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

Keynote Address
Fourth Annual Seminar
Securities Activities of Banks
Sponsored by
Legal Times and Law & Business, Inc.
New York, New York

October 4, 1984

Bank-Securities Activities: A Public Policy Analysis

Charles L. Marinaccio
Commissioner

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

I appreciate very much your kind invitation to address this important conference on bank securities activities. You have honored me by asking that I provide the keynote address and I know of your deep interest in a public policy analysis of bank-securities activities and the direction that public policy is likely to take in the future.

The Congress is about to adjourn, perhaps tomorrow, without enacting major banking legislation. This will be the first time since 1978 that Congress has adjourned without enacting a major banking bill. That is not to say that Congress did not work very hard in this Congress on financial reform. Much time and effort went into financial deregulation but in the end I think it apparent that the ramifications of financial industry legislation vitally affect so many competitive sectors of the economy that a consensus was not achievable without the expenditure of a good deal more time and effort.

It is not too early to begin thinking about the implications of inaction by this Congress. There are two possible theories in my view that may shed light on where public policy formulation is headed in the future.

One theory is that the division between the House and the Senate is so deep, and the divide between the securities and banking industries is so wide, that political stalemate is inevitable as far out into the future as can reasonably be forecast.

The other theory is that a combination of political and economic factors will drive Congress to reassert its primacy over developing national policy regarding financial services within the next Congress.

I subscribe to the second theory but I do not underestimate the powerful forces at work in the opposite direction.

The Senate now as in the past is considerably ambitious in moving in the direction of deregulating the financial services industry. The Senate bill is an extension of the deregulation of the financial industry that was begun by the Senate in the mid-1970's with the passage of the Financial Institutions Act, a bill that died in the House but was subsequently enacted in major part in legislation in 1980 and in 1982.

Now as in the past there is a substantial agenda which the House wishes to accomplish. The House Banking Committee has considered legislation concerning credit card protections and disclosure of banking fees and funds availability. The House is also in the process of exercising a significant oversight over the consequences of large bank failures on public policy. A report has been issued by another House committee on the causes of failures and regulation of large banks. The House Judiciary Committee has shown interest in interstate branching and the House Energy and Commerce Committee has a deep and abiding interest in bank securities activities. The House appears to be more cautious than the Senate on product deregulation and appears to be emphasizing the role of the Federal government in managing large failures and the impact that the Federal insurance system has on a competitive financial system. While it appears that the House needs more time to establish its own consensus, the only way to accomplish its agenda is in a conference with the Senate.

It is inevitable, given the overwhelming passage in the Senate of the Senate Banking Committee's bill that whenever the House passes a substantial banking bill, the Conference Committee will have to deal with a significant number of bank deregulation matters in the securities area. To conclude otherwise would be to have decided either (1) there will be no banking or securities legislation for years to come (2) Senator Garn will change his mind or (3) Chairman St. Germain does not wish to structure in his own way the development of the financial services industry. Having said this I would not dare to predict the final text of the next major banking bill.

There are two additional factors, one political, and the other economic, which I believe strongly point in the direction of passage by both the House and Senate of major legislation in the next Congress and the appointment of a Conference Committee which will have to deal with legislation proceeding from possibly divergent premises.

The significant political factor is plain and simply that in the absence of legislation, national policy over the evolution of the financial services industry will continue to be set by the bank regulatory agencies and the courts. Congress will not wish to stand by and allow the financial services industry to be deregulated in this manner for a very important reason. The regulatory agencies are not capable of making the tradeoffs that are necessary to develop a coherent national policy that will be supported by a wide consensus.

There is already agreement in Congress on closing so-called loopholes that permit a substantial derogation of existing branch banking restrictions or permit states to change the character of financial services in other states, while maintaining the status quo in their own. The agreement has not resulted in legislation because there is disagreement over new powers for banks and securities firms and the precise role that market regulation will have over a modified financial services sector, including the role of depository insurance, the Federal reserve discount window, IMF assistance that fortifies international portfolios, and disclosure policy versus confidentiality and protection of depositors. With more hearings early next year, these issues will surely ripen for Congressional action.

On the economic side, it is apparent that change continues to alter financial markets. Financial institutions beset with portfolio problems or earnings difficulties will continue to seek to venture into other fields where they perceive the grass is greener. This includes both banking organizations and securities firms.

Consumers continue to adapt to market conditions and, ever increasingly sophisticated in financial matters, are no longer driven by loyalty to any class of provider of financial services. Consumers are willing to buy new products even though offered by non-traditional or non-insured financial institutions. Institutions and their managements are driven by competitive instincts and want the market to perceive them as growth oriented with beneficial effects on share prices. Thus, some securities firms wish to be in the banking business, insurance firms wish to be in the securities business, and banks increase their worldwide presence by substantially enhancing their securities capabilities overseas and at home while the market continues to blur the line between raising capital overseas and at home.

In my view, these economic factors most likely will result in the continued blurring of old lines of demarcation between banking and securities and serve to reinforce the political factors operating upon the Congress to chart a national policy direction for the financial services industry.

Let me now turn to my own views of the value of the separation between banking and securities and the substantial policy issues that must be faced by the Congress if a significant erosion in Glass-Steagall is to become our national policy.

I believe Glass-Steagall has served the nation well. During the past 50 years there has developed on this continent a capital market that is truly the envy of the world. An independent and viable securities industry has been the hallmark of this capital market. Regulation of this market by the SEC has as its chief characteristic a reliance on full disclosure in the marketplace.

Underwriting of corporate securities is fundamentally at odds with the goals that the public demands for bank regulation to provide, including safety of depositors funds and allocation of credit to the market based upon objective lending criteria. There are also a whole host of other securities activities where banks clearly have the capacity to provide the product and where there is consumer demand that provides the identical dilemma. The SEC has testified, for example, that mortgage backed securities are privately issued and privately assessed, carrying no government guarantee, and thus not a proper investment for banking institutions. Likewise, municipal revenue bonds carry no government guarantee and each time Congress has authorized banks to underwrite particular bonds, such as housing bonds, there has been a demonstrated public need to develop a market for the bonds. No such exception is applicable respecting municipal revenue bonds where the market is already highly competitive. Respecting mutual funds the Supreme Court said in powerful language: "Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment bankers pecuniary stake in the success of particular investment opportunies was destructive to prudent and disinterested commercial banking and of public confidence in a commercial banking system." Discount brokerage too carries substantial risk, certainly more than that of a full line broker dealer and recent history shows that even full line brokerage has substantial volatility and consequent failures.

Nevertheless it is clear that banks engage in activities which upon objective analysis are related to securities activities. Banks do underwrite general obligation bonds and certainly can handle municipal revenue bonds and mortgaged backed securities. Banks offer pooled trust funds which are similar to mutual funds. Banks have accommodated customers by acting as brokers and they surely can act as discount brokers. And customers do want these services.

Bank entry into the securities business is taking place outside the purview of the securities laws which have played such a crucial role in establishing investor confidence which is the cornerstone of our capital markets. Direct bank discount brokerage takes place without the protection of securities requirements and regulation. National banks are established for the purpose of marketing collective investment vehicles for employee benefit plans outside the securities laws. And bank investor advisors breaking new ground need not register under the Investment Advisers Act. Investor protection demands that, at a minimum, when banks enter into any phase of the securities business they should abide by the same standards and enforcement mechanisms that apply to securities firms under the securities laws.

There is, however, another more pervasive danger in the current non-Congressionally sanctioned regulator-court drive to deregulate the banking and securities business by slowly but inexorably eroding the line of demarcation provided by the Glass-Steagall Act. That danger is that our capital markets may undergo a complete restructuring without the careful thought and protection that only Congress can provide by statute. The plain fact of the matter is that regulatory agencies and the courts do not have the same breadth of vision that the Congress does when it come to establishing national policy. Their interests are more narrowly focused and their mandate is too narrow to establish comprehensive policy. A continued regulatory-court approach poses the risk of substantially weakening this nation's capital raising mechanism.

An independent and viable securities industry has prospered under Glass-Steagall. The capital markets in our nation have been free from the conflicts of interest which characterize other economies. Consistency dictates that if banks are to be prohibited from entering into the securities business, that securities firms be prohibited from entering into the banking business. However, should it be determined that bank entry into the securities business is desirable, it should follow that the deregulation should be equal. There would be then no good argument for keeping securities firms out of the banking business. One-sided legislation that seeks to enhance bank securities powers while restricting securities firms reciprocal right to enter into the banking business will only serve to deprive securities firms -- especially medium sized firms -- of the earnings they need so badly to maintain their position as full service securities firms, which enable them to play such a big role in the capital formation market for regional and new enterprises. Only a comprehensive approach by Congress to Glass-Steagall reform will do the job that needs to be done. Congress will need to take into account the different regulatory premises between bank regulation and securities regulation and their effect on the structure of financial markets in any such examination before reaching a decision.

Bank regulation proceeds primarily on the basis of guaranteeing the safety of depositors funds and the soundness of banks and the banking system. Bank failures are to be avoided at the expense of the discipline of the free market. Securities regulation is premised on the proposition that the investor is entitled to full disclosure. Central to securities regulation is the concept that the market works best when all material information is disclosed, even and especially when the information may be damaging, and result in the failure of the enterprise. Because of their special place in the life of our economy as impartial allocators of credit, banks have been given special treatment under Federal law to foster the objective of public confidence in their viability and of maintaining their continued operation. There is a special statutory structure underpinning the insured financial system that is in reality a safety net for the system. The safety net consists of a federal deposit insurance program which can be called upon to ensure against bank failure and assure a deposit base for the institution; an ability of the Federal Reserve to advance funds to banks in distress without limit to undergird the solvency of the financial system (an ability I might add in passing that is not statutorially limited to bank assistance but which the Federal Reserve would not exercise for any other corporate enterprise); and an international lending agency which is authorized to make loans for the purpose of stabilizing the international financial structure.

The safety net is of primary benefit to large banking institutions. In the market, large banking institutions derive substantial competitive advantages from the operation of the safety net. When Arthur Burns was Chairman of the Federal Reserve about 10 years ago and made a very comforting statement about not letting large banks fail there developed a two tier price structure for bank borrowing which favored money center banks over regional banks. Chairman Burns' comforting statement has now become a reality in fact. FDIC and Federal Reserve assistance to large banks in distress substantially cushions, if not avoids altogether, market discipline that might otherwise impact on bank management and shareholders. IMF assistance makes it possible for third world countries to pay their obligations as they come due which otherwise would not be the case in order to maintain a world trading system.

The safety net for insured large banks is a reality and meets desirable public policy objectives but raises a further question concerning whether it is in the public interest to permit those banks which benefit by the safety net to engage in securities activities. I would argue that if public policy goes in the direction of combining the industries then, at a minimum, bank entry into the securities industry should be accompanied by abandonment of the safety net for large banks; and policies that lead to effective market discipline on banking institutions through full disclosure should be adopted.

Commissioner Treadway has stated that the structural issues of the permissible range of nonbank activities by banks, and the issue of disclosure and market discipline for banks are two sides of the same coin. He says that "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 risks 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 be truly subject to market discipline." Even Commissioner Treadway's arguments might not be compelling if there were some overriding public benefits to be derived from bank entry into the securities field. Governor Wallich makes a powerful case to the contrary, however. He says in a recent article published in London: "The experience of American banks with nonbanking activities has not always been a happy one. Their record of performance seems to be rather worse than that of the industry generally. This raises a question, at least, about the ability of commercial banks to perform better in real estate, insurance, and securities activities than those already active there." End of quote.

The Senate bill that did not pass in this Congress, but which will be back for consideration in the next Congress, took a giant step in the direction of dealing with the questions of public policy I raise. The Senate bill provided that banks engaging in underwriting municipal bonds, commercial paper, or mortgaged backed securities, could only do so through the holding company or through a separate subsidiary and would have to include in that separate entity the existing securities bank business such as underwriting govenment backed bonds. The Senate bill also prohibited the use of a common name between a bank and its bank holding company securities affiliate.

The House was deeply concerned by these issues in the context of additional securities powers for banks. Chairman St. Germain stated: "The Federal Government, through its bank supervisory system, has decided that it is responsible for everything at Continental. If indeed this is a precedent and the assets of big banks and bank holding companies are a contingent liability of the Federal Treasury then we must look anew at how these institutions operate and under what control. Under the Continental-style bailout, the new powers to be grabbed up would increase the exposure for the insurance fund, the discount window, the Federal Treasury and the American taxpayer." End of quote. I am sure the House in the next Congress will continue its searching examination into the use of Federal guarantees, either in the form of insurance or otherwise, to the banking system and the implication of those guarantees upon competition in and structure of securities and other nonbank markets.

As I have stated, I believe that the political and economic factors will point in the direction of both the House and Senate asserting their control over the development of a national policy direction for the financial services industry in the next Congress. As the Congress does so, I would submit that the following thoughts are appropriate for consideration:

The Glass-Steagall separation between banking and securities has resulted in a viable capital raising market in this nation second to none and devoid of the conflicts of interests that inhibit the growth of venture capital in other world markets;

Congress, not the courts or the bank regulatory agencies, should dictate the pace and scope of change in a financial services industry that seeks to provide needed services to the market;

If Congress determines to deregulate Glass-Steagall, it should proceed along parallel tracks. No substantial securities powers should be given to commercial banks without a reciprocal right for securities firms to enter into the banking business;

If Congress amends Glass-Steagall it should use the Senate bill's functional regulation provisions as a guide and require that all bank securities powers be conducted only in a separate securities subsidiary under equal tax and regulatory treatment including market regulation and adequate capitalization;

Congress should prohibit the use of a common name or common management or any financial dealings between the bank and the separate securities affiliate;

Congress should prohibit the use of Federal insurance or Federal Reserve assistance to protect deposits of over $100,000 in any way, including merger assistance; and Congress should adopt a public policy that requires large banks with securities activities to be subject to identical market discipline regarding failure as are nonbanking institutions; and

Congress should make clear that the operation of the parent holding company and any securities subsidiary derive no intrinsic benefit from affiliation with a banking institution and that if a failure occurs each unit is on its own and the most likely occurance is a break-up of the enterprise.

Glass-Steagall has fostered a competitive economy. If it is to be substantially altered it should be done so on the basis of parity and with protections which will serve to ensure that the competitive economy will not be adversely affected by conflicts of interest in the financial sector.

I am indebted to you for your attendance and attention to my remarks.