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THE IMPACT OF EXPANDED BANKING ACTIVITIES UPON THE SECURITIES INDUSTRY

SECURITIES INDUSTRY IN THE 1980'S CONFERENCE

ATLANTA, GEORGIA

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The Impact of Expanded Banking Activities Upon the Securities Industry

Securities Industry in the 1980's Conference

Atlanta, Georgia

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I would like to compliment Mike Wolensky, the SEC Regional Administrator in Atlanta, for organizing this conference. The multiple issues facing the financial service industries warrant broad national discussion.

This morning, I would like to highlight some recent developments in the banking and securities industries and then invite your comments and questions.

Keen Competition

Banking and securities are keenly competitive industries. For example, institutional brokerage commissions average less than 4/10ths of 1% and retail commissions, less than 1.4%. And insured commercial banks earn about 1% before taxes on their assets.

Money Market Funds

As a result of the Garn-St Germain Depository Institutions Act of 1982, which removed limitations on the interest rates thrift institutions can pay, we have witnessed an unprecedented movement of capital. Just since December:

- o the bank and savings and loan association new Money Market and Super Now Accounts have grown from scratch to over $370 billion;

- o and money market funds have declined $54 billion or 24% to $168 billion.

Some estimate that over $25 billion of the money market bank accounts came out of the money market funds and that the bulk of the balance came out of conventional bank accounts and certificates of deposit.

It is notable that the $54 billion contraction of the money market funds has been handled without incident. About half of these funds are believed to have gone into money market accounts and most of the balance into the strong stock market.

For the six months ended March 31st, SEC filings of new money money market funds have declined 45% - and equity fund filings have increased 70% - as compared with a year ago.

In addition to the money market bank accounts, banks are already investment advisers to over 15 money market funds; and several bank-related investment companies have effective registration statements, including:

- o Citibank's IRA Collective Investment Trust */;
- o Crocker National Bank's Working Capital Trust #/;
- o The Boston Five Cent Savings Bank's School Street Mutual Fund +/;
- o The Guaranty Savings and Loan Association's Government Money Market Fund **/;
- o and the United States League of Savings Associations' Liquidity Fund for Thrifts ##/.

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*/ Series fund with four portfolios offered to individuals establishing individual retirement accounts with Citibank. The bank sponsors, advises, and distributes shares of fund pursuant to Comptroller ruling that such activities fall within bank powers to collectively invest assets received by it as trustee.

#/ Money market fund distributed in connection with first CMA-type account offered by a bank. The Crocker National Bank serves as investment adviser. Brokerage and distribution services are provided by Bradford Broker Settlement, Inc. and Massachusetts Financial Services.

+/ Money market fund sponsored and distributed by a wholly-owned subsidiary of a state-chartered FDIC-insured savings bank, The Boston Five Cent Savings Bank.

**/ Money market fund sponsored by an indirect subsidiary of a state-chartered FSLIC-insured savings and loan association. Shares are offered to customers of the savings and loan, Guaranty Savings and Loan Association.

##/ Money market fund sponsored by a wholly-owned subsidiary of a savings and loan trade association, The United States League of Savings Associations. It is marketed to savings and loan associations to provide them an investment vehicle able to meet their liquidity requirements.

The Commission's Position

With respect to Glass-Steagall Act questions raised by such investment companies, in the absence of adverse rulings by the bank regulators, the SEC has merely required disclosure of such possible regulatory problems.

Discount Brokerage

The thrifts are also aggressively entering the discount brokerage field:

- o the Bank of America has acquired Charles Schwab & Co., the nation's largest discount broker;
- o the Chase Manhattan - Rose & Co.;
- o the Security Pacific - Kahn & Co. and the RMJ Co., a government bond dealer;
- o the Union Planters National Bank - Brenner Steed & Co.;
- o INVEST is offering brokerage services nationally through 141 branches of 24 S&Ls;
- o and six other S&L service corporations have obtained Federal Home Loan Bank Board permission to enter the discount brokerage business.

Discount brokerage is the fastest growing segment of the brokerage industry. Its share of retail commissions has more than doubled in the past five years - increasing from 3.8% to 8.4%. Bank and S&L units will execute about 20% of all discount retail brokerage transactions this year -- and perhaps 50% by 1985. #/

This is a fertile field for the thrifts, because the discount brokers have been averaging about 20% after taxes on their equity (which compares very favorably with most thrifts); and also because of the reluctance of the major brokerage firms to enter the field for fear of disaffecting their account executives. However, General Motors would not be the company it is, if it had not been willing to add models which competed with its existing lines; and the downtown full service department stores bear witness to the consequences of their reluctance to open discount operations in shopping centers.

#/ Roger T. Servison of Fidelity Brokerage Services, New York Times p. D-10, April 19, 1983.

Two-Way Street

However, I would hasten to add that the traffic is moving in both directions. Securities firms are aggressively expanding their bank-like activities. In addition to the money market funds, cash management accounts, and paying interest on credit balances:

- o Shearson-American Express has acquired the Boston Safe Deposit and Trust Company;
- o The Fidelity Group - Fidelity Trust of New Hampshire;
- o Dreyfus - the Lincoln State Bank of New Jersey and has a charter pending for a national bank in New York City;
- o Merrill Lynch has proposed the addition of an S&L to its complex;
- o and Sears, which owns a large west coast S&L, has acquired Dean Witter Reynolds, a major full service securities firm.

Position of Bank Regulators

The federal regulators' attitudes toward such financial conglomeration vary.

The Fed, which regulates about 1,000 state banks, is in favor of permitting banks to underwrite revenue bonds and commercial paper, and manage commingled agency accounts, and of permitting bank holding companies to own discount brokers, but opposed to securities firms and others acquiring non-bank banks - which are banks that do everything except commercial lending.

The Treasury would permit bank holding companies to underwrite municipal revenue bonds and sponsor mutual funds, through separate corporate affiliates; and under certain circumstances, would permit securities firms to engage in banking activities, through separate banking affiliates, but has called for a moratorium on securities firms acquiring or setting up their own non-bank banks.

The Comptroller, which regulates about 4,500 FDIC insured national banks, has permitted discount brokerage, and Citibank to set up a pooled IRA fund, and has granted preliminary approval to charter applications by non-bank banks, but recently imposed a moratorium on new applications by non-bank banks.

The FDIC, which regulates about 9,000 FDIC insured state banks, has permitted banks to enter the discount brokerage field and sponsor mutual funds, and securities firms and others to acquire non-bank banks.

The Federal Home Loan Bank Board, which regulates about 3,000 FSLIC insured federal S&Ls, savings banks and other thrifts, has permitted S&Ls, through their service corporations, to establish discount brokerage affiliates.

SEC Position

The SEC supports the Treasury's approach. Specifically:

- that depository institutions be permitted to underwrite municipal revenue bonds, sponsor investment companies - and continue to engage in certain other securities activities **/ - through separate corporate affiliates, subject to the same rules, regulations and tax treatment as all other broker-dealers;

- and that broker-dealers that engage in no greater securities activities than those permitted the banks, be permitted to set-up separate banking affiliates, subject to the same rules, regulations and tax treatment as all other banks.

Fair Competition

Competition should be fair. Competing teams should play by the same rules, with the same referees. Banks and securities firms presently play by different tax, regulatory and self-financing rules.

For example,

- money market funds can solicit investors throughout the nation, but inter-state banking is restricted by the McFadden Act;

- on the other hand, banks have access to low cost federally insured funds (i.e., deposits) and to the Fed's discount window;

- banks are permitted to underwrite tax-exempt general obligation bonds, and to deduct for tax purposes the interest costs of carrying such positions, but broker-dealers are not;

**/ Underwrite municipal general obligation bonds and provide dividend investment, employee and customer stock purchase plans, and other brokerage services.

- o banks which provide brokerage services directly, rather than through separate corporate affiliates, are not subject to the securities law requirements concerning the character, competence and supervision of securities salesmen, nor to the "suitability" and "know your customer" rules;

- o bank-sponsored collective funds - employee benefit and other plans - compete with mutual funds, but are not subject to as stringent disclosure or advertising requirements;

- o and bank money market accounts are federally insured; but money market funds are not, which is one of the reasons securities firms and money market fund managers are acquiring non-bank banks in order to offer federally-insured money market accounts, as well as to provide trust services to pension funds.

These are the major disparities which should be removed, to facilitate capital formation and mobility, fair competition and investor and depositor protections.

At the same time, it is necessary to continue to restrict potential conflicts of interest. Prior to the Glass-Steagall Act, banks provided all of the following services to corporate clients. They held their deposits, provided short term working capital loans and underwrote public offerings of stock and bonds to pay-off such short term loans. Sometimes, they also purchased such stocks and bonds for their trust accounts. When the market collapsed in 1929, the banks were accused of doing so-called "bail-out financing" - public offerings to pay-off their own soft loans - and of laying-off their unsold underwriting positions in their trust accounts.

Because of such possible conflicts of interest, none of the federal regulators have as yet suggested that banks or their affiliates be permitted to underwrite corporate securities or that securities firms be permitted to engage in full scale commercial banking activities.

The foregoing is a snapshot of the present battle scene of the banking and securities industries.

Thank you.

Addendum

In response to questions concerning legislative and other initiatives in prospect, Chairman Shad responded:

At the present time the Fed, Comptroller, FDIC and Federal Home Loan Bank Board administer the full disclosure requirements of the thrift institutions under the Securities Act of 1934. The SEC administers it for thrift holding companies and all other publicly-owned corporations. In the interest of efficiency and uniformity of public disclosures, it would make sense to consolidate these activities within the SEC.

Last year the proposed amendments to the Glass-Steagall Act included consolidation of the insurance functions of the FDIC, the FSLIC and the National Credit Union Administration, which offers operating and other advantages. Risk-related insurance premiums have also been proposed by the FDIC and others.

It has also been suggested that when the FDIC facilitates an upstream merger of a troubled bank, that depositors of over $100,000 be subject to "haircuts" (i.e., less than full recovery).

The foregoing, full disclosure, risk-related premiums and "haircuts" on large deposits would bring additional disciplines of the marketplace to bear upon thrift institutions; which has the advantage of facilitating evolutionary change in response to economic conditions. Some of the thrifts' problems are attributable to relatively inflexible regulations - which tend to be reactionary to past problems, rather than anticipatory of future needs and opportunities.

The foregoing measures would enable and induce investors and depositors to more carefully assess the risk and rewards offered by investments and deposits in such institutions.

It has also been suggested that the antitrust responsibilities of the Fed, the FDIC, the Comptroller and the FHLBB be consolidated in the Justice Department; and that their consumer protection responsibilities be consolidated in the Federal Trade Commission.

Some of the bank regulators have also suggested consolidating the regulatory and examination responsibilities of the Fed, the FDIC, the Comptroller and the FHLBB into a single agency, which would include representation in its governing body of such agencies. The Fed has indicated that it would like to retain its regulatory authority in order to stay in close touch with the banks, in the exercise of its central bank and monetary policy responsibilities.

The Fed is presently engaged in a comprehensive study of the margin regulations. I have suggested that such regulations be transferred to the securities exchanges (i.e., the self-regulatory organizations); which is the manner in which margins are presently regulated in the futures markets; and that all margin regulations of securities and futures be subject to the oversight and coordination by a three-man committee, consisting of an SEC Commissioner, a CFTC Commissioner and a Fed Governor, in order to coordinate margin regulations so that similar financial instruments compete on their economic merits, rather than their margin regulations.

In addition, at the present time, securities and commodities brokers are subject to oversight and regulation by the SEC, the CFTC, approximately 20 self-regulatory organizations and 50 state regulators. In order to reduce duplicative, overlapping and conflicting regulations and the attendant paperwork, I have suggested that a single self-regulatory organization have the responsibility of monitoring and inspecting such firms through the use of standardized forms and inspection teams, which would refer violations to those agencies or SROs which have the enforcement responsibilities.

Some have suggested consolidation of the SEC and the CFTC, but it does not appear to be a politically practical possibility at the present time. Instead, it is suggested that these two agencies' regulatory schemes, margin, disclosure and suitability requirements be coordinated and harmonized. The two agencies are presently working in this direction.

	As of December 15, 1982 (in billions of dollars)	As of April 20, 1983 (in billions of dollars)
Money Market Deposit Account	--	$342.6
Super Now Account	--	30.1
Taxable Money Market Funds	$222.8	171.8 (May 4: $168.3)
Tax Free Money Market Funds	14.2	15.6 (May 4: $15.0)

Differences in Size of Money Market Funds: 12/15/82 to 5/4/83

Taxable	(54.5)	=	(24.45%)	decline
Tax Free	0.8	=	5.09%	increase
Total	(53.8)	=	(22.68%)	decline

Discount Broker Market Share

	1977	1978	1979	1980	1981	1982	1990 DEPA est.
Shares of Retail Commission Revenues	3.5%	3.8%	4.5%	5.6%	6.3%*	8.4%*	10%
Shares of Retail Transactions	7.0%	7.6%	9.0%	11.2%	12.6%*	16.8%*	20%
Share of Gross Revenues	-	-	1.7%	2.1%	1.6%*	1.8%*	-

*Source is SIA

Note that the discount brokers' share of retail transactions assumes that the commissions of these firms are 50% of the commissions of full service firms. These estimates were derived by multiplying the measures of the discount brokers' share of retail commission revenues by two. Because they are one assumption removed, the share of retail commission revenues may be more accurate.