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CHANGING FINANCIAL SERVICES AND REGULATION

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I appreciate the opportunity to participate in this Financial Institution Forum focusing on the current redefinition of the boundaries between the banking and securities industries, the impact of these changes, and what Congress and federal and state regulators should be doing in the public interest. Over the last several years I have had the privilege of working closely with many of you. We have not always been in agreement on all issues, but we have sought to support each other and to coordinate our efforts to assure that investors are treated fairly and that our securities markets facilitate capital formation in an efficient manner.

As all of us are aware, the convergence of the securities and banking industries is not a new phenomenon. However, the pace of change has accelerated in the past several years. The focal point of this activity is the Banking Act of 1933, commonly referred to as the Glass-Steagall Act, which was enacted to limit the extent to which individuals and institutions could engage in both commercial and investment banking. The printed materials sent to you in September by Houston Matney, chairman of your Committee on Financial Institutions and Legislation, cover the important sections of this Act. Thus I will assume that all of you are familiar with its basic provisions.

Increasingly, members of the commercial and investment banking sectors each claim that the other is not complying with the restrictions imposed by Glass-Steagall. In light of recent events, such feelings are quite understandable. Earlier this month, the Federal Reserve Board authorized the Bank America Corporation, which owns the largest bank in the United States, to buy Charles Schwab & Company, which is the nation's largest discount brokerage firm and a member of the New York and other stock exchanges. Also, late last year, the Comptroller of the Currency determined that the establishment and promotion of a collective investment trust for Citibank individual retirement accounts, which would be registered as an investment company, would not violate the Glass-Steagall Act. In addition, within the last year or two we've seen an explosion in the growth of personal money management accounts, such as Merrill Lynch's Cash Management Account, which integrate a brokerage account with a money fund, a regular bank checking account, a charge card or debit card and automatic borrowing through a margin loan against securities. Furthermore, last month the Federal Deposit Insurance Corporation, approved an application by Dreyfus Corporation, a major mutual fund complex manager, to acquire Lincoln State Bank, a New Jersey chartered non-member insured bank.

The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

There are at least two major problems in dealing with the increasing convergence of the securities and banking industries. One is that Congress did not clearly define the dividing line between them. The other is that similar activities engaged in by these two competing industries are subject to significant regulatory differences. Both of these problems have become more critical as institutions, using new telecommunications and computer technology, have structured competing instruments to circumvent Glass-Steagall restrictions and offer functionally equivalent services.

There are some in the securities and banking industries and in state and federal regulatory agencies who argue that the way to deal with these problems is to clarify and strengthen the prohibitions contained in the Glass-Steagall Act in order to erect a stronger and more effective barrier between investment and commercial banking. I disagree with that approach. I believe that legal impediments to financial activities that enterprising individuals desire to develop in response to market forces, including customer preferences, impose significant economic inefficiencies and costs. Moreover, experience indicates that such restrictions generally are not effective in the long run. For instance, when banks and other depository institutions were precluded from paying interest on demand deposits, it was only natural that those institutions desiring to attract additional depositors offered to permit transfers between savings accounts paying interest and checking accounts which could not. When market interest rates rose to more than three times the rate banks and thrift institutions were permitted to pay on liquid savings deposits, the money market mutual fund with a high rate of return and full liquidity was an ingenious free market response. Its rapid growth and and success is conclusive evidence that it filled an important public desire.

Because of its competitive superiority, it is not surprising that there were attempts at the state and federal level to impose rate ceilings, reserve requirements and other bank-type regulations on money market funds. I provided testimony in opposition to these regulatory proposals on the basis that they were unnecessary for investor protection and that their apparent purpose was to reduce the attractiveness of money market funds vis-a-vis traditional deposit accounts. I expressed a strong view that it would be more appropriate to remove restrictions on would-be competitors instead of further interfering with the efficiency of the free-marketplace. Fortunately for individuals with relatively moderate savings, new restrictions on money market funds were not adopted.

Thus, in order to be competitive, banks were forced to innovate. Operating within existing restrictions, they developed sweep arrangements in cooperation with money market funds through which the benefits of liquidity and a high rate of return would be made available to their depositors. Banks also utilized 42 month certificates of deposit, on which there are no rate limits, to provide high interest, and added liquidity without the required penalties for early withdrawal by making "loans" to customers who wanted to withdraw funds prior to expiration of the certificate.

The money market deposit account which the federal government recently authorized did away with the need for banks and other depository institutions to develop resourceful contrivances in order to compete and is a much better regulatory response than earlier proposals to restrict money market funds. However, the desirable features of these new accounts, including federal insurance, may now have tilted the balance in favor of deposit institutions. Some in the securities industry are reacting by seeking to provide insurance on their money market funds in amounts comparable to the federal deposit insurance on the money market accounts. In fact, such proposals are contained in registration statements filed with the Commission. Broker-dealers are also developing ways to offer their customers participations in the insured, liquid instruments offered by depository institutions. For instance, late last year, after Congress approved money market accounts, the Federal Home Loan Bank Board indicated, in a response to an inquiry from a broker-dealer, that it would consider a participation in a jumbo certificate of deposit issued by a savings and loan to be the same as an account in an S&L. This means that broker-dealers could purchase very large certificates of deposit with high yields and parcel out pieces of the certificate to individual customers who would still retain federal insurance coverage. There are also other proposals under consideration.

Instead of trying to stifle these efforts to offer more attractive financial services to the public by imposing additional government regulation, I believe we should not only permit but encourage enterprising individuals to seek greater profits through the development of innovative financial services. In other words, I believe it is generally in the public interest to remove anti-competitive barriers and limit government intervention to rules and regulations providing appropriate minimum standards of operation in specific areas of possible abuse.

Fears about depositor confidence in safe and sound banking, concentration of economic power, self dealing, conflicts of interest, fair competition and investor protection should be resolved through deposit insurance and effective enforcement of capital requirements, antitrust statutes, limitations on certain types of transactions between affiliates and appropriate disclosure standards. These requirements should be administered by regulators with authority, under Congressional oversight, to be flexible enough to meet new situations. This does not mean that all barriers between commercial and investment banking should be removed immediately or that additional study is unnecessary. Changes of this magnitude are usually accomplished best in a step-by-step approach so that businesses may adjust their activities in a responsible manner and regulators can better judge the consequences of various modifications. However, I believe there has been sufficient study for Congress to determine that it is not necessary to prohibit banks from underwriting municipal revenue bonds and sponsoring mutual funds within a structure that provides for regulation comparable to that of broker-dealers engaged in these activities. Nonetheless, additional study could be helpful in other areas, such as determining whether banks should be permitted to act as full service broker-dealers, including underwriting corporate securities, and how to to deal with conflict of interest problems that could exist if this were permitted.

I have been asked on occasion why the Securities and Exchange Commission does not take a more active role in questions of whether certain activities by banks are appropriate under the Glass-Steagall Act. The main reason for this is that the Glass-Steagall Act is, in reality, the Banking Act of 1933, and the SEC does not have authority to establish rules, regulations or interpretations under that statute, whereas Federal bank regulators do have such authority for banks under their jurisdiction. On the other hand, the Commission does participate in the decision making process by giving its views to bank agencies on the basis of our expertise in securities matters. In appropriate instances, we also participate as a friend of the court in cases dealing with Glass-Steagall issues. The most recent example of this was in connection with the question of whether third party commercial paper is a security.

In addition, the Commission has taken the Glass-Steagall Act into account in making decisions with respect to requests for acceleration of registration statements. This has been done because the Commission must make a public interest finding as a prerequisite to accelerating a registration statement under Section 8(a) of the 1933 Act. For example, in July of last year the Commission considered whether to accelerate the effective date of the registration statement of the School Street Mutual Fund, the investment adviser and principal underwriter of which were to be wholly owned subsidiaries of a state chartered savings bank which itself would be prohibited by Glass-Steagall from operating the Fund directly. The Commission decided to delay acceleration pending consultation with the Federal Deposit Insurance Corporation, the pertinent federal regulatory bank agency for this Glass-Steagall issue. After satisfying itself that the FDIC did not object to the proposed arrangement, the Commission granted acceleration. At the same time, the Commission emphasized that there should be adequate disclosure by registrants of possible problems presented by the Glass-Steagall Act and the potential consequences if there were adverse rulings on such issues by bank regulators or the courts.

It is important to understand, however, that acceleration is not necessary for a registration statement to become effective. Applicants may withdraw their delaying amendment and go effective by lapse of time. If this occurs, as was the case in some instances following the Commission's decision last year, any action the Commission might take must be based on the securities laws and not the banking laws.

It seems to me that if Congress authorizes national banks to underwrite revenue bonds and sponsor mutual funds, as a matter of competition, state banks will receive the same authority. That has been the pattern throughout the history of our dual banking system. Thus, such decisions will have a significant impact on state regulators. At the same time, I do not know how state bank regulators and state securities administrators fit into the continuing debate over the degree, if any, to which investment and commercial banking should be separated by federal law.

Whatever Congress does or does not do to facilitate the more orderly development of full service financial institutions, there are questions of regulatory jurisdiction that should be resolved in order to provide efficient, comparable regulation of competing firms. Over nine years ago, shortly after being appointed to the Commission, I recommended that federal regulatory jurisdiction be determined by the type of activity performed rather than by the type of institution involved. That approach is now receiving more support. However, there are currently a growing number of financial services which combine elements of insurance, investment banking, and commercial banking. As long as several regulators have jurisdiction over the activities of various financial institutions performing similar services, there will still be potential problems of inconsistent and overlapping regulations. Thus, there have been suggestions that regulation of financial institutions might be better if there were only one federal financial institution regulatory agency combining the jurisdiction of the federal bank agencies, the Federal Home Loan Bank Board, the Federal Credit Union Administration, the Commodities Future Trading Commission, and the SEC.

It seems to me that, considering the evolution taking place toward the full service financial institution, consolidation of regulators would be desirable in many respects. A possible approach would be to establish a single financial institution regulatory agency with separate operating divisions to deal respectively with responsibilities such as disclosure, examinations, enforcement, capital requirements and market structure. These divisions could operate under a multi-member board or commission composed of individuals with expertise in the various areas. Possible benefits of consolidation are obvious. There are also some negative aspects. Even assuming a decision that there would be net benefits, we should not underestimate the difficulty of attempting to conform the different regulatory structures of the several industries.

In addition, such basic questions as whether the agency would be independent or an executive department and whether there should be only direct regulation or also self-regulatory organizations, need to be answered.

Last month a Task Group on Regulation of Financial Services was formed to develop legislative recommendations on consolidating the federal agencies. The members of this group are certain top administration officials and the heads of federal agencies dealing with financial intermediaries. In his letter of invitation, Vice President Bush referred to the suggestion "that the fragmented structure of federal regulatory agencies is impeding further progress toward a less regulated environment for financial institutions" and "is imposing significant unnecessary cost on consumers of financial services, as well as creating an unnecessary burden on capital formation."

If there is general agreement that it is desirable to resolve jurisdictional problems and remove unnecessary regulations and burdens on capital formation at the federal level, we should ask ourselves whether there is adequate reason to limit the effort to federal regulation. I suggest that there is not. Certainly, there are serious conflicts and overlapping between state and federal regulation and among the states themselves. We are all aware of the differences between the CFTC and state securities administrators on the issue of jurisdiction. We are also all familiar with the difficulties encountered between state and federal regulation in the tender offer area and in the continuing efforts of the SEC and the North American Securities Administrators Association to develop uniform exemptions from registration of securities offerings.

How should these important issues be resolved? Should the federal government deal only with securities offerings above a certain size, say $10,000,000? If so, should the jurisdiction of state administrators be limited to offerings below such an amount? What about the regulation of small offerings that go beyond state boundaries? Is it in the public interest to permit states to impose additional requirements or restrictions on inter-state offerings within their boundaries?

The major problem of overlapping jurisdiction is the lack of consistency and uniformity. Indeed, Congress recognized this problem in the Small Business Incentive Act of 1980 when it asked the Commission and the states to work together to develop uniform limited offering exemptions. However, if the two are made completely uniform, why have two? There have been suggestions that federal preemption should be considered as a possible solution. Could it be that the nature of financial products and services is becoming so interrelated throughout the United States that regulation should be the same in all states? Or do the benefits from the present federal/state approach outweigh the costs? These are important questions and I believe state administrators should participate in the process of providing answers. Thus, if the Bush Task Group intends to go beyond making recommendations with respect to federal regulation into the question of the most desirable overall structure, it seems to me that the states should be represented in the discussions.

As we endeavor to find solutions to the many problems and questions presented by the rapid developments taking place in the financial service industries, we must seek and consider the views of all concerned parties. We must also be willing to rise above our parochial interests in order to achieve our most important goals of assuring that depositors and investors are adequately protected and that financial intermediaries are regulated in a way that minimizes burdens and facilitates the efficient allocation and distribution of financial resources. I am confident that our best efforts will be equal to the task.