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The Integration of Securities and Banking Activities in the United States

I. Introduction

Technology, market forces, and competitive zeal have contributed to a substantial blurring of distinctions among the providers of financial services in the United States. Whether the degree of integration that has occurred is desirable, or even is legal, is a source of heated debated and extensive litigation in our country. Furthermore, various regulatory agencies are in conflict over numerous issues, and the legislative process has not yet produced an overall policy direction for our country. Unless and until that occurs, our steps toward and away from consolidation of the financial services industry will continue to occur in ad hoc, and frequently contradictory, fashion.

At work in our country are forces and concerns that, I presume, are present in other countries. One is the need to form capital pools that are of sufficient size to meet the needs of issuers and can be distributed rapidly and efficiently. The formation of larger and larger pools of capital, however, carries with it elements of concentration of power and a potential for conflicts of interest. If that concentrated power becomes monolithic, the potential to suppress innovation also exists.

Despite the blurring that has occurred, to some extent a dividing line nonetheless remains in the U.S. between depository institutions, principally banks, and non-depository institutions, such as traditional securities brokerage firms and investment companies. Complicating the matter is the fact that the federal laws that either permit or bar functions to providers of financial services (generally based upon the deposit-taking function) are embodied in no less than twenty-two (22) presently existing separate federal statutes. In turn, these federal laws are administered or enforced by no less than five separate federal departments or agencies, each operating essentially independently. In attempting to summarize the various barriers and the extent of erosion in the financial services industry, one Congressional committee has released a report with the revealing title, "Confusion in the Legal Framework of the American Financial System and Services Industry." I commend it to all of you.

As a general proposition, today banks in the United States cannot:

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

As a general proposition, today U.S. banks can:

1. organize and manage common and commingled trust funds, forms of pooled investment vehicle;

2. engage in retail discount securities brokerage in an agency capacity, at least through a separate subsidiary of a bank holding company;

3. arrange for the private placement of securities, render advice with respect to mergers and acquisitions, and conduct other investment banking type services; and

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

Our existing regulatory framework is based on the assumption that commerical banking and investment banking should be separate. This legal separation was a response to the 1929 Stock Market Crash and the Depression and represents an effort to restore widespread confidence and stability in the banking system. The separation was not, as some have mistakenly argued, to insulate traditional securities firms from competition by banks.

II. The Glass-Steagall Act.

My comments today will focus principally on recent events. In understanding the regulatory structure in the United States, you should remember the events which led to, and the rationale of, the federal legislation of the 1930's which separated the banking and securities industries.

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. I doubt that any country represented at this meeting has ever experienced so many bank failures.

During the 1920's, large commercial banks set up securities affiliates financed indirectly in many instances by the banks. The securities affiliates frequently used bank employees to recruit public investors for issues of speculative corporate securities. Thus, these issues were underwritten in effect by the bank itself. Many economic historians have concluded that the banks' financial stability became linked to the securities issues underwritten by their affiliates when the banks made ill-advised loans to such issuers to shore up the prices of the securities underwritten. When the Stock Market Crash came, the affiliates and the banks collapsed like houses of cards, triggering a nationwide run on bank deposits. From 1929 to 1933, more than 9,000 banks failed. 4,004 failed from 1932 to 1933.

The Banking Act of 1933, and its Glass-Steagall provisions, were explicitly designed to promote the safety and soundness of banks and to encourage depositor confidence. Banks simply were barred from activities perceived to be potentially troublesome or risky. With certain minor exceptions, they

were forbidden to underwrite or deal in investment securities and generally were permitted to engage only in those activities necessary to conduct the business of banking. Interest was prohibited on demand deposits, interest rates on time deposits were regulated, and federal bank examiners were given additional powers. In exchange, however, banks were given a monopoly on certain activities, principally that of accepting deposits.

Such a regulatory scheme was intended to assure potential depositors that the likelihood of anything adverse happening to banks was remote, and, in the unlikely event that a bank failed, depositors' funds were nevertheless insured. Whatever the merits or weaknesses of this approach, its "protectionist" philosophy cannot be gainsaid. As Gerald Corrigan, the President of the Minneapolis Federal Reserve Bank has said:

> Putting aside for the moment practical problems of definition, it would seem that the case for segregating <u>essential</u> 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. _/

The Chairman of the SIA, Richard H. Jennrette, has said in Congressional testimony, in arguing for a separation of the

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_/ Corrigan, "Are Banks Special?", Federal Reserve Board of Minneapolis, 1982 Annual Report 13 (1982).

banking and securities business: "Banks have no right to fail."

III. Recent Bank Involvement in the Securities Industry and Recent Securities "Banking" Activities.

With that history, let me turn to three more specific areas of current interest in our country:

1. discount brokerage activities conducted by banks;

2. banks acting as underwriters or distributors of third party commercial paper; and

3. the acquisition of limited purpose banks by non-depository institutions as a means to combat bank entry into securities activities.

In 1983, the Federal Reserve Board allowed BankAmerica Corporation, the holding company for the Bank of America, to acquire Charles Schwab & Co., a large discount retail stock brokerage house. Schwab's activities -- retail discount securities brokerage in an agency capacity -- were found to be similar to services historically provided by banks; therefore they were deemed "closely related" to banking and were a legally permissible activity under the Bank Holding Company Act. The Board also concluded that the proposed acquisition would not violate the Glass-Steagall Act, which on its face prohibits affiliations between banks and securities firms "engaged principally in the issue, flotation, underwriting,

public sale, or distribution . . ." of securities. Agency brokerage transactions were found not to be public sales.

In a major decision, our Supreme Court in July 1984 affirmed this decision. The Court ruled that retail discount securities brokerage, conducted through a subsidiary of a bank holding company and essentially limited to the purchase and sale of securities as agent for the account of customers, without the provision of investment advice to a purchaser or seller, does not violate the anti-affiliation provision of the the Glass-Steagall Act (Section 20). Unresolved by the decision, however, is the extent to which banks directly can engage in various securities activities and still comply with the Glass-Steagall Act.

Bankers Trust Company's activities as agent for several of its corporate customers in marketing their high-quality commercial paper led to another recent significant Supreme Court decision on the Glass-Steagall Act this past July. The Federal Reserve Board had approved this activity for Bankers Trust. The FRB concluded that commercial paper more closely resembled a commercial bank loan than a transaction involving investment securities; thus, the Federal Reserve Board reasoned, "investment securities" of the type contemplated by the Glass-Steagall Act were not involved.

The Supreme Court reversed. The Court held that commercial paper was a security for purposes of the Glass-Steagall Act and affirmed the principle that Glass-Steagall had declared

some commercial banking and investment banking activities to be fundamentally incompatible. The Court's opinion, however, did not resolve the precise level of involvement which a bank can have in connection with third party commercial paper, such as rendering advisory services and granting back-up extensions of credit.

Another recent controversial development in the United States involves "non-bank" banks. In response to competitive pressures from banks entering traditional securities activities, non-banking enterprises, such as traditional securities or investment advisory firms, have sought to acquire banks as subsidiaries but to avoid bank holding company status by simultaneously divesting the bank of its commercial loan portfolio. Our Bank Holding Company Act defines banks as institutions that both (1) accept demand deposits, and (2) make commercial loans. Any organization that acquires a "bank" becomes a "bank holding company" and must register and be regulated under our Bank Holding Company Act. The acquired bank would then not be a "bank" for Bank Holding Company Act purposes because it would not make commercial loans, even though it still would accept deposits. The acquiror therefore would not be a "banking holding company," subject to banking law restrictions which prohibit certain affiliations with securities firms, because it technically does not own a bank.

Not surprisingly, this has created conflict. The Comptroller of the Currency, which regulates the chartering

of national banks, has approved such acquisitions as consistent with Glass-Steagall. The Federal Reserve Board, which regulates bank holding companies, contends that the ownership of a national bank by an investment adviser even one divested of its commercial loan portfolio, would violate the Glass-Steagall Act. The Federal Reserve Board has stated that it intends to enforce the Glass-Steagall Act. The Federal Reserve Board has recently moved to close the non-bank bank loophole by proposing to redefine a "bank" for purposes of the Bank Holding Company Act.

IV. Legislation

Although a number of legislative proposals have came forth dealing with the banking - securities area and, there are two principal approaches.

The first approach is embodied in the so-called Garn bill in our Senate. It would allow non-bank banks, permit banks and thrift institutions to engage in discount brokerage, and permit banks and threft institutions to deal in mortgage-backed securities and underwrite municipal revenue bonds through affiliates.

A different approach is taken on the House side. Two slightly different bills are pending, but essentially they would substantially cut back the securities activities of banks and draw a clear line between banking and securities.

V. Continential Illinois National Bank & Trust Company

I suppose no discussion of banking and securities developments and the erosion of the barrier between the banking and secuities industries in the United States would be complete without some reference to Continental Illinois National Bank & Trust Company. The $4.5 billion rescue package for Continental, the sixth largest commercial bank in the United States, has made abundantly clear the intention of the 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, and which gave the Federal Deposit Insurance Corporation the right to hire and fire management, is considered by many to be de facto nationalization of a major United States bank. The long-term political question is whether Continential Illinois may produce a political reaction that will erase some of the integration of the the banking and securities industries which has occurred over the past several years and undermine banks' broader quests for more powers.

VI. Conclusion

Whether the Glass-Steagall Act and other legally-imposed barriers to the full integration of the suppliers of financial service providers has served the United States well is, at this point, a source of continuing debate. Those who say "no" focus on the perceived artificiality of the barriers,

impediments to the most efficient aggregation and movement of capital, protection against the desirable forces of competition, and, in the end, a higher cost to consumers and investors.

Those who would contend that such barriers, or at least some distinctions between the providers of financial services, are ultimately beneficial focus on the concentration of power, conflicts of interest, the potential for the elimination of regional providers of financial services, and the potential to discourage innovation.

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