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Statement by

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before the

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Committee on Banking, Housing and Urban Affairs

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I am pleased to present the views of the Board of Governors of the Federal Reserve System on various issues raised in connection with the Subcommittee's study of the securities activities of commercial banks. The Study Outline prepared by the Subcommittee indicates a desire to reexamine the provisions of Federal banking and securities laws as they may apply to bank involvement in securities activities, especially new activities which, in recent years, banks have demonstrated increased interest in pursuing.

Bank participation directly in certain securities activities has been limited since enactment of the Glass-Steagall Act in 1933. A key purpose of that Act was to separate commercial banking from certain investment banking and securities distribution activities, which in combination had resulted in numerous abuses and exposed the banking system to considerable risk. Thus, commercial banks are expressly prohibited from underwriting and dealing in corporate securities. In various other securities activities, however, there often have been differences in interpretation as to whether or not the Act prohibits commercial bank involvement. Most of the activities in which the Subcommittee has indicated a special interest have come into question, for one reason or another, with regard to the applicability of Federal banking or securities laws.

The range of activities under your review might be categorized conveniently as functions in which the bank performs in the capacity as agent, as investment adviser, or as underwriter. In the agent capacity, the new services being investigated are dividend reinvestment plans and automatic stock purchase plans. In the investment advisory function, relatively new service areas are certain investment management services for individuals and the provision of advisory services to real estate investment trusts and closed-end investment companies. With regard to underwriting, the Subcommittee is focusing on the issue of bank underwriting of municipal revenue bonds, which is not permitted by the Glass-Steagall Act.

The interest of commercial banks in offering new types of financial services to the public has been generated by their perception of a potential market for these services and the potential profits which may be earned, along with competitive pressures from other financial institutions, such as insurance companies. All of the services singled out by the Subcommittee are substantially related to activities in which banks have engaged in prior to and since enactment of the Glass-Steagall Act. The relatively new agency services, for example, are specialized products developed from the usual agency functions performed by banks. New investment management services derive from traditional trust department activities, while underwriting of municipal revenue bonds would be an extension of bank participation in the underwriting of general obligation issues.

It is still too early to determine whether or not banks have accurately judged the market for several new services. In numerous areas the present situation appears quite fluid, and the future evolution of the market is not at all clear. The extent of bank involvement in several of the new product areas is quite small, with around 30 banks offering automatic investment plans, for example. And these plans apparently have a considerably smaller number of customers than had been anticipated by some banks. On the other hand, dividend reinvestment plans now cover about 450 corporations, although comprehensive information on shareholder participation is not available.

The likely future extent of bank participation in offering new agency and investment advisory services depends upon a variety of factors. Among these is the regulatory climate, of course. But, in addition, factors influencing bank participation are the demand for the services and the ultimate profitability for banks. Demands for the services offered by banks are related to the financial market environment -- for example, the poor price performance of equity markets in general over the past few years has discouraged investor participation -- and importantly to the competitive environment among banks and nonbank institutions offering similar services. Thus, in some lines of activity the markets may broaden and encourage increased participation by banks and other firms, while other activities are likely to remain comparatively small with little interest for commercial banks over-all.

An appraisal of the desirability of continuing to permit bank activities of the sort under discussion, or extending the range of

activities in the case of commingled managing agency accounts and underwriting of municipal revenue bonds, needs to take carefully into account the likely public benefits and risks of the activities. As a general matter, the Board believes that, within limits, commercial banks in securities-related activities can play a constructive role in serving the public, strengthening competitive forces, helping to enhance individual participation in capital markets, and ensuring efficiency in the allocation of investible funds. At the same time, the need for adequate safeguards for the public and the banks must be given appropriate attention. Each securities-related activity will tend to raise issues of its own, but an overview of the nature of the benefits and risks of the services will help provide a perspective of the Board's position on bank involvement in new service areas.

A principal benefit to the public from banks' offering securities-related services is the convenience to the public at reasonable cost. In a number of cases banks have offered services not readily available elsewhere. The automatic investment plans, for example, provide small investors with an opportunity to participate regularly in particular equity issues of their own choice. The brokerage industry generally has not aggressively sought to provide extensive services to small investors, primarily because of the high cost and low return. Through the automation of many aspects of servicing accounts, and the ability to achieve economies in transactions costs by pooling small orders,

banks are largely filling a need not previously met by other market participants. Dividend reinvestment plans also are geared to providing a convenient service to small investors. In the case of individual portfolio management services, the willingness of some banks to take on clients with relatively small portfolios is perhaps the first time such services have been available to small investors.

Bank participation in new financial service areas seems likely to provide greater convenience and lower cost to the public over time as a result of competitive forces. Innovative efforts by a few banks are likely to prompt increased competition from other banks and other financial institutions. The public could thus be a beneficiary of the interplay of competitive forces in the market-place.

Efforts by banks to provide new services may also help to generate broader public participation in capital markets, particularly equity markets. Over recent years, individual investors have reduced their participation in equity markets, reflecting high transactions costs, poor performance of the market, and growth of substitute investment outlets. If we are to meet effectively the substantial capital needs of our economy, increased participation of individual investors in equity markets is necessary and desirable. Individuals traditionally have been a source of liquidity in equity markets, and consequently broad-based participation of individuals in equity markets will help strengthen the performance of the market. The limited evidence available suggests that banks have been moderately successful in attracting new

individuals into the market. Surveys by three banks showed that roughly between 40 and 60 per cent of the participants in automatic investment plans were first-time stock market investors.

Benefits to the banks will accrue in the form of additional profits, assuming their services on the whole prove successful. In a number of agency and investment advisory activities, additional services may provide opportunities for more efficient use of existing data processing and bank customer service capabilities. Hence, the activities are a natural extension of services which should provide economies of scale.

The public risks of bank participation in securities-related activities would seem to relate principally to the potential for conflicts of interest. These potential conflicts are not new, since they already exist in the traditional agency, trust, and underwriting activities of banks. Areas of possible conflict arise, for example, with regard to use of inside information, inappropriate timing of buy and sell orders, and attempts to influence the value of corporate shares for the banks' own benefit. In our judgment, even though the potential for abuse exists, banks on the whole have performed in a prudent manner.

Moreover, there are safeguards to insure against inappropriate bank behavior with regard to potential conflicts of interest. These safeguards include the Federal and State bank examination procedures,

and the Federal securities and other laws applicable to the conduct of those handling financial transactions. With regard to examination procedures, all State member banks exercising trust powers are examined annually by Federal Reserve bank examination personnel. This examination is designed to determine whether the bank's fiduciary activities are conducted in accordance with safe and sound banking practices and, if they are not, to define any contingent liability that may follow from the inappropriate practices and the potential impact on the over-all condition of the bank. Of particular concern to trust examiners are transactions or relationships which may involve conflicts of interest arising from the bank's trust or investment activities.

Another type of risk in new securities-related activities is the potential exposure of bank capital and the possible impact on bank soundness in the event of adverse experiences. Since most of the activities are not capital intensive, bank capital is not put at risk directly. In the case of municipal revenue bond underwriting and dealing, however, bank capital would be risked when positions are taken in the normal course of business. Setbacks suffered by banks in some of these new activities, as well as in their long-standing functions, could conceivably have spill-over effects on the bank as a whole. Depositors, for example, might lose confidence in the bank and withdraw funds, threatening the viability of the institution. While such an event is not likely except in rare cases, the possibility needs to be considered in the framing of public policy.

A different type of potential risk that often receives attention is the long-run effect of increased competition on the concentration of resources. Some observers have suggested that bank entrance into various activities will only supplant those of existing market institutions and ultimately lead to increased concentration of resources as well as reduced competition. It is by no means clear that the activities under review pose such a threat, or that a potential threat would in fact be realized. But in a broader perspective, we must, nonetheless, remain alert to the dangers of moving to a position where banks or other institutions command overwhelming control of capital markets and the economy.

In reviewing the securities-related activities of commercial banks that are considered in the Study Outline, the Board has taken into account the potential benefits and risks I have enumerated. It might be useful at this point to review briefly each of these activities and to indicate the Board's current thinking on the desirability or need to amend the Glass-Steagall Act.

First, with regard to agency-type activities, the Glass-Steagall Act expressly permits national banks to purchase and sell securities without recourse upon the order and for the account of customers. Banks acting as agents perform an intermediary role between their own customers and broker/dealers who execute transactions. One of the traditional bank services in this area is the offering of custodial accounts. In such an account customers may deposit cash or



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securities and the bank -- at the direction of the customer or his financial advisor -- will buy or sell securities, collect dividends and interest, disburse proceeds of the account, and provide for the safe-keeping of securities. Another traditional bank agency service involves the transfer of shares and disbursements of dividends on behalf of corporate security issuers.

The newer types of bank agency activities in general appear to be outgrowths of these traditional agency activities of bank trust departments. The dividend reinvestment plan, for example, provides a means for shareholders of a participating corporation to direct their dividends to a bank which purchases additional shares of stock for the customer. Shareholders using such plans may also channel additional cash to the bank for the purchase of shares. In the automatic investment plan, a bank checking account customer may elect to have a specified amount of funds deducted monthly or semi-monthly from his account and used to purchase shares of stock in companies selected by the customer from a list compiled by the bank. The stocks appearing on the list, under current practice, generally are those of the 25 to 40 largest corporations traded on the New York Stock Exchange.

The Board believes that both dividend reinvestment services and automatic investment services are appropriate activities for commercial banks. For both services there appear to be minimal potential risks to the banks and the public, while there are appreciable potential

benefits to the public. Hence, the Board believes that banks should be authorized to continue offering these services.

A second broad category of bank activity in securities markets results from commercial banks offering investment advisory services. Commercial banks have long acted in an investment advisory capacity in connection with the fiduciary and custodial activities of their trust departments. In this function banks have handled the assets of individual as well as institutional customers. Much of the institutional service is accounted for by the management of assets in private pension or profit-sharing plans. In recent years the investment advisory activities of banks have been expanded, within existing trust departments as well as by establishing investment advisory affiliates of bank holding companies.

Investment management services for individuals until recent years generally had been offered to those with portfolios of \$100,000 or larger. However, some banks are now offering portfolio management services, on a discretionary or nondiscretionary basis, to customers with portfolio values of considerably smaller amounts. These services are also provided by a number of banks for self-employed individuals under Keogh plans, and could well emerge for Individual Retirement Accounts, given recently enacted legislation. The Board believes that the potential benefits of these services outweigh presently foreseeable risks.

The efforts of banks to provide certain types of investment management services to small investors have been constrained, however, by the Supreme Court decision in 1971 which provided that commingled managing agency accounts were in violation of the Glass-Steagall Act. As a result, banks are not permitted to achieve the economies of pooling for nontrust or agency accounts, and this acts to limit indirectly the extent of the potential market for bank management services available to small investors. The question of amending Glass-Steagall to permit commingled managing agency accounts is one that the Board has not yet explored with sufficient thoroughness to arrive at a judgment.

Other types of investment advisory services being examined are those where banks or affiliates of bank holding companies have acted as advisors to real estate investment trusts and closed-end investment companies. These are areas where the Board believes legislation is unnecessary at the present time. It should be noted, however, that the Board regulation in the investment company area is presently being challenged in the courts.

The third general area covered by the Subcommittee's Study Outline deals with bank underwriting and dealing in municipal revenue bonds. Bank underwriting and dealing in Federal Government obligations and general obligations of State and local governments were expressly permitted by the Glass-Steagall Act. In the early 1930's revenue bond issues were a relatively unimportant source of funds to governmental units, but as their capital needs have increased revenue issues have been employed to an appreciable extent.

Over the past two decades or so there have been a number of bills introduced in the Congress to authorize bank underwriting and dealing in revenue bonds. During this period numerous pro and con arguments have emerged. The pro arguments generally focus on the benefits to governmental units in the form of lower interest costs and improved market efficiency, while the con arguments center on potential conflicts of interest and risks of market concentration. The Board, on a number of occasions, has reviewed the question of extending bank underwriting privileges to municipal revenue bonds of investment-grade quality, and since 1967 has consistently voiced its belief that the public benefits of such action outweigh any potential risks. In view of recent developments in the municipal securities markets, however, the Board would wish to take a fresh look at the situation before reaffirming its position on this matter.

In conclusion, the Board believes that appropriate public policy in regard to the securities-related activities of commercial banks requires a careful and considered weighing of the potential risks and benefits. The experience of recent years suggests the need for prudence in the expansion of bank activities, and an awareness of the potential risk new activities pose to the adequacy of the capital base of banks. Furthermore, undue potential conflicts of interest must be avoided and safeguards to the public must remain adequate. But we should not overlook the benefits to be derived from bank participation

in certain securities-related activities. The erection of barriers to restrict bank competition in new activities would limit benefits to investors and serve to hamper the efficient performance of the nation's financial markets.