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**News
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CHALLENGES FOR THE U.S. FINANCIAL SYSTEM IN THE 1990S

E.J. Faulkner Lecture by

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It is a great pleasure to be here today and to have a chance to deliver the E.J. Faulkner lecture. When Governor Kay Orr encouraged me to accept this invitation, she assured me that I would find this a very rewarding opportunity to discuss issues of national concern with the entire community of scholars, students and friends of the University here in Lincoln. After two days of talks, I am certainly pleased to have had this opportunity.

We live in a time of great economic change. The process of converting the domestic economies in the West into a larger global economy is continuing rapidly, as exemplified by both the so-called "EC '92" process and the impending conclusion of the Uruguay Round of trade talks. At the same time, this economic integration of the Western nations has been overtaken by the collapse of communism and by the sudden and profound reshaping of the political and economic structure of Eastern Europe. Events in the Soviet Union continue to move rapidly, with both economic and political changes of heretofore unimaginable proportions underway.

Many of the changes that have swirled around us in the last two years are extremely positive. Indeed, they should be a source of pride at the fulfillment of many of the values and objectives of Western foreign policy over the decades since Winston Churchill so vividly characterized the "Cold War" and the

imposition of the "Iron Curtain" in a speech here in the midwest. To those who remember the courage and the determination of President Kennedy when he stood in Berlin, across a narrow strip of land from legions of Soviet tanks, and proclaimed "Ich bin ein Berliner", the peaceful reunification of Germany under democratic rule and as a member of NATO is a triumph for democracy. I suppose it also demonstrates how large an LBO can really get!

Last June I visited Berlin, and the area around the Berlin Wall had been occupied by young "entrepreneurs" selling alleged fragments of the Wall. For only a few Deutschemarks, you could rent a hammer and chisel for five minutes and have at the wall yourself. From hammer and sickle to hammer and chisel in only a few months is certainly remarkable. Of course the revolutions in Poland, Hungary and other countries in Eastern Europe are no less striking.

In Hungary, I had an opportunity to help reopen the Budapest Stock Exchange, which had been closed for 42 years. While visiting the Hungarian Parliament I was told that virtually all the magnificent stained glass windows were original, having survived two world wars. When I pointed out a very small window containing the Hungarian flag and a communist "red star", the guide responded with evident deep feelings that "No, that window is not original. And it won't be here when you make your next visit."

Paralleling the political change in Eastern Europe has been a revival of interest in free markets as the best mechanism to achieve economic growth. However, despite the euphoria stemming from political developments, the restoration of markets and the restructuring of the economies of these countries will be a long and difficult process. Literally generations of distorted economic policies must be overcome, and whole industries will probably disappear while these economies adjust to international competition. The job will be most difficult of all in the Soviet Union.

Change has not been confined to Eastern Europe. Just one week ago I met with President Carlos Salinas of Mexico before signing an agreement of cooperation in securities regulation and enforcement with our colleagues at the Comision Nacional de Valores of Mexico. Coupled with earlier agreements between the SEC and Canadian authorities, this Agreement will help move toward realization of a "North American" capital market.

Mexico is well along in a program to close or sell all of the hundreds of state-owned companies, and to open its markets to foreign trade and foreign investment. It is also working to reduce substantially the involvement of the government in economic decisionmaking by a program of regulatory flexibility similar to the very successful U.S. steps to reduce unnecessary

government regulation. Mexico has cut its tax rates in half, while significantly broadening the tax base. Everywhere we went in Mexico, people expressed strong support for a free trade system linking the U.S., Canada and Mexico in what would be the world's largest trading zone.

These and many other important developments represent only a portion of the international forces reshaping the U.S. economy. The importance of international trade and exports is certainly well-understood in Nebraska and other states with strong agricultural sectors. However, our financial markets may be even more directly linked internationally than any other sector of the economy.

Numerous statistics demonstrate this fact. Literally trillions of dollars in investments flow across borders every year, and almost 15% of trading in the New York Stock Exchange involves a foreign individual or institution on one side of the trade. Last year almost \$100 billion in equity investments were made internationally, representing a powerful source of capital for many countries.

In many respects, the "United States" securities market has been replaced by a tightly linked global market. Our own ability to enforce the laws against market manipulation, to protect market stability through capital rules and other oversight of

intermediaries or to regulate trading systems has been weakened due to the ease of arranging virtually any transaction to occur through a foreign market or firm. Thus, the ability of each nation to regulate its share of the world market has become highly dependent on the cooperation of other countries.

Fortunately, we share many common objectives like market stability and investor protection, and there is a steadily growing amount of joint international action to establish and enforce sensible regulatory standards. Plainly we must work harder to develop more consistent accounting and disclosure standards, common capital requirements, mechanisms for joint or cooperative examinations of multinational firms, increased reciprocal recognition of registration of professionals or products and strengthened international law enforcement in the years ahead.

However, I am quite optimistic about our ability to move forward on these issues in a very productive manner. Indeed, last month the SEC hosted our colleagues from the United Kingdom and Japan for two days of talks. This was the first time that the regulators of the world's three largest securities markets -- together representing about 2/3rds of the world's equity market capitalization -- had met as a group to discuss how to meet our common objectives.

While we will need to adapt to many new dynamics arising out of the international arena, from my perspective perhaps the biggest task that lies in front of us in this decade is the reinvigoration of the domestic U.S. financial system. For far too long a vast array of ineffective, inefficient or counterproductive laws and regulatory programs have been allowed to undermine the safety, profitability and competitiveness of U.S. markets and firms. Too many banks and securities firms are not as strong as they should be, and our regulatory system too often is either inadequate or counterproductive.

After suffering the worst financial debacle in human history in the collapse of the savings and loans, and facing intense global competition, it is time for us to face up to our problems. This means summoning the will and the courage to take strong action, and even to retire a few sacred cows to the pasture.

Both the banking and the securities industries in the United States are characterized by significant overcapacity, weak earnings, unnecessary costs and structural difficulties. Consider for a few moments the banking system. During the last three years, U.S. banks have incurred aggregate loan losses of more than \$80 billion dollars. That is an extraordinary sum, equal to all the research and development expenditures in the entire U.S. economy annually.

Only one U.S. bank is now among the 25 largest in the world, which is not entirely surprising since the U.S. is the only major nation not to allow its major banks to operate on a nationwide basis. Since size and capitalization determine lending limits, the relatively small size of U.S. money center banks in world terms means that they will be unable to fund projects nearly as large as their foreign competitors.

More than 700 banks have failed in the past three and one half years, and the reserves of the FDIC have plummeted to unprecedented low levels. Between troubled loans in commercial real estate, third world exposures and "highly leveraged transaction" (LBO) loans that may prove vulnerable if the economy is less than robust, some specific institutions face obvious challenges. Beyond that is a more general weakness. Over the past two decades, the intermediated loan has become increasingly more costly compared with securities offerings like the sale of commercial paper. As the product demands of their customers shifted, banks often faced legal barriers like the Glass-Steagall Act to offering the new types of products their customers were seeking. At the same time that there was a steadily shrinking demand for traditional loans, the deposit insurance program, coupled with interest rate deregulation, resulted in huge volumes of lendable funds flowing into the banking system, often far in excess of quality borrowing needs.

The regulatory system for banks has worked far better than that of the S&Ls, but it too has problems. Certainly one problem is the severe distortions that are caused by deposit insurance. Today taxpayers stand behind about \$5 trillion in assets of insured institutions. Few taxpayers probably note on their financial statements that they have a 1/100 millionth share of a \$5 trillion contingent liability, but that approximates the result of the current deposit insurance program.

If the taxpayers are going to have such a massive exposure, and provide their credit, through the Treasury, to banks, at least they should be told the cost of the program, to say nothing of the value of the insurance. At present, however, foreign depositors, uninsured depositors and even general creditors are often "bailed out" by the FDIC, depending on how generous it feels on a particular day, though no premium whatsoever is collected for this protection. Even for insured domestic deposits where a premium is charged, until 1989 it took an act of Congress to raise the insurance premium banks pay. This may account for why the actual premium had not been raised since 1935.

Most measures of the value of deposit insurance suggest that a U.S. Treasury "credit enhancement" has a market value of between 80 and 150 basis points. Since the premium next year is currently slated to be slightly under 20 basis points, this represents an enormous implicit subsidy. The magnitude of that

forgone premium revenue not only may leave the FDIC underfunded, but it also may drive excessive levels of savings into bank deposits rather than other forms of financial instruments.

Another problem of the banks is inadequate capital reserves. In order to continue absorbing tens of billions per year in loan losses, as well as to meet higher capital requirements sought by the bank regulators, the U.S. banks need to raise huge amounts of capital. This will not be easy for any industry with weak profits. It will be harder for the banks, because investors appear reluctant to acquire bank stocks. This may be related to the fact that investors have lost more than \$7 billion as a result of the failure of only a few of the larger banks and thrifts during the last six years.

Another barrier to banks raising capital in the market is that the traditional bank accounting standards have permitted historic "cost" accounting for most of a bank's securities portfolio. This enables an institution that may have incurred enormous losses in the value of its securities, like government bonds, to directly overstate its actual financial condition and results of operations on its financial statements. Creditors and investors learn about the bank's asset values "once upon a time" rather than what currently exists.

With stock price/earnings ratios that may be one-third of

market averages, it is reasonably clear that the market does not believe the reported earnings of many banks. This situation breeds uncertainty and increases the costs of financing.

An even bigger obstacle to raising capital for the banks is the fact that in the United States today it is unlawful for firms from outside the banking "club" to acquire a bank. Successful American corporations like IBM, AT&T, General Electric or others may not invest either their capital, or their technological and managerial resources, in a U.S. bank. This restriction is now seriously counterproductive. Why should it be lawful for Mitsubishi Heavy Industries to be one of the largest shareholders of Union Bank in California, but not for a comparable U.S. corporation? The current law shuts banks off from the largest pool of capital in the U.S. and also increases foreign ownership of our banking system.

To address these and other weaknesses will require major changes in our current banking laws. However, the time has unquestionably come for removing all remaining geographic branching limitations. I believe that it is also time to allow the ownership of banks by any type of firm within an appropriate holding company structure that will insulate the capital of the bank from the demands of a parent corporation or other affiliates. We should define explicitly the extent of our federal safety net, and firms or individuals that are not insured should not be entitled to receive a gratuitous federal bailout.

Perhaps it might even be beneficial expressly to preclude FDIC payments to individuals without a legal claim for insurance. Realistic premiums should be considered, along with some consolidation of the federal supervisory agencies to reduce enormous duplicative costs.

To promote more effective competition, both the Glass-Steagall Act and the Bank Holding Company Act should be substantially revised. Competition should be promoted by allowing holding companies to own separate affiliates that engage in banking, securities and other activities. In such a system, supervision of the operating unit (bank, broker/dealer, etc.) would be on a "functional" basis by the most appropriate agency.

In the event of such a restructuring, it would be critical to decide the degree of oversight of holding companies and the form such oversight should take. Here the traditions of the banking and securities systems are substantially different. While bank holding companies are not allowed to have activities outside the field of banking, parent firms of broker/dealers can and do include many large and diversified firms like American Express, General Electric, Prudential and Equitable Insurance and Sears. These large and well-capitalized firms have proven to be a source of capital, management and overall stability.

The current system of detailed prior review of major

business decisions of bank holding companies would be obviously inappropriate for diversified holding companies. The G.E. board of directors, not a Federal Reserve staff member, should decide the levels of investment in securities, jet engines and appliance manufacturing. The banking system could be protected by requiring realistic capital levels to be paid into any subsidiary bank, and then not allowing the parent corporation to withdraw or otherwise utilize such capital. Similarly, a holding company that could not maintain adequate capital investment levels in its subsidiary bank should expect that such bank would be sold or otherwise recapitalized before its net worth reached zero.

Perhaps the most effective and efficient structure for regulation of such holding companies would be to maintain the accounting and disclosure requirements of the SEC, and to add a right on the part of bank and other supervisory agencies to conduct an inspection or examination of the parent firm and other affiliates whenever such action is deemed advisable. Under this approach a holding company with a bank, a securities firm and an insurance company as subsidiaries could expect to be subject to examinations by any (or all) of the relevant bank, securities or insurance regulators.

I have tried to examine some of the important problems facing the U.S. banking system, and to suggest possible new

approaches in several areas. However, I would not want to suggest that there are not any appropriate changes that should be made in the securities system. As with banking, there is significant current overcapacity in the industry. The fragmentation of regulatory oversight over stocks, options and stock index futures is also a problem that needs to be solved. Finally, we must find ways to reduce the duplication and unnecessary cost and delay represented by the various state securities laws. The states have a very strong record in attacking fraudulent practices, yet the barrier to liquidity of multiple filing requirements in dozens of states is of questionable desirability today.

I do not mean to suggest that the thoughts outlined above are the only "right" answer on how to overhaul the U.S. financial structure. Clearly simplification and consolidation of our laws and regulatory bodies can help produce more streamlined, more stable, and more profitable financial firms. Some of this work can be done by the government, and I expect the Treasury Department will provide much more specific proposals for reform by early next year. However, it will be critical to also have the input and creativity of the private sector in finally addressing our fundamental problems. Somehow this must be done outside the framework of traditional industry "official" pronouncements, and in a spirit of genuine pursuit of the strong national interest in safe and competitive markets and firms.

Many of these measures to improve our financial regulatory system, and to reduce the cost of capital, are beyond the control of my agency, the SEC. We have, however, perhaps the most important responsibility of all: maintaining and improving public confidence in the U.S. securities markets. Individuals and institutions, domestic and foreign, will not invest in the U.S. markets unless they are confident that the markets operate legally and fairly. Without such investment, companies will not have the capital they need to innovate, improve and expand. Confidence in the integrity of our markets, therefore, is critical to our quest for sustained economic growth.

Maintaining and building investor confidence is why the SEC places so much emphasis on enforcing the laws against market manipulation, insider trading, and other forms of securities fraud. Whether it is a broker churning customer accounts, or an investment banker seeking to manipulate prices of an entire market, securities fraud is an attack on the health of our markets and the strength of our economy. We will continue to strive to detect and punish all types of violations of the securities laws. We have just received, in the Enforcement Remedies Act of 1990, the authority to fine violators of the securities laws, and to order them to cease and desist from illegal practices. We will continue to work with the criminal authorities to see that those who engage in serious violations of

the securities law serve time behind bars.

Maintaining individual investor confidence is also the reason why the Administration has proposed that a federal agency, rather than the futures exchanges, regulate margins on stock index futures. Margin requirements limit the amount that can be loaned to an investor. The margin level for securities, set by the Federal Reserve Board, has been 50% since 1974, which means that a broker may not loan a customer more than half of the purchase price for securities. The margin level for stock index futures is set by each exchange, and varies from exchange to exchange and from time to time. In October 1987 and October 1989, margin levels were as low as 2%, meaning that a broker could loan a customer as much as 98% of the purchase price of a stock index future.

Last October 13, in less than two hours that afternoon, 50 million Americans lost \$160 billion in the value of their IRAs, mutual funds, pensions, college funds and other investments. One factor in the speed of the market's fall was excess speculation fueled by grossly inadequate margins in the stock index futures markets, where 97.8 percent leverage was in effect for many market participants as the plunge began, and by increases in these margins levels while the stock market was falling. E. Gerald Corrigan, President of the Federal Reserve Bank of New York, recently observed that if you are forced to raise margins

in a crisis, the margins were inadequate in the first place to do their job of protecting the payments system. It should not take a Nobel prize economist to help us decide that a market built on 98% speculation is not likely to be stable.

After the debacle of the thrift industry, the public wisely demanded that capital levels be set by an agency not under the domination of the regulated industry. Imagine the outcry had the U.S. League of Savings Institutions been authorized to set the thrift capital levels. Yet, the futures industry has fought furiously to maintain the industry's power to set margin levels without any restriction or public oversight. President Lincoln rightly pointed out that a house divided against itself cannot stand. In this case, \$3 trillion of the American public's money is in the house, and there are not any sound policy reasons for taking unnecessary chances with the investment savings of 50 million Americans.

This issue is not, as some news reports have suggested, just a squabble between the SEC and the Commodity Futures Trading Commission, or between the securities and commodities industries. What is at stake is the stability and safety of our securities markets, in which 50-60 million people participate. The issue also has nothing to do with agricultural futures; the SEC does not suggest that any agency other than the CFTC should regulate such futures. Indeed, the CFTC would have the time to do a

better job overseeing agricultural futures, and thus it would serve the agricultural community better, if it did not spend so much time worrying about financial instrument futures.

Achieving an overhaul of a financial regulatory system with decades of barnacles will be difficult. Nonetheless, we simply cannot afford to allow U.S. financial markets and institutions to be uncompetitive or unduly risky, or to accept a cost of capital substantially higher than that of our competitors. Together, we can help insure that the U.S. economy continues to enjoy a financial system that is the envy of the world.