking at the U.S. Samuel Montagu & Co. recently announced the formation of a new unit in New York -- Samuel Montagu Capital Markets Inc. A Montagu managing director stated "[t]his is another building block in our efforts to establish a deeper and broader presence in the U.S. . . . . The new group will play a key role in our interest rate and currency swap business from the U.S." 62/ Montagu is, of course, 60% owned by Britian's Midland Bank PLC and 40% owned by Aetna Life & Casualty Company of Hartford, Connecticut.

Other U.S. firms are closely watching the situation. This trend poses a tremendous challenge for us. But even as each country modifies its internal regulatory structure, what regulatory problems will emerge as a result of the internationalization of these firms?

Obviously, international coordination will be most difficult until we arrive at our internal consensus. But the continuing internationalization of the financial markets dictates that more international cooperation on structural issues be addressed at the earliest possible time.

* * * * *

61/ Wall St. J., Aug. 23, 1984, at 26

62/ Id.

their notes for the little gold which existed, which they spirited out of France. To demonstrate that formal disclosure documents are not required for effective disclosure, as word spread that the gold might not be there, the trickle of redemptions became a torrent. Finally, one fine Summer day in 1720, the mob in the Bank was so dense that 15 people were crushed to death. Law's legacy to France was broken fortunes, ruined businesses and an enduring suspicion of banks.

This story illustrates the value of a sound banking system and a stable currency. But it also demonstrates that public confidence in a banking system can be a fragile thing and that progressively greater risk-taking can affect the bank itself, even if done indirectly and not by by the bank itself, and for the best of motives. The impact of disclosure is also eloquently demonstrated by the story. Full disclosure of the use of the proceeds of Law's offering may well have stopped the scheme before it got out of hand. On the other hand, such disclosure would have undermined public confidence in the Bank, the Bank would not have gotten off the ground, and the French economy would not have been rejuvenated, albeit briefly. Indeed, it was disclosure which shook public confidence and brought the Bank down.

Whatever answers the panelists may provide about the appropriate activities of banks, the appropriate level of risk to which they should be subjected, and the role and value of disclosure, we should at least acknowledge that an abiding conflict between safety and soundness regulation and full disclosure, and the question of the proper range of bank activities, have been with us at least 250 years, thanks to John Law. I started this morning by saying that my comments could be labelled a "once-upon-a-time" story. We all should join in the hope that the John Law story will remain a "once-upon-a-time" story.

As a keynote speaker, I have been afforded the luxury of philosophizing and posing questions without offering answers. Needless to say, I have fully availed myself of that luxury. I leave to our distinguished panelists the task of providing the hard answers. They are most qualified for the task.

* * * * * * *

ATTACHMENT A

NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

Keynote Speech to

Third Annual Seminar

SECURITIES ACTIVITIES OF BANKS

New York City, New York

September 29, 1983

A SEAMLESS WEB: BANKS, NEW ACTIVITIES AND DISCLOSURE

James C. Treadway, Jr.
Commissioner

The views expressed herein are those of Commissioner Treadway and do not necessarily represent those of the Commission, other Commissioners, or the staff.

A SEAMLESS WEB: BANKS, NEW ACTIVITIES AND DISCLOSURE

Once Upon a Time

Those with a liking for logic might suggest that we should start with a clear understanding of what a bank is before attempting to talk meaningfully about the expansion of bank securities activities and bank disclosure obligations, the topic of this two-day gathering. That's why my comments could be called a "once-upon-a-time" story. Once upon a time, when we were children, we all knew what a bank was. It was a ceramic, flowered pig where our pennies went for safekeeping. It had a limited function, that of safekeeping funds, and its integrity and inviolability were not subject to doubt. The fact that this flowered pig had only a limited function wasn't viewed as a shortcoming; in fact, it added to its special significance. As we grew older, our views did not change significantly. Pennies became dimes or quarters; perhaps the pig got bigger, or became a toy cash register or other mechanical device; but it remained essentially the same -- a totally safe place having a clearly defined and limited purpose.

When we grew old enough to take the money from the piggy bank to the local bank, our ideas remained relatively unchanged. The goal of safekeeping continued, with perhaps some modest idea of earning interest. But earning interest was almost an afterthought. Appropriately, the local bank was a solemn, serious place, with a Greek revival facade, much marble and hardwood in the interior, and an air much like that of a church. Safety continued to be the key characteristic, and the prominently displayed main vault underscored that characteristic. Perhaps we came to appreciate that only a select few of the most conservative and trustworthy citizens could acquire a charter, which made you a real bank.

But things generally are more complex than we perceive as children, and banking is no exception. But additional forces have been at work in the world of banking. Today, it's not always called banking, and certainly those who engage in it are not limited to persons having a charter formally denominating them as a bank. Instead, it's called the financial services industry, and its array of products baffles many customers and frequently the regulators. Now well-known is the transition from a simple mix of checking and savings accounts offered by depository institutions to NOW accounts, Super-NOW accounts, money market deposit accounts, money market certificates, repurchase agreements, reverse, retail, and overnight repurchase agreements, cash management service, and on down the line.

Non-depository institutions, such as Merrill Lynch, will take your money and invest it in money market funds, business development companies, insured savings accounts, certificates of deposit, and, even occasionally, old-fashioned stocks and bonds. Some of the investments you buy through Merrill Lynch are even covered by federal deposit insurance. And by no means does Merrill Lynch have a monopoly. American Express does international banking, issues credit cards and travelers' checks and, through Shearson/American Express Inc., provides full-line investment banking, money management, securities brokerage and commodities services. Sears, formerly a place to buy clothes and tools, now offers consumer credit through Sears, insurance through Allstate Insurance, real estate through Coldwell Banker, securities brokerage, commodities, investment banking and various money management services through Dean Witter Reynolds, and de facto banking through Allstate Savings and Loan. Little distinguishes these non-depository companies from banks, even though they lack a charter which denominates them a bank, they disclaim that they take deposits, and they engage in commerce in addition to "banking."

But, then, one might ask, "So what?" So it's difficult to tell what a bank is. Does it matter? Well, for one thing, only banks are supposed to accept "deposits," an activity Congress has declared to be affected with a public interest. And if banks have a monopoly on certain activities such as taking deposits, yet are precluded from others to assure that banks are operated safely and soundly and do not fail, the inescapable conclusion is that banks remain special, if not unique.

That is why the status of banks under the federal securities laws, whether the discussion focuses upon the permissible range of bank activities and the appropriate amount of diversification and risk-taking or upon disclosure issues, is so complex. And frustrating logical analysis is the fact that the issues of permissible range of activity and disclosure cannot be discussed as separate issues. Indeed, they are the proverbial two sides of the same coin. Developments on the structural front affect disclosure considerations. As disclosure becomes more accepted for banks and their affiliates, that may well lead to a cry for banks to have the authority to engage in yet a broader range of activities. That is my principal thought for today.

We all have heard various calls for changes in the regulatory structure to permit banks to compete with other financial service providers. "Level playing field," a catchy phrase now shop-worn, remains the goal of many. But the old tension between two firmly--entrenched regulatory schemes -- one adopted for banks and having a "protect-the-enterprise-and-system" theme, and the other having a full disclosure and "protect-the-investor, even at the expense of the enterprise" theme -- interfere with creating that level playing field. Seemingly missing is a full appreciation of the extent of that tension and conflict. Some reason that banks should be free to compete and take risks, but that banks nonetheless are special and must be protected. Yet that reasoning undermines efforts to make logical decisions about the proper range of bank activities and appropriate disclosure requirements.

Protectionism and Disclosure

From 1933 to at least recently, any discussion of banking regulation was on shaky conceptual ground if it did not recognize that, first, last and always, came the safety and soundness of the banking system. Public interest demanded it. History demonstrates why. Between 1820 and 1930, our economy was characterized by successive cycles of growth, boom, speculative frenzy, and financial panic and bust. During a panic, any hint of instability in a bank led to a run and frequent collapse of the bank, as depositors withdrew their money. From 1913, when the Federal Reserve Act was adopted, through 1933, 15,502 U.S. banks failed, more than all banks existing today. From 1929 to 1933 alone, more than 9,000 banks collapsed. Little wonder that Congress adopted the Banking Act of 1933 and established the Federal Deposit Insurance Corporation.

Federal deposit insurance promoted monetary stability and public confidence by absolutely guaranteeing depositors that they could always obtain their money with no loss of principal. That achievement has been characterized as "the change most conducive to monetary stability since state bank note issues were taxed out of existence immediately after the Civil War." Although 4,004 banks failed the year before the FDIC was created, only 62 failed in the following year, nine of which were insured. One economist and historian has observed:

> "The FDIC was what the Federal Reserve had not succeeded in being--an utterly reliable lender of last resort, one that would immediately and without cavil come forward with whatever money was needed to cover the insured deposits."

So successful has federal deposit insurance been in fostering public confidence that some now complain that depositor and bank management complacency is a by-product of federal insurance.

The Banking Act of 1933 was designed to promote safety and soundness of banks in other ways too. Banks were barred from activities perceived to be potentially troublesome. With certain minor exceptions, they were forbidden to underwrite or deal in securities and were permitted to engage only in those activities "necessary to carry on the business of banking." Interest was prohibited on demand deposits, interest rates on time deposits were regulated, and bank examiners were given additional powers. The result was a partnership between the federal government and the banks it regulated, with the government as a senior partner. And predating the Banking Act of 1933 by twenty years was the Federal Reserve Act, which focused upon a sound central monetary policy.

So by 1933, a pervasive scheme of federal regulation of banking was firmly in place, which I would characterize as having three principal objectives. The first objective was a sound and stable monetary policy. The second was the promotion of public confidence in the banking system. The third was the promotion of public confidence in individual banks. The combined effect was to encourage people with available capital to deposit it and leave it in banks, with assurance that nothing adverse would happen to the institution and, in the unlikely event it did, they were nevertheless insured. If my characterization of the three principal goals is correct, then subjecting banks to a full disclosure spotlight or allowing them to compete in risk-laden activities seems inconsistent with those goals. Either one, and certainly the two in concert, seem fully capable of producing contrary results.

The Securities Act of 1933 was adopted at the same time as the Banking Act of 1933, is essentially a companion piece of legislation, and even emanated from the same Senate Committee. In a larger sense, both regulate the investment process -- the process by which people entrust their investible capital to another -- and both proclaim that they are designed to promote public confidence in that process. But unlike the Banking Act, the Securities Act seeks to promote public confidence in a totally contrary manner, by mandating full disclosure, even of adverse information, and even at the risk of damage to the enterprise. Why are the basic themes of securities and banking legislation, both adopted at virtually the same time, so different, if not irreconcilably in conflict?

Perhaps as much as anything, the perceptions of the times and politics are the reason. In that respect, the Banking and Securities Acts are no different from other legislation. The number of bank failures before 1933 to which I alluded seems to provide some clear rationale for the protectionist theme of the Banking Act. As to the Securities Act, it has been said that President Roosevelt believed the moral offenses of investment bankers would be curbed by exposure to public scrutiny. Some historians contend that adoption of a disclosure scheme was influenced by the states' disappointing experience with merit regulation and a hostility to federal merit review by some, particularly Congressman Sam Rayburn, Chairman of the House Commerce Committee. But many of Roosevelt's principal campaign advisers also believed that the securities markets had partially caused the Depression by misallocating capital. They viewed a potential securities law as a means to allocate capital to specific, selected industries as part of an integrated industrial program.

But Roosevelt rejected direct regulation of capital allocation as the basic concept of the Securities Act:

> "Our draft remained true to the conception voiced by the President in his message of March 29, 1933, to the Congress, namely that its requirements should be limited to full and fair disclosure of the nature of the securities being offered and that there should be no authority to pass upon the investment quality of the security...We also provided for the passage of a period of time before a registration statement could become effective...It would give an opportunity for the financial world to acquaint itself with the basic data underlying a security issue and through that acquaintance to circulate among the buying public as well as independent dealers some intimation of its quality."

Notwithstanding a proclaimed disclosure objective, in an August, 1933 article in Fortune magazine, Felix Frankfurter, a key draftsman of the Securities Act, described the legislation as "a modest first installment of legislative controls to assure commerce and industry a continuous flow of their necessary capital...." Those terms suggest a latent capital allocation theory behind the Securities Act, at least in the minds of some.

But regardless of any allocation theory that may have been in Frankfurter's mind, two regulatory schemes emerged simultaneously, each with a dramatically different approach to encouraging public confidence among those who would entrust their money to others. Logic suggests that the two schemes are flatly antithetical. The harsh spotlight of full disclosure creates a healthy skepticism and is prepared to sacrifice if necessary the enterprise to encourage public confidence. Safety and soundness regulation seeks to preserve the enterprise and assure the absolute safety of investment. That eliminates any need for skepticism. For those two regulatory schemes to co-exist peacefully, side-by-side, would seem to require that each scheme apply to separate, non-competitive economic activities. No wonder the sparks fly as the financial services industry consolidates and as regulatory lines are crossed by participants.

Drawing the Line on Function

As I observed, the line drawn in 1933 between a protectionist regulatory approach and a disclosure approach afforded banks a special status. Banks were precluded from engaging in certain potentially profitable activities, but were protected from competition from non-banking enterprises. I will not speculate whether that special treatment has any latent suggestion of an effort to allocate capital, as I suggested you might read into the history of the Securities Act. But, undeniably, at least an indirect effect was to allocate capital, in the form of deposits, by influencing the transfer of money into the banking system.

In the last five years, the historically neat separation of commerce and banking has simply collapsed. Each player in the financial services area wishes to be free to do anything that any other player is free to do. The use of any legal loophole to achieve that end is fair. Dollars, whether in the form of deposits or equity investments in the stock market, are fair competition from all quarters. These developments naturally have produced distortions and conflicts in the heretofore peacefully co-existing regulatory schemes.

The Department of the Treasury has recently proposed legislation to resolve some of these conflicts about proper function. Treasury's proposal would permit national banks to underwrite and deal in municipal revenue bonds; sponsor, manage, advise and distribute mutual funds; underwrite and sell insurance products; and develop, invest in and sell real estate. These activities and all other securities activities, however, would have to be carried out through a non-bank subsidiary of a bank holding company. The corporate separation of these activities would tend to resolve some of the regulatory conflict by placing the activity in entities that could be regulated separately by the appropriate regulatory agency.

<u>The Relationship Between Function and Disclosure and Some Predictable Conflicts</u>

Having briefly summarized Treasury's approach, let's return for a moment to my original thought that the proper range of activities of banks and questions of disclosure are related issues. With that thought in mind, let us reflect upon some already-existing and potential conflicts between the respective regulatory schemes.

The matter of federal deposit insurance comes first to mind. Deposit insurance has successfully promoted safety and soundness by fostering public confidence. What does federal deposit insurance have to do with the securities laws, securities activities of banks, and disclosure issues, and why is there any potential conflict? Historically, perhaps it had little relevance, and there was no potential conflict. But proposals abound for a number of changes in the insurance system. Some have suggested, for example, that the FDIC should not provide <u>de facto</u> insurance for deposits above $100,000 through mergers of failing institutions. Some have suggested that the insurance coverage should be reduced to $25,000. With reduced insurance coverage, depositors will be less complacent in choosing a bank because they may lose their funds. Bank management thus will be subject to "market discipline" in competing for capital in the form of deposits and in taking business risks.

Another suggestion is to base federal deposit insurance premiums on risk. Those banks that are high risk would pay more than low risk banks for equivalent coverage. Depositors will be more skeptical of the financial institutions they deal with, and management of banks will become more "business-like" to avoid paying high premiums, particularly as banks diversify into other activities.

Yet, if they come to pass, these two developments seem designed to raise doubts about banks, which is contrary to the original idea of fostering public confidence through federal deposit insurance. That is particularly so if securities law disclosure concepts are introduced. For example, what quantity and quality of disclosure, positive and negative, should be made to large depositors whose deposits are not insured and will not be protected in a "bail-out" merger? Presumably that would be more than large depositors traditionally have received, since full disclosure was largely irrelevant. Notwithstanding the Supreme Court's decision in <u>Marine Bank v. Weaver</u> that insured certificates of deposits issued by national banks are not securities, are large uninsured certificates securities? Furthermore, if risk-related premiums are instituted, should both depositors and equity investors be informed of the rating and the factors that went into the rating? That information certainly may be material under the securities laws. My point is that, once the bank is removed from a totally protected atmosphere and ostensibly subjected to market discipline, disclosure assumes much significance. The effect of either lower insurance coverage or risk-related premiums is some measure of market discipline.

Conflicts are on the horizon in the area of banks offering brokerage services. The quantity and mix of securities activities which may cause a bank to become subject to registration under the purposes of the Securities Exchange Act of 1934 remains to be precisely defined. Such registration would subject the bank to the Commission's examination authority, net capital requirements, and potential administrative proceedings. Perhaps immediate concerns about such matters can be eliminated or reduced if all brokerage activities are transferred to a separate corporate affiliate, as envisioned by the Treasury Department, which then registers. Only the securities affiliate becomes subject to the Commission's jurisdiction. But what if an examination of the broker-dealer raises issues which force the Commission to inquire into the inner business affairs of the sister bank, which, although publicly-owned or part of a publicly-owned holding company, is still cloaked with some form of safety and soundness regulation and resists full disclosure? In that case, has the conflict between the regulatory schemes been eliminated, or has the confrontation merely been postponed?

Reflecting further, some have suggested the repeal of Section 12(i) of the Exchange Act, which would transfer to the Commission the responsibility for overseeing the registration and reporting provisions of the Exchange Act as they apply to publicly-held banks, not just bank holding companies. If not an outright potential for conflict, this has at least the potential for some new experiences by publicly-owned banks. Such a transfer would give the Commission the effective authority to set accounting standards for banks, an authority we previously have had only for bank holding companies and an authority which includes broad power to define the information about bank operations which must be disclosed.

The traditional confidentiality of bank examination reports already has been the focus of conflict between the bank regulatory scheme and the securities laws. That conflict promises to be no less as banking and non-banking activities are further combined. In Securities and Exchange Commission v. Youmans, a federal district court held that a bank's officers violated the federal securities laws by failing to make public disclosure of criticisms contained in a bank examiner's report. Youmans concluded that adverse information contained in an examination report is not entitled to secrecy if that information is material under the federal securities laws. The potential impact on public confidence through compromising the confidentiality of the examination report was not controlling. As banks diversify into more and more non-traditional banking activities, it seems to me that the potential for further compromising the heretofore sacred confidentiality of the examination process is increased.

In terms of some specific disclosure developments, there have been recent changes, dramatic in the view of many, in the disclosure requirements for troubled loans of publicly-held banks and bank holding companies. These changes have come about even though the banks are conducting traditional banking operations and not new securities activities. Banks are now required to disclose more information about troubled loans. The effect of such disclosure, of course, may be to arouse some concern among depositors and the general public. Some contended that the very confidence bank regulation historically has promoted would be eroded or destroyed by these new disclosures. Obviously, those arguments were not persuasive to the regulators.

In addition, an apparently emerging preference, at least on the part of some banking regulators, for more regulation by "market discipline" should be noted. Some argue that this is contrary to traditional safety and soundness regulation; others argue that market discipline will promote long-term soundness. Regardless of which argument you find appealing, a preference for market discipline has potentially significant consequences. If market discipline is to become a truly effective regulator of banks, three factors must necessarily exist. First, banks must be required to make prompt, full disclosure of all material information, positive and negative, even at the risk of damage to or collapse of the enterprise. Second, banks must be allowed to fail just like other enterprises. Third, both stockholders and large depositors must be left to bear their losses. Only then will banks truly be subject to market discipline. As I said, if the bank regulators are serious about letting market discipline become the regulator, that is most a significant development. In that environment, all undoubtedly would concede the overriding importance of full and prompt disclosure.

My original premise was that the structural issue of the appropriate activities of banks and the general issue of disclosure are but two sides of the same coin. The relaxation of a strict protectionist attitude toward banks has tempted or encouraged banks to engage in non-banking ventures to realize greater profits. Many of those activities carry risks other than those to which banks are accustomed. The new enterprises and new risks in turn create a need for yet greater and more refined disclosure. And so the momentum grows.

Perhaps the question ultimately will be whether our society is willing to allow banks to engage in a wider range of progressively riskier activities, to subject banks to the spotlight of disclosure, particularly as they diversify, and to subject banks to the ultimate market discipline I have suggested. Whether that will occur remains to be seen.

But if that is not to occur, the only theoretically pure alternative is to go back, give banks an absolute monopoly on certain activities, remove them from market risks, and draw an iron curtain between banking and commerce. It's extremely difficult to believe that will happen. But unless we go to the other extreme, that of full disclosure and ultimate market discipline, a regulatory system with inconsistent and conflicting objectives will continue to exist. Certainly, the much sought-after "level playing field" will not have been achieved.

Conclusion

Certainly there is no balance between the two extreme approaches I discussed which will achieve universal acclaim. But most would agree that a clear relationship exists between a healthy banking system and a flourishing economy.

Our difficulties in striking a balance between the conflicting regulatory schemes I have discussed, however, may not be unprecedented. The prior experience of others may demonstrate how difficult the task is. In 1716, Louis XIV had just died and France was in appalling financial condition. In modern day parlance, there were cash flow problems, as expenditures were twice receipts. The Royal Treasury was chronically empty.

But John Law, an enterprising Scotsman, then arrived on the scene. Through high-born acquaintances, Law obtained the right to establish a bank with capital of about 250,000 English pounds. The bank was authorized to issue notes, which it did. The principal borrower was the French Crown, which used the notes issued by Law's Bank to pay off its creditors and declared the notes legal tender. The Bank notes loaned to the government and floating through the the system stimulated the economy. General optimism engendered by Louis' death furthered a substantial economic revival.

At this point, in the interest of full disclosure, I should pause and note that John Law's primary reason for being in France, where he was rapidly becoming that nation's central banker, was that he was fleeing a murder charge in England. He had been singularly successful in a duel. In addition, he had gambled his way through a considerable inherited fortune in his home country.

But back to the French banking system. All these events had such a beneficial effect that the Royal Regent proposed an additional issue of notes by Law's Bank. Law agreed, but even he was becoming concerned that the growing volume of notes in circulation -- now a form of paper currency -- was not backed by a sufficient reserve of hard currency -- gold coins in those days. Perhaps Law didn't call it public confidence, but that was his concern.

Even in 1719 banks apparently were restricted in what they could do, so Law had to look to ventures outside banking to realize profits and support the bank. So in 1719 Law established the Mississippi Company, later called the "Company of the Indies," which was to explore for gold in Louisiana. I suppose this could be called a separate corporate affiliate. The gold was to be minted into gold coins, which would back the notes or the soft currency issued by Law's Bank. The Company of the Indies also received an exclusive trading monopoly in India, China, and the South Seas, a monopoly on tobacco, and the right to coin money.

John Law also understood the hot issues market. His next step was to take this burgeoning financial services conglomerate public. It was truly a hot issue. The value of the initial shares rose phenomenally, and throughout 1719 more and more shares were issued, ostensibly to be used to find gold in the Louisiana wilderness to make the gold coins to back Law's Bank's notes.

But that was not the case -- in those days there were no full disclosure documents discussing the use of proceeds. Instead, the funds raised were loaned to the Crown. Only interest paid on those loans was available to the Company for its operations. One historian described it as follows:

> "Law was lending notes of the [bank] to the government (or to private borrowers) which then passed them on to people in payment of government debts or expenses. These notes were then used by the recipients to buy stock in the Mississippi Company, the proceeds from which went to the government to pay expenses and to pay off creditors who then used the notes to buy more stock, the proceeds from which were used to meet more government expenditures and pay off more public creditors. And so it continued, each cycle being larger than the one before."

But there were problems, of course, in the form of the notes and that small matter of public confidence. Early in 1720, a royal prince sent a batch of notes to the Bank to be redeemed in hard currency. This was the first suggestion of a lack of public confidence in the banking system. Others, then began to redeem

ATTACHMENT B

Are Banks Special?

Introduction

*The recent evolution of the financial structure in the United States has produced two competing points of view regarding the proper direction for further change. On the one hand, there is the view that the "financial services industry" — encompassing banks, thrifts, brokers, investment banks, and insurance companies — should be looked at as a single entity. According to this view, efforts to distinguish among kinds of institutions are both futile and unnecessary. This view of the financial services industry is based on the belief that many financial services offered by various classes of institutions are so complementary to (or such close substitutes for) one another that institutional distinctions are rendered useless. Implicit in this view is the assumption that banks are not special.**

This "separation doctrine" in banking grew out of concerns about concentration, conflicts of interest, and appropriate risks for institutions that lend depositors' money.

The competing, if not opposing, view is that banks are indeed special. This view holds that specialization of financial institutions has worked well and, at least in some cases, specialization may still be more efficient and also better serve the public interest. This view is associated with the historical separation of banking from commerce and from investment banking. In general, this "separation doctrine" in banking grew out of concerns about concentration of financial power, possible conflicts of interest, and the appropriate scope of risks banks should incur in the face of the special trusteeship falling on institutions that engage in the lending of depositors' money. In a shorthand way, as pertains to banks and the banking system, these concerns are typically captured by the phrase, "safety and soundness."

These two points of view do not necessarily represent mutually exclusive approaches to financial market structure. For example, in the context of a large financial services holding company, banks could be legally separated from nonbanks, but it is not clear that such separation would necessarily provide the kinds of protections that are currently built into federal banking laws.

Thus, assessing the merits of these two competing views must start with some very basic questions: Are banks "special" or are they simply another provider of financial services? Does it matter what kinds of risks banks incur? Does it matter who owns banks? Is "safety and soundness" a cliche, or should it have genuine and substantial meaning for banks, for bank regulators, and for the public at large?

While banking practices have naturally evolved over time, recently a combination of events has shifted that process to one of an almost revolutionary character. Amidst this process of rapid change, with market innovation and new sources of competition, there is a perception that banks' competitive position — and presumably their market share — has slipped. Casual observation of the growth of the commercial paper market, the thrift industry, money market mutual funds (MMMFs), and the de facto trend toward ownership of banks by securities firms and commercial enterprises, tends to support that perception. Indeed, there are numerous instances in which nonbanks have been able to provide "bank-like" services at a lower cost (or a higher rate of return) to the individual or corporate customer, thereby drawing business away from banking institutions.

*In this essay the term "bank" is used in a generic way that makes no effort to distinguish commercial banks from thrifts and other depository institutions. This is done merely to simplify the discussion. However in considering the essential functions of banks in light of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 it is clear that in substance there are no longer meaningful differences. To be sure differences in powers in regulatory treatment and in tax status remain but the basic characteristics that distinguish banks from other classes of financial and nonfinancial enterprises now seem to apply to thrifts as well as to commercial banks.

Analysis does not bear out the perception that banks have lost ground in the domestic marketplace over the past three decades.

High on the list of reasons that are cited for this perceived shift of market position from banks to nonbank competitors is the extra burden of regulation on banks. The fact of a heavy regulatory burden on banks is beyond dispute, but in some cases it is also true that regulation — relating to, for example, deposit insurance or access to the discount window — provides powerful incentives for individuals and businesses to maintain relationships with banks. While it is difficult to judge the net competitive results of differing degrees of regulation, it does seem clear that of all the regulatory burdens on banks, there have been two that stand out in terms of their impact on banks' competitive position over time: Regulation Q and limitations on the scope of bank services. This is not to suggest that other regulations on banks — ranging from reserve requirements to community reinvestment — have not been costly. But, at the cutting edge of market position or market share, it is Regulation Q and service line restrictions that have been the most critical restraints on banks.

Despite these regulatory restraints, banks have not stood still in the face of changing financial markets and new sources of competition. By using the flexibility provided by the Bank Holding Company Act, by developing sophisticated liability management techniques, by major expansions abroad, and by creative and innovative adaptations of "conventional" banking services, banks have actually fared rather well in terms of preserving their overall market position. While it is not easy to measure what has happened to the relative position of banks over time, the appendix to this report (pages 19-24) makes such an effort. Allowing for the inherent measurement problems in such an exercise — to say nothing of the data limitations — the analysis simply does not bear out the perception noted earlier that banks have lost ground in the domestic marketplace over the past three decades. (While not captured by the data, banks have, of course, made major expansions abroad during this period.) The analysis does not, however, imply that heavy regulation has not constrained the growth of banks and their market share, for it is quite possible that absent such regulations, banks' position would have risen rather than essentially held steady. Nor does the analysis indicate whether a rising or falling bank share is good, bad, or indifferent from the perspective of the public interest. To some extent these issues depend upon whether, in fact, there is something special about banks that is worth preserving. Indeed, if banks are special, it would not be in the public interest for the features or functions that make banks special to be eroded by competitive, regulatory, or legislative forces. By the same token, if what is special about banks dictates a <u>relatively</u> heavy dose of regulation, public policymakers should not be goaded into eliminating <u>necessary</u> regulation simply because bank market share might grow to some higher level without that regulation.

What Makes Banks Special?

Reduced to essentials, it would appear that there are three characteristics that distinguish banks from all other classes of institutions — both financial and nonfinancial. They are:

1.Banks offer transaction accounts.

2.Banks are the backup source of liquidity for all other institutions.

3.Banks are the transmission belt for monetary policy.

As long as banks issue transaction accounts they incur, by definition, "term structure" risk.

These three essential bank characteristics and the interrelationships between them are discussed below. Of necessity, the discussion treats each factor separately. However, it is clear that these essential characteristics are highly complementary and furthermore that it is the relationship among them that best captures the essence of what makes banks special.

Issuance of Transaction Accounts

Only banks issue transaction accounts; that is, they incur liabilities payable on demand at par and are readily transferable by the owner to third parties. The owner of a transaction account can demand and receive currency in the face amount deposited in the account; write a check in the full amount of the account; or, perhaps most importantly, the owner of the account can transfer the full amount of the account to a third party almost instantaneously by wire transfer. The liquidity, mobility, and acceptability of bank issued transaction accounts permit our diverse economic and financial system to work with the relative ease and efficiency to which we are accustomed. Moreover, in periods of financial stress, the capacity to quickly move transaction account balances to third parties takes on special significance by providing elements of flexibility and certainty in making and receiving payments that help to insure that financial disruptions do not spread. Individual banks can also create these highly liquid and mobile balances through their lending function. The capacity to "create" liabilities with these characteristics is vital to the ongoing needs of commerce, but it takes on special significance in periods of financial stress.

Because of the peculiarities of law and regulation, not all classes of transaction accounts have the same precise legal or regulatory characteristics. The "demand deposit" is the purest form of transaction account, since, for example, negotiable order of withdrawal (NOW) accounts and some share drafts at mutual organizations have restrictions on the extent to which they are payable on demand. However, from the perspective of both the issuing institutions and their customers, these differences appear to be without substance since the accounts are perceived and treated as transaction accounts both by the issuing institution and by the public. For this reason, a contemporary definition of "transaction" accounts — at least for purposes of identifying and defining special characteristics of banks — should focus on functional characteristics rather than existing legal or regulatory distinctions. If a financial asset satisfies the functional test of being payable on demand at par and readily transferable to a third party, it should — for those purposes — be a "transaction" balance.

A case can be made that nonbank financial institutions incur liabilities that appear to have

The public safety net reflects a consensus that banking functions are essential to a healthy economy. Its presence also implies that banks have unique public responsibilities.

some or all of the characteristics of a transaction account issued by a bank. However, on close inspection it appears that such instruments — whether MMMFs, retail repurchase (RPs) agreements, customer credit balances with brokers, sweep accounts, etc. — do not, at least in a technical sense, in fact possess the characteristics associated with the bank issued transaction account. However, as is discussed later, making the distinction is particularly difficult in the case of MMMFs. In all of these cases, including money market mutual funds, instruments which appear to have bank transaction account characteristics take on those characteristics in part because the acquisition or disposition of such assets involves, at some point, the use of a transaction account at a bank. However, technology makes it possible to manage these financial assets in a way in which their ultimate dependence on a bank account is not apparent to the individual holder of the asset.

As long as banks issue transaction accounts they, by definition, incur a form of "term structure" risk. That is, the presence of transaction balances on the books of a bank makes it difficult, if not impossible, to match the maturities of assets and liabilities, particularly in a contemporary setting in which bank holdings of liquid assets have shrunk and in which some assets, traditionally considered as liquid, may not, in fact, be all that liquid. Indeed, the asset side of the balance sheet for at least some banks provides a small margin of functional liquidity that can readily be brought to bear to meet large and sudden deposit outflows. In this setting, the inherent term structure mismatch on the books of banks is one of the realities that gives rise to concerns about strains on bank liquidity and sudden drains on bank deposits.

Banks and bank regulators have long since recognized the importance of banks acting in ways that preserve public confidence in banks' capacity to meet their deposit obligations, thereby minimizing the likelihood of large, sudden drains of bank deposits. Deposit insurance and direct access to the lender of last resort are uniquely available to banks to reinforce that public confidence. Indeed, deposit insurance and access to the lender of last resort constitute a public safety net under the deposit taking function of banks. The presence of this public safety net reflects a long-standing consensus that banking functions are essential to a healthy economy. However, the presence of the public safety net — uniquely available to a particular class of institutions — also implies that those institutions have unique public responsibilities and may therefore be subject to implicit codes of conduct or explicit regulations that do not fall on other institutions.

Experience suggests rather strongly that public confidence in a bank — with or without deposit insurance and the Fed's discount window — is ultimately related to public perceptions about the financial condition of banks and specifically about the quality of banking assets, liquidity, capital, and the capacity to absorb short-run shocks. Sudden drains on bank deposits occur when depositors conclude that loan losses or other circumstances might jeopardize a bank's ability to meet its deposit obligations. The evidence is overwhelming, for example, that most "problem" bank situations in recent years involved concerns growing out of losses or perceived losses associated with lending, securities activities, foreign exchange activities, and/or poor management. In this regard, it should be noted that even when "problem" bank *situations have been resolved with a minimum of costs to the individual institution, these situations have, on occasion, involved high costs in terms of generalized financial market disruption. Thus, while deposit insurance and access to the lender of last resort may rightly be viewed as the public policy safety net under banks' deposit taking function, the integrity of the deposit taking process and therefore the strength of the public safety net process depend to a substantial degree on the prudent management and control of risks on the part of the banking system as a whole.*

Public confidence in banks is ultimately related to public perceptions about the quality of banking's assets, capital, and the capacity to absorb short-run shocks.

Looked at in this perspective, the critical difference between banks and other classes of financial institutions rests with the capacity of banks to incur (and to create) liabilities that are payable on demand at par and that are readily transferable to third parties. The resulting mismatch of the maturities of assets and liabilities makes banks particularly vulnerable to sudden drains on deposits that can jeopardize their solvency. In practice, depositors — reinforced by the public policy safety net — have demonstrated tendencies to drain deposits from particular banks only when confronted with the reality or the perception of losses growing out of asset management problems and/or poor management of banking organizations. Thus, while the deposit taking function of banks is what makes them unique, the integrity of that process depends upon the risks, real and perceived, associated with the lending and related activities of the banking system as a whole and its capacity to absorb shocks in the short run.

Backup Sources of Liquidity

As discussed above, the fact that banks issue transaction deposits is the key factor that distinguishes them from other classes of financial and nonfinancial institutions. However, experience also suggests that public confidence in the ability of banks to meet their deposit obligations is ultimately related to the quality of bank assets and to the overall financial condition of the bank. This relationship takes on additional importance when it is recalled that banks can also create, through their lending activities, transaction deposits. Indeed, in a very real way, banks are the primary source of liquidity for all other classes and sizes of institutions, both financial and nonfinancial.

The extent to which banks play this role cannot be judged simply by looking at the number and value of loans on the books of banking organizations. For these purposes, contingent credit obligations of banks, such as loan commitments and standby letters of credit, must be considered in virtually the same light as direct loans. These standby credit facilities are, for example, the arrangements which permit most financial markets and institutions to function as they do. It is highly unlikely that the commercial paper market would function very well were it not for the presence of standby bank credit facilities obtained by those corporations that issue commercial paper. Similarly, it is very difficult to imagine that even the best managed and capitalized broker/dealers could handle their day-to-day business with the efficiency that is now so common without ready access to bank lines of credit. The same, of course, applies to nonfinancial corporations. Indeed, while all such institutions may, over time, have access to a wide variety of funding sources, direct or standby bank credit facilities are the cornerstone upon which these alternative sources of credit rest. If there are problems in one

In a very real way, banks are the primary source of liquidity for all other classes and sizes of institutions, both financial and nonfinancial.

segment of the credit network, institutions will simply shift their borrowing activities elsewhere in the network. However, if the problem is in the banking sector, banks must either turn to each other or to the central bank.

Even in the "normal" course of events, the direct and standby credit facilities provided by banks are the foundation upon which other credit markets depend for their vitality. This relationship takes on special significance, however, in periods of selective or generalized financial stress. For example, in virtually every case of "selective" financial shock in the 1970s and early 1980s, troubled institutions — financial and nonfinancial, bank and nonbank — turned to the banking system to provide at least a bridge until more lasting solutions to the problem could be worked out. At the very least, these bridging arrangements helped to contain problems and prevent them from spreading to other institutions or to the financial system generally.

Banks' ability to supply credit and liquidity, particularly in situations where other institutions or markets may be unwilling or unable to do so, arises because the deposit creating function of banks (in tandem with banks' relationship with the central bank) provides an element of credit and liquidity elasticity which is not immediately available to other institutions. In point of fact, the extent and frequency with which banks have had to directly rely on extraordinary funding by the central bank (either through the discount window or via open market operations) have been quite limited. In the normal course and even in periods of stress, individual banks and the banking system as a whole are able to provide necessary liquidity because of their ability to quickly fund loans through a variety of market sources including the domestic and foreign interbank market, RPs, the issuance of large certificates of deposit (CDs), and so on. For many banks, access to these markets has become the primary source of bank liquidity.

Banks' access to these markets — and by extension, banks' ability to function as backup sources of liquidity — occurs in a context in which individual suppliers of such funds — whether federal funds, CDs, Eurodollars, etc. — make judgments about the strength and vitality of individual banks and the banking system as a whole. Experience is clear, for example, that individual banks experiencing problems with classified assets, earnings, and so on, often see that phenomenon first manifest itself in the form of having to pay a risk premium over the "going" rate for federal funds and large CDs. Similarly, when concerns about the banking system arose in 1974-1975 and more recently in 1982, an early manifestation was a widening of the interest rate spread between bank and treasury liabilities of comparable maturities. In the extreme cases of severe problems with individual banks, widening spreads ultimately result in these sources of funding being cut off, with a consequent need to either contract the size of the bank, borrow from the Fed's discount window or, in some cases, close or merge the bank.

The point is, of course, that the ability of a bank to fulfill its role as a backup supplier of liquidity to the financial and business communities depends on easy access not only to traditional sources of deposit liabilities, but also to markets for nondeposit sources of *funding. The same applies to the banking system as a whole, because while one or a few banks can turn to the London market to fund themselves in times of adversity, it is clear that the banking system as a whole cannot. Thus, as with the preservation of the integrity of the deposit taking function described earlier, experience clearly suggests that the ability of banks to provide the essential function of a backup source of liquidity is ultimately dependent on market judgments as to the quality of the banks' assets and overall financial strength.*

Banks are able to provide necessary liquidity because of their ready access to a variety of domestic and foreign market sources.

Looked at in this light, the ability of banks to fulfill their role as standby sources of liquidity and credit rests importantly on the quality and consistency of credit judgments made by banks. This is particularly true in periods of stress when banks may be called on to supply credit to borrowers who, for one reason or another, temporarily do not have access to other sources of funds or to make the even more difficult decisions as to which borrowers are experiencing problems of a fundamental or irreparable nature. It is in these particular circumstances that banks must be in a position to make rigorous, impartial, and objective credit decisions, because it is precisely in such circumstances that the potential for compromise in the impartiality of the credit decision making process is greatest and the potential for asset quality deterioration is the largest. It is in this light that considerations about the commingling of banking and other interests and concerns about the ownership and control of banks become compelling.

To summarize, virtually all other financial markets and other classes of institutions are directly or indirectly dependent on the banking system as their standby or backup source of credit and liquidity. Banks can fulfill this function for a variety of reasons, including their relative ease of access to deposit and nondeposit sources of funding. However, experience suggests that the capacity to provide this function or, more directly, to provide access to these markets and sources of funding — like the integrity of the deposit taking function — is ultimately related to the overall financial strength of banks and the quality of bank assets. This role of banks as a standby source of liquidity takes on special significance in periods of stress and in this light underscores the importance of rigorous and impartial credit judgments by banks. This, in turn, provides a particularly relevant context in which concerns about the commingling of banking and other interests should be evaluated.

Transmission Belt for Monetary Policy

As the preceding discussion suggests, there is a direct link between banks and the central bank arising in part from the central bank's lender of last resort function. More broadly, the fact that banks are subject to reserve requirements places the banking system in the unique position of being the "transmission belt" through which the actions and policies of the central bank have their effect on financial market conditions, money and credit creation, and economic conditions generally. To put it somewhat differently, the required reserves of the banking system have often been described as the fulcrum upon which the monetary authority operates monetary policy. The reserves in the banking system also serve the complementary purpose of providing the working balances which permit our highly efficient financial markets to function and to effect the orderly end-of-day settlement of the hundreds of billions of dollars of transactions that occur over the course of each business day.

Banks must be in a position to make rigorous, impartial, and objective credit decisions.

Some have argued that neither monetary policy nor the payments mechanism are dependent on the relationship between reserves and the banking system. There have been, or are, schemes for conducting monetary policy and operating a payments mechanism that do not use bank reserves and the banking system in the way the U.S. system currently operates. However, it is also true that any of these alternative arrangements would entail major institutional changes and run the risk that they might not work as efficiently as the current framework or the possibility that they might not work at all. In short, to justify departure from the current arrangement the weight of evidence should be overwhelming that the current system is not working or that some alternative system would work decidedly better.

In fact, the current system seems to work rather well, although recent developments may have introduced elements of slack into the transmission belt. For example, the proliferation of close substitutes for bank-issued transaction accounts narrows the effective scope of reserve coverage. The narrowed reserve coverage can introduce more slippage into the process of monetary control, and it also means that a relatively smaller reserve base is supporting a larger flow of payments. Similarly, the deregulation of the liability side of banks' balance sheets seems to imply that, in order to achieve a given degree of monetary restraint, a higher level of market interest rates is required than might otherwise have been the case. Further, increased leverage of banking organizations may work in the direction of introducing slippage into the monetary control process, in that a larger volume of credit flows may be associated with some given rate of growth of "money." Finally, higher leverage and greater risk exposure may weaken the capacity of the banking system to adjust to and to absorb the changes in credit market conditions that must accompany periodic monetary restraint.

As suggested above, these and other forces may already be working to introduce a larger margin of slack into the transmission belt. While the slack evident today is of manageable proportions, the future design of the banking and financial system must leave intact a strong yet adaptable mechanism through which monetary policy and the payments mechanism can function. This imperative underscores the case for attempting to segregate essential banking functions into an identifiable class of institutions and seeking to ensure that these institutions have the financial strength and vitality to perform their essential functions and to absorb changes in the credit market and economic conditions associated with periods of monetary restraint.

Defining a Bank

From the previous discussion, it should be clear that there are in fact certain special and unique functions of banks and that they are essential to the functioning of an efficient and safe financial and economic system. However, it also seems likely that if "banks" did not provide these essential functions, someone else would — just as it is abundantly clear that the process of market innovation has already produced services which are close substitutes for essential bank services. Given these considerations, the threshold question that arises is whether it is still desirable, from a public interest point of view, to attempt to segregate essential banking functions into an identifiable class of institutions and, if that is the case, whether it is possible to define a bank in a manner that is both functionally and intellectually satisfactory.

Banks are in the unique position of being the transmission belt for monetary policy. Recent developments may have introduced elements of slack into that belt.

Putting aside for the moment practical problems of definition, it would seem that the case for segregating essential banking functions into an identifiable class of institutions is every bit as powerful today as it was in the 1930s. If anything, concerns regarding financial concentration, conflicts of interest, and the fiduciary responsibilities associated with lending depositors' money may be more relevant today than they were 50 years ago. To be sure, the lines of distinction may not have to be drawn in the same way and in the same place that they were in the past, but the earlier discussion of the essential functions of banks serves as a powerful argument for separation at some point. Indeed, to reject the notion of separation would — as a matter of logic — require that deposit insurance and access to the lender of last resort, together with the associated supervisory and regulatory apparatus, either be done away with altogether or be made universally available to any institution that provides essential banking functions — irregardless of what other types of business or commerce it might be engaged in. However, as a practical matter, the case for separation is only viable if we are able to provide a satisfactory definition of a bank.

Over time, a variety of tests have been used for the purpose of defining a bank. These tests ranged from a charter test to the functional test of issuing demand deposits and making commercial loans. At one time, each of these tests was satisfactory. However, currently neither existing statutes nor regulations seem to contain a definition that is satisfactory.

A satisfactory definition of a bank must start with a clear recognition of the essential functions provided by such institutions. From the earlier discussion, it is clear that the single characteristic of banks that distinguishes them from other classes of institutions is that they issue transaction accounts; that is, accounts that in law, in regulation, or in practice are payable on demand at par and are readily transferable to third parties. A powerful case can be made that the definition of a bank should stop right there: a bank is any organization that is eligible to issue transaction accounts. If an institution meets this test, it would (1) be eligible for government deposit insurance; (2) have direct access to the discount window; (3) be subject to the Fed's reserve requirements; and (4) have direct access to the Federal Reserve's payments services, particularly the wire transfer system. For these purposes, an appropriate statute would have to redefine transaction accounts. At a minimum, such a definition would have to include conventional demand deposits, NOW accounts, and share drafts. It might also include the new money market deposit accounts (MMDAs) and, depending on the standards of definition, perhaps even MMMFs or other nonbank institutional arrangements that provide "check" writing capabilities.

On the surface, this definition of a bank may seem inadequate because it contains no corollary asset or lending test; it focuses only on the liability side of the balance sheet. This seeming inadequacy arises in part because the current Bank Holding Company Act's definition requires that a bank issue demand deposits and make commercial loans. More substantially, the absence of a lending test seems to fly in the face of arguments made earlier

To reject the notion of separation would logically require doing away with — or making universally available — deposit insurance, the discount window, and supervision/regulation.

concerning the critical link between the deposit taking function and the lending or asset acquisition functions of banks. However, it is precisely because of the nature of the relationship between deposit taking and asset acquisition that the essential definition of a bank should be couched in terms of its deposit taking function — without regard for the particular distribution or classification of its loans and/or investments. Taken by itself, there is nothing unique or special about the asset side of a bank's balance sheet, except for the limits on the scope of asset acquisition powers discussed below. Concerns about the nature and risk characteristics of bank assets arise in the context of the unique nature of bank liabilities, the need to preserve the integrity of the deposit taking function, and the special trusteeship growing out of that function. Thus, while it may be appropriate from the standpoint of public policy to limit the asset powers of banks to certain less risky activities, the definition of a bank need only deal with the liability side of the balance sheet.

The absence of an asset test might, however, create a definitional loophole. That is, "banks" could conceivably refrain from issuing transaction deposits while funding their asset acquisition activities with insured time and savings deposits. However, this problem could be minimized by reliance on such an institution's eligibility to issue transaction accounts. If so eligible, it would be defined and regulated as a bank even though, in practice, it refrained from issuing transaction accounts. An institution that was not eligible to issue transaction accounts would not be a bank and would not be eligible for deposit insurance, access to the Fed, and so on.

By this definition, existing commercial banks, thrifts, and credit unions would be considered "banks." Similarly most of the "nonbank" banks formed in recent years under the Bank Holding Company Act (by not engaging in commercial lending) would be banks, as would, depending on state laws, some "industrial" banks. Treating thrifts and certain other institutions as "banks" raises a host of difficult and politically charged issues relating to regulatory treatment, tax status, divestiture, and grandfathering arrangements. However, for purposes of this discussion, the fact that certain "nonbank" financial institutions are, for a variety of reasons, banks does not require immediate or perhaps even parallel regulation. Rather, the suggestion would be that there is an essential core of regulation that should apply more or less equally to this broader class of institutions which provides essential banking functions.

The issue of whether money market mutual funds fit the definition of a bank — even at a conceptual level — is not so easy to deal with. Many such funds certainly appear to have all the characteristics of bank transaction accounts. In the case of the money market mutual fund, the critical distinction relative to a bank transaction account appears to be the extent to which the liabilities in question are payable at par. In the case of a bank deposit, deposit insurance, the capital of the bank, and the bank's access to alternative sources of short-run funding provide assurances that a depositor can withdraw dollar-for-dollar from the bank the principal amount deposited — even when changes in interest rates may have reduced the market value of bank assets.

In the case of the money market mutual fund the ability to pay out dollar-for-dollar the amount of the initial "deposit" is less certain. The fund itself does not have capital as such, and in the short-run it cannot easily tap alternative sources of liquidity to pay out to some shareholders thereby buying time for assets to mature or for interest rates to reverse course. As a related matter, the fund is not insured so that even though the risk of loss to the individual shareholder is small, it does exist. The fact that in recent months a number of money market mutual funds have taken steps in the direction of securing some form of private insurance would suggest that some fund managers perceive that there is an important distinction to be drawn between the fund shares and bank deposits. The irony of this, of course, is that to the extent funds obtain insurance, they come even closer to possessing bank-like characteristics.

To preserve essential bank functions, banks must be able to maintain profitability, attract capital, and hold a de facto monopoly on transaction accounts.

From a competitive viewpoint, the question of whether a money market mutual fund is a bank is far less important today than it was before the introduction of MMDAs at banks. Indeed, if being a "bank" is equated with deposit insurance, access to the Fed's discount window, and payments services — the costs of reserve requirements notwithstanding — some money funds might not object at all to being called a bank in the current market setting. Moreover, if the power of banks or bank holding companies was expanded to permit such institutions to offer mutual funds, the question, from a competitive point of view, would be even less pressing.

However, in terms of intellectual consistency, the question of whether money market mutual funds (or similar arrangements which permit "check" writing) should fall within the definition of a bank does not disappear simply because current competitive conditions render the issue less compelling. On technical grounds, it would seem that the distinction arising from the payment at par principle could justify treating money funds as nonbanks. On functional grounds, however, and particularly from the perspective of the shareholder, the check writing features of some funds simply may create too much of a "look alike" situation to make a meaningful distinction on the technical grounds of payment at par. It may therefore be necessary to place certain restrictions — such as limits on the number of third-party transfers (as with bank-issued MMDAs) and/or reserve requirements — on "nonbank" financial instruments or institutions that provide check writing features. Of course, if MMDAs were defined as transaction accounts, then the case for treating MMMFs as banks would become powerful.

Bank Powers and Structure

If a bank can be satisfactorily defined along the lines suggested above, there are three related questions which must be answered in order to sketch out a reasonable approach to the future scope and structure of banking activities and banks. They are: (1) What kinds of subsidiary powers should banks have? (2) What restraints, if any, should be placed on the ownership or control of banks? (3) Is it important, from a public policy perspective, whether the subsidiary activities of banks are performed in the bank, a subsidiary of the bank, or in a subsidiary of a bank holding company?

Subsidiary banking activities should not entail excessive risk of loss and should not impair the impartiality of the credit decision making process.

The answers to each of these questions must be guided by the earlier discussion of what it is that makes banks special and the relationship between the integrity of the deposit taking function, the financial strength of the bank, and ultimately the strength of the financial system. That discussion implied that in thinking about asset powers, ownership, and the organizational structure of banks, substantial weight needed to be given to safety and soundness considerations, the special trusteeship of banks and the objectivity and impartiality of the credit decision making process. This is not to suggest that other factors such as concentration and public convenience and need are not important from the perspective of public policy. Indeed, these things may be very important, but their importance — in the context of questions relating to banking powers, ownership, and structure — is secondary to the safety and soundness factors.

Having said that, a case can be made that whatever weight safety and soundness and related criteria have been given in the past, these factors should be given less weight in the future. Better information and management systems, more efficient markets, greater disclosure, improved supervision, and the presence of the public safety net, all seem to work in the direction of reducing public policy concerns about the safety and soundness of banks.

However, there are strong forces working in the opposite direction. Financial affairs generally are much more complex and more interdependent than they once were. One consequence of this is that when problems arise they are more difficult to isolate and contain than in the past. Perhaps more importantly, the combination of liability management techniques and deregulation has significantly altered the overall liability structure of banks. Stable and low cost core deposits are virtually a thing of the past. These developments have, in combination with more sophisticated and interest-rate conscious corporate treasurers and individuals, increased the term structure risk at banks and made banks more susceptible to sudden deposit shifts. At the same time, "spread management" — whereby banks attempt to float the rate of return on assets in some reasonably fixed relationship to changes in the cost of funds — may, subtly but insidiously, be working to undermine the traditional disciplines of both borrowers and lenders. Finally, the far-flung international activities of banks have introduced new elements of risk into the equation. While it is a matter of judgment as to whether this crosscurrent of events is working to reduce or to increase the risks associated with the activities of banks, it does seem prudent to conclude that they are working in the direction of creating greater risks.

Bank Subsidiary Powers

As suggested earlier, to preserve and protect the essential functions of banks, banks must be competitively viable institutions. This means, among other things, that banks must be able to offer a sufficiently wide and competitive range of services to maintain profitability, attract capital, and preserve a de facto monopoly on the transaction account business. Without delving into the specific types of powers banks should have, the preceding discussion is suggestive of the general criteria which should be used in making judgments about the scope of banking powers. While a number of factors may be relevant in this regard, the essential functions of banks as described earlier suggest the primacy of two general criteria. They are:

subsidiary banking activities should not entail excessive risk of loss and should not impair the impartiality of the credit decision making process. This dual criteria, while conceptually useful, is operationally ambiguous. To some extent, it becomes more clear in a context in which secondary criteria relating to competition/concentration considerations are introduced. Similarly, as a practical matter, defining the extent of appropriate subsidiary banking powers can be guided by policies governing bank ownership. That is, logic would seem to dictate that a particular set of powers be vested in banks only to the extent that there is a willingness to permit another institution engaging in those activities to own and/or control banks. For example, if we are willing to permit banks to engage in commerce generally (that is, the acquisition, manufacture, or distribution of goods and nonfinancial services), then we should be prepared to say that firms engaged in such business, whether oil companies or shoe stores, can own and control banks. The converse also should follow: if we are unwilling to permit banks to engage in such activities, then logic would seem to dictate that such commercial firms should not own banks. The symmetry of this argument is important, for it lends weight to the apparent consensus that the separation of banking from commerce generally is appropriate and should be maintained in both directions.

A particular set of powers should be vested in banks only if there is a willingness to permit another institution engaging in those activities to own or control banks.

However, even in the realm of so-called financial services, the risk/impartiality criteria do not provide unambiguous insights as to how far banking powers should be extended. For example, if there is a consensus that the risk/impartiality test should not preclude banking organizations from engaging in the sale and distribution of mutual funds shares or in the distribution and brokerage of securities, it is by no means clear that such a consensus would extend to activities relating to the underwriting of stocks and corporate bonds generally or to taking positions in commodities. The point is, of course, that while it is a fairly easy matter to conclude that a continued separation of banking and commerce makes sense, it is not nearly so easy to conclude — as a matter of public policy — that the full range of financial services should be fair game for banking organizations. At the very least, the risk/impartiality criteria suggested above and the bank ownership/control questions discussed below suggest that we should not be indifferent to the scope of financial services offered by banking organizations.

Bank Ownership

If there is some agreement (1) that the segregation of essential banking functions into identifiable classes of institutions makes sense; (2) on the definition of a "bank"; and (3) on the appropriate scope of powers to be housed within banking organizations, then dealing with the question of bank ownership becomes fairly easy. That is, nonbanking organizations would be permitted to own banks only insofar as the activities of such entities match the activities in which banking organizations would otherwise be permitted to engage. For example, a securities firm whose activities did not go beyond the activities directly permissible to banks and bank holding companies could own a bank, but in the process that organization would become a bank holding company. On the other hand, financial or nonfinancial firms could not own a bank unless they were willing to divest those activities which fall outside the list of permissible activities for banks and bank holding companies. Thus, depending on the determination of the scope of banking powers — which, as noted earlier, should be

The holding company structure is neither a substitute for prudent management nor a fail-safe device for containing risk.

undertaken primarily within the context of the risk/impartiality criteria — this approach would require that a number of existing situations involving the ownership of "banks" by financial and nonfinancial firms would have to be grandfathered or, perhaps in some cases, divestiture arrangements would have to be worked out over a period of time.

Banking Structure

Finally, in this context, questions will inevitably arise as to whether it matters, from the perspective of public policy, if particular subsidiary activities of banks are carried out in the bank, in a subsidiary of the bank, or in a subsidiary of the bank's holding company. Given the earlier discussion about the importance of segregating essential banking activities and the importance of the risk/impartiality criteria for purposes of evaluating the appropriate scope of banking activities, it would seem to follow that there is a powerful case for placing some subsidiary activities of banking organizations into affiliates of bank holding companies. This case is reinforced by the protections against self-dealing, which are made possible by certain provisions of the Bank Holding Company Act and by the de facto segregation of capital that is made possible by the holding company structure.

However, it does not follow from the above that we can be indifferent as to the degree of risk associated with such activities simply because they may be housed in a separately organized and separately capitalized subsidiary of a bank holding company. To the contrary, experience suggests rather clearly that in times of peril it may not be possible to insulate the bank from the problems of its sister organizations — even when such problems arise in affiliated organizations, including subsidiaries of bank holding companies. While there are good and sufficient public policy reasons for concluding that at least some "nonbank" activities of banking organizations should be housed in subsidiaries of bank holding companies, such organizational arrangements are not likely to produce a situation in which the bank is immune from the problems, risks, or losses that might develop in such subsidiaries. In short, the holding company structure is neither a substitute for prudent management nor a fail-safe device for containing risk.

In Conclusion

This essay started out with a seemingly straightforward question: Are banks special? Having answered that question in the affirmative, it does seem appropriate that the current debate about the powers and structure of banks be framed in a context that gives greater weight to the underlying issues of what banks are, and what, from the perspective of public policy, we want them to be. Looked at in that light, and with a firmer grasp on what it is that makes banks special, it becomes somewhat easier to grapple with the very difficult questions relating to the definition of a bank, the scope of banking powers, the ownership and control of banks, and the structure of banking organizations. This approach — entailing as it does an element of going back to square one — can help to ensure that bankers, regulators, and legislators approach successive steps in the reshaping of our financial system in a manner which helps to preserve the unique functions and characteristics of banks while at the same time encouraging those elements of competition and innovation that will permit the banking system and the financial system more generally to safely and efficiently meet the needs of a growing and stable domestic and international economy. — *E. Gerald Corrigan*