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Statement by

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Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Securities

of the

Committee on Banking, Housing and Urban Affairs

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I am pleased to appear before you this morning to discuss proposals to expand bank participation in securities markets by allowing them to underwrite municipal revenue bonds and offer mutual funds. These measures involve the natural extension of activities already being done by banks, but their significance should not be underestimated. They could have major effects on bank customers and competitors, and the structural and regulatory framework within which these proposals are implemented may set the pattern for other changes to be considered by Congress as part of its broad reexamination of the laws governing our financial system. As you know, the Treasury Department has put forward a plan to mandate that the proposed new powers be exercised in a separate affiliate of a bank holding company. The Treasury's bill also treats other features of bank holding company organization and regulation, but I will confine my remarks to those aspects dealing with bank securities activities.

The Board favors granting banks the authority to underwrite and deal in most state and local government revenue bonds. In addition, we think that trust departments of depository institutions should be allowed to establish collective investment funds--analogous to mutual funds--that could be offered to the general public and not limited to those customers who had entered into trust agreements. For now, we would limit the investments of these more broadly available funds to stocks and bonds; bank or thrift sponsorship of money market funds seems to us to be in effect a "back-door" method of deregulating deposit rate ceilings. As such, it would undermine the authority of the Depository Institution Deregulation Committee--the body established by Congress to oversee an orderly phaseout of these ceilings--and in the process would tend to aggravate an already difficult situation caused by erosion of the traditional deposit base of depository institutions in favor of investments in money market instruments.

Because these proposed activities are the natural extension of services banks already undertake in various departments, we believe that the easiest and most beneficial method of implementing the new activities would be to allow them to be carried out in the appropriate section of the bank. Bank participation in these areas would be conducted under the same basic legal and regulatory structure that applies to nonbank participants, but responsibility for supervising the new activities would logically fall to the agencies that now perform this task for the related existing activities in banks. Within this framework, we can achieve equity in regulation between bank and nonbank entities competing to deliver the same services, and we can protect the public interest in safeguarding the soundness of our financial institutions.

The Board does not see the need for requiring that the proposed activities be done in a separate affiliate within the corporate structure. We believe that this approach would reduce some of the public benefits that could derive from bank or thrift entry into these areas, would be unnecessarily expensive and burdensome, particularly for smaller institutions, and would not by itself provide effective protection of the bank from risks to the combined organization that these activities could in some circumstances entail.

Municipal Revenue Bond Underwriting

The Board has long supported legislation that would allow banks to underwrite and deal in municipal revenue bonds. We believe that this would be a logical and reasonable extension of current bank activity in the tax-exempt market. Revenue bonds played a minor role in state and local government finance in the early 1930s when Glass-Steagall restrictions were imposed, but by last year they had grown to around 70 percent of tax-exempt

bond sales. The entry of banks into this area would allow them to utilize the expertise of their municipal bond departments more fully and efficiently, and the additional competition should reduce costs for many revenue bond issuers.

We believe that the provisions of Section 301 of S.1720 introduced by Senator Garn in the last session of Congress would be sufficient to protect against a bank assuming excessive risk when underwriting revenue bonds and against conflicts between the interests of the bank as underwriter and as investor or fiduciary. Banks would be permitted to underwrite or deal in only those issues in which they could also invest, and their holdings of the obligations of any one issuer would be limited to 10 percent of the bank's capital and surplus. Moreover, transactions between the bank's dealer department and its investment or trust accounts would be regulated. Indeed, we would recommend that the Congress extend those protections to bank transactions in G.O. municipal securities as well.

Departments already established by the banks to deal in tax-exempt securities are now subject to the same regulations of the Municipal Securities Rulemaking Board as are nonbank securities dealers, and those regulations would also apply to revenue bond activities. Enforcement of the rules of the MSRB and SEC and examination of tax-exempt bond underwriting and dealing would continue to be left to the primary bank regulator. Personnel from the banking agencies have been specially trained to examine for compliance with these rules, and also are trained to look closely for potential conflicts of interest or unsound practices that may stem from the combination of investment and commercial banking functions.

Offering Mutual Funds

Stock and bond funds. Bank trust departments are in the business of managing investment funds for their customers and have a long and well developed expertise in this field. Although banks are permitted to combine funds of some types of accounts to realize the efficiencies of investing them collectively, they are authorized to offer this service to individual investors only if they have established a trust relationship with the bank.

The Board believes that the needs of smaller investors would be better served if bank trust departments were allowed to offer collective or comingled funds investing in stocks or bonds--as do investment companies--for accounts handled on an advisory basis. This would increase the potential outlets for the savings of small investors through participation in diversified investment funds, and would seem an especially appropriate change in view of the broadened availability of IRA and Keogh accounts that has just taken place. Although thrift institutions generally do not have trust departments, federally chartered saving and loan associations were authorized by Congress in 1980 to offer trust services. The Board believes that any institution having a trust department should be eligible to offer the proposed service, and we recommend that any new legislation reflect this approach.

Because collective investment funds offered to the public on an agency basis would be functionally equivalent to a mutual fund, we suggest that it would be appropriate for the banks to register the funds under the Investment Company Act of 1940 and abide by its rules. However, to protect against special difficulties that may be associated with bank entry into this area, the Board believes that additional restrictions

should be imposed on the bank trust department procedures, at least until some experience is gained with the activity. To avoid excessive promotion of the new services to depositors or other customers, banks should be permitted to offer only funds that do not involve payment of a front end "load" or sales charge at the time of purchase. The advertising by banks of their comingled funds should also be constrained by regulation, to prevent undue public identification of the bank with the performance of its collective funds.

The primary bank regulators have responsibility for supervising collective funds now administered in bank trust departments, and this authority could be extended readily to the new comingled accounts. These agencies have special trust examiners who are sensitive to the potential for conflicts of interest between the trust and commercial areas of the banks. The bank regulatory agencies have adopted specific guidelines to require a "Chinese Wall" between fiduciary and other bank activities that would be used also in connection with this new activity. Trust examiners could be instructed to look for compliance with the rules of the SEC under the Investment Company Act, which provide added safeguards against conflicts of interest. And the examiners, of course, would be particularly sensitive to any attempted use of bank resources in support of a troubled investment fund.

Money market funds. Unlike funds investing in stocks and bonds, collective or mutual funds holding short-term money market instruments have attributes closely resembling bank deposits. Like deposits, money market funds have a fixed asset value (except in extreme circumstances) and generally are accessible by check or phone transfer so that they can be used for third party transactions. The Board recognizes that there has already been

substantial substitution of MMF shares for deposits by the public, and that many depository institutions view the power to issue money market funds as an appropriate defensive response. But this is a very troubling process that could have undesirable effects on the financial system, and one that would be greatly accelerated if MMFs were offered by banks, given the convenience of these institutions and the aura of safety that sponsorship by a highly regarded local banking organization would transfer to associated MMFs. Because of its concerns, the Board is opposed to allowing banks or thrifts the right to sponsor or sell money market funds or similar facilities at the present time.

A major consequence of the growth of MMFs has been an erosion of the deposit base of many institutions, forcing them to cut back lending or to replace lost deposits with funds acquired in the open market at high interest rates. For those institutions--like S&Ls--that hold longer-term fixed-rate assets, this has resulted in a sharp erosion of earning capacity. Concern for these institutions has constrained the pace at which the Depository Institutions Deregulation Committee has been able to proceed with the phasing out of deposit rate ceilings. But allowing depositories to offer money funds would in effect void the existing rate ceilings, putting additional pressure on an already deeply troubled thrift industry and conflicting with the intention of Congress when it created the DIDC--namely, that the transition to market-determined rates on deposits be managed to minimize the possibility of severe dislocations in the financial system.

The diversion of deposits to MMF shares also is of concern because of its possible impact on the distribution of credit. Funds are drained from local institutions, where they are available to make loans in the

service area, and invested instead in instruments issued mainly by the largest banks and corporations. Local lenders can replace these funds in the credit markets or through government agencies to some extent, but the cost and availability of credit to small local borrowers could well be affected by an accelerated conversion of deposits to MMFs. Moreover, this problem is not readily alleviated by allowing banks to sponsor their own MMFs, since prudential rules of diversification and arms-length dealing may well restrict the ability of bank sponsors to purchase their own liabilities.

The Board is also troubled by the implications for public confidence in our financial system of rechanneling funds from insured deposits to uninsured MMFs. Difficulties in one or more MMFs, though a remote possibility, could lead to a more general loss of confidence in all MMFs and perhaps other institutions--especially the banks or thrifts offering the MMFs. Such a development could produce sudden readjustments and disruptions in credit flows; and it could give rise to the need for potentially massive federal action to bolster affected institutions and borrowers.

The similarities of MMF shares with deposits, and the substitution of these shares for deposit balances--including for use in transactions--also present problems for the conduct of monetary policy. Interpretation of the behavior of the monetary aggregates becomes more difficult and less confidence can be placed in any particular monetary target in helping to achieve the nation's economic goals. Our ability to control the monetary aggregates also may suffer. Congress structured the Monetary Control Act so that all transactions balances held in depository institutions would be subject to reserve requirements at the Federal Reserve. MMFs obviously are outside this provision, and we have therefore requested authority from Congress to place

reserves on MMF accounts that are accessible for transactions--a need that would only be intensified if banks were to offer MMFs.

The problems that may be associated with banks or thrifts offering money market funds in the present environment seem to me to argue forcefully against congressional authorization of this activity. Deposit deregulation should remain the responsibility of the DIDC and not be effected haphazardly through means that may produce undesirable shifts in deposits and credit flows, unwind our system of federal insurance of the public's liquid deposit accounts, and threaten to undermine the conduct of monetary policy. These difficulties are directly associated with the diversion of deposits to money market fund shares, and they could be greatly alleviated by lifting the ceilings on deposit offering rates. The financial system would be far better served by this straight-forward approach to deregulation, and the Board urges the DIDC to proceed with this process as quickly as circumstances permit.

Securities Affiliates

The Treasury's proposed bill joins the expansion of bank and thrift powers with a mandate that all securities activities be carried out only in separate affiliates. This requirement would apply not only to the new activities, but also to existing dealer functions for any banks wishing to take advantage of the expanded powers. As I understand it, the affiliate form of organization is proposed in order to ensure that the securities activities of banks are subject to the same rules, regulations and investor safeguards as those of nonbanks, and to insulate the banks from any additional risks that these activities might entail. The use of securities affiliates is also advanced as a means to prevent abuses possible when the same organization engages in commercial and investment banking.



The Board has no objections to a bank holding company voluntarily establishing a securities affiliate subject to appropriate supervisory oversight; we have in the past approved bank holding company applications for just this purpose. However, the Board views the Treasury's proposed requirement that these new activities be conducted in such an affiliate as both unnecessary and possibly counterproductive. The changes in powers are evolutionary in nature, building on the established business and expertise of the banks, and the benefits from bank participation in the new areas can be realized most fully if they are lodged in those departments of the bank already engaged in the related activities. From a regulatory perspective, we would want to apply the same basic set of rules to a given activity whether performed by a bank, its nonbank affiliate, or a nonbank firm, and the Board sees advantages in utilizing the supervisory apparatus already in place for banks and thrifts. We believe our proposals would adequately protect the public against abusive practices by banks or thrifts and would better safeguard the public interest in maintaining a sound depository system. Moreover, the benefits of bank and thrift entry into these activities can be fully realized without incurring expenses and inefficiencies of the affiliate form of organization.

The requirement to establish a securities affiliate would be especially burdensome for smaller banks that undertake only a few underwritings of municipal securities issues each year because it would entail separate capitalization and all of the expenses of incorporation and independent operation. If local and regional banks were to forego revenue bond underwriting because of this burden, a significant part of the benefits of allowing banks into this activity would be lost. Enhanced competition is likely to result in the most significant savings for smaller issuers with limited local

markets--precisely those units offering securities that small- or medium-sized banks would be best positioned to underwrite.

Even for larger banks we do not see anything to be gained from forcing them to shift their activities in the U.S. Government and Federal agencies markets to a separate affiliate, as the Treasury proposal would mandate for banks desiring to underwrite revenue bonds. There has been no evidence of problems or inequities in competition between banks and securities dealers in this important financing area.

It is true that the securities affiliate form would eliminate the advantage enjoyed by banks over non-bank dealers that results from the tax treatment of bank interest expense. But this advantage has had little impact on the relative abilities of banks and nonbanks to compete for underwriting business-positioning securities is not an important aspect of this activity, and nonbank dealers have done a substantial share of the underwriting of general obligation bonds over the years. The tax advantage may be of somewhat greater significance for trading in the secondary market, which requires dealers to hold securities. Redressing this inequity by increasing the tax burden on banks, however, could well reduce their willingness to participate in the municipal securities markets. I question whether this is desirable at a time when these markets are already under great strain, and I would urge the Treasury and Congress to seek other methods of redressing the tax imbalance.

Although the Board considers the securities affiliate requirement to be inferior to allowing these new activities to be conducted in the banks themselves, we could reluctantly accept the mandated affiliate concept provided that it incorporates adequate safeguards for the banking system.

It is with respect to defining this last point that we appear to differ most markedly with the Treasury.

Generally, the Board does not view the use of the securities affiliate form by itself as providing sufficient protection for the banking part of the organizations. Exposure of the parent to excessive risk-taking in the affiliate, arising in part from the strong prospect of public identification of the securities affiliate with the banking name, means that serious problems in the affiliate would very likely have an adverse impact on the bank. Restrictions such as those I have discussed for municipal bond underwriting and the sale of collective funds thus are necessary whether the activity is carried out by the bank or in a separate affiliate. It is true that putting these activities in a separate corporation triggers statutory barriers that limit transactions between a bank and its affiliate--barriers that would need to be extended by amending Section 23A of the Federal Reserve Act to include advised or sponsored entities to cover the collective funds. But while such restraints are helpful in limiting the use of bank resources to support a troubled nonbank affiliate, they have not been and are not likely to be fully effective in convincing either the markets or the public that a bank is immune to the problems of its affiliates. The Board has seen on several occasions situations in which difficulties in nonbank affiliates were quickly reflected in the cost and availability of funds to affiliated banks because of the close links within the banking organization.

An important premise of the Treasury proposal is that the fates of bank and nonbank affiliates can be effectively separated, provided that safeguards are erected to forestall unsound transactions between the two.

From this premise flow a number of provisions of the Treasury bill, including one which the Board finds particularly troublesome. This proposal would deny us the authority to examine nonbank affiliates, including the new security affiliate, except where the Board makes a prior finding that the financial condition of the affiliate is likely to have a materially adverse effect on the safety and soundness of the bank.

As I have said, it is our experience that the public's confidence in a bank is generally linked with the financial strength of any important nonbank affiliate. For this reason, the Board believes that continuing regulatory oversight of the nonbank activities of a banking organization, including those that manage investment funds and underwrite securities, is critical to the maintenance of the soundness of the entire organization. Therefore, we would urge that, if the Congress accepts the Treasury's concept of separate affiliates, such affiliates continue to be subjected to oversight by the bank regulatory authorities as provided for in existing statutes. These authorities would be expected to enforce rules of the SEC as well as their own, and should also have prompt access to any information that the SEC generates in examinations or any other actions it undertakes. But we are strongly of the view that the particular circumstances of banking and the special status accorded banks in our financial system require the continuing presence of banking supervisors to protect the public interest.

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