Remarks by:

Martha R. Seger

Member, Board of Governors
of the Federal Reserve System

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"Introductory Remarks"

It is a pleasure to be here in Chicago and to participate in this conference. Over the years, this particular conference has certainly grown in importance and it is probably the very best annual conference which addresses regulatory issues of financial institutions, especially those pertaining to structure. The issues discussed here seem more and more relevant every year.

This particular session and the theme of the entire conference deal with the merging of commercial and investment banking. There can be little doubt that the Glass-Steagall Act that in 1933 separated the traditional linkage of commercial and investment banking is currently under siege. And given the decisions that were made last week at the Board of Governors, the timing of the conference is about perfect. I am sure that Silas Keehn planned it that way.

As you can see on your programs, we have a distinguished set of panelists to discuss this issue. But before delving into the specifics of the merging of commercial and investment banking, I think it would be helpful to set the stage for the discussion by putting this issue into a broader perspective.

A New Environment: Some Background

There can be little doubt that we are in a radically different financial environment today than we were just a few years ago. Financial institutions have been the focus of more change than any other sector of the U.S. economy in recent years. The environment in which financial institutions operate has changed in a number of ways and there are a set of complex reasons for the changes that have occurred.

Advances in electronics technology which have dramatically reduced the costs of processing and transmitting information certainly is one important factor altering the financial environment. These developments have enabled financial institutions to profitably handle massive volumes of business while at the same time facilitated the mobility of capital both between and within countries. As a result, we have seen the world-wide integration of credit and capital markets. We now observe trading around the globe taking place at all hours of the day in certain financial markets. And our financial markets now react to Japanese and German monetary and fiscal policy decisions as well as to such policy decisions in the U.S.

These changes and the associated world-wide integration of capital markets has effectively encouraged significantly more competition from various foreign banks and financial institutions. New products have emerged partly in response to this new competition but also because of incentives to circumvent existing regulations as well as to hedge against the volatility that has characterized financial markets in recent years.

Major pieces of legislation such as the Monetary Control Act of 1980 and the Garn-St Germain bill of 1982 also importantly changed the regulatory environment and promoted additional competition among financial institutions. More specifically, all three major forms of restraints or regulations affecting financial institutions--namely (1) price regulations, (2) geographic restrictions, and (3) product restraints--have either broken down or are currently being severely tested. And even the continued viability of our public deposit insurance systems are being questioned.

It is interesting to note that virtually all of these major forms of regulations were either imposed or reaffirmed by banking legislation in the 1930's. In a sense, therefore, fifty years later we are still facing problems and working to undo the damage that was created by often inappropriate increases of regulation of financial institutions enacted during the Great Depression. This goes to illustrate just how much harm can be brought about by bad monetary policy.

The Evolution of Regulations: leading or following change?

Unfortunately, legislative efforts to regulate tend to react to existing crises whereas efforts to deregulate all too often follow change rather than truly initiate change. It is frequently the case, for example, that certain regulations themselves create incentives for innovation or action to circumvent the law. Regulations, therefore, often produce results that are not intended by their authors. To paraphrase Ludwig Von Mises, the ultimate outcomes of regulatory efforts are often the result of human action rather than the result of human design.

The contention that deregulation has often followed change rather than initiated change can be illustrated by looking at the facts. It is the case, after all, that price deregulation or the removal of interest rate ceilings followed innovations or new products that circumvented existing regulations on deposit ceilings. Geographic deregulation has also followed innovations or new institutions and products that effectively circumvented existing law. And product deregulation appears to be following the same pattern. In particular, regulators and legislators are slowly coming to realize that the legislative walls that partitioned the American financial system into separate commercial banking, insurance, investment banking, savings and mortgage lending segments are rapidly eroding. Regulations separating institutions by activity are being circumvented in a number of ways which will be discussed this morning by our panelists. Indeed, regulators are gradually understanding that failure to deregulate may involve more risk to the financial system than deregulating.

Banks, after all, are regulated in order to provide a healthy financial system. Maintaining existing regulations--or failing to deregulate--may allow important bank functions to be assumed by institutions whose safety is not protected. If this happens, it would defeat the very purpose of regulating and protecting banks. In a sense, then, regulators are coming to realize that if they do not deregulate, in time they will have nothing left to supervise.

In spite of this belated recognition, regulations and regulatory procedures are often very slow to change given the very dynamic environment in which we live. An example may serve to illustrate this. One of my favorite examples has to do with the definition of banking markets in cases related to holding company acquisitions.

In particular, banks now face increased competition from a varied set of institutions such as S&L's, credit unions, money market mutual funds, as well as from other nonfinancial institutions. It is well know that one can bank by telephone or even computer. Customers can also obtain credit from a whole host of nontraditional financial concerns.

Yet in considering holding company acquisitions, we at the Federal Reserve still focus almost exclusively on bank deposit shares and concentration ratios that do not include most of these competitors in the calculation, except to give partial weight to S&L's. It is not an exaggeration to suggest that in today's financial environment such practices are obsolete.

The point is that you cannot continue to impose static, outmoded regulatory practices on a dynamic industry; regulators cannot continue to behave as though the world is the same as it was 20 and sometimes 50+ years ago. And it is apparent that legislative and regulatory processes do not keep up with the pace of change in the marketplace; governments are slowly reacting to change occurring in a dynamic, everchanging marketplace, rather than shaping or leading such change.

Merging Investment and Commercial Banking

This session and the theme of the conference deals with an important element of product or activity deregulation; namely, the merging of investment and commercial banking. The forces I have mentioned a minute ago certainly apply to this area. In particular, product regulation is being severely tested and the legislative walls partitioning the U.S. financial system have been rapidly eroding in recent years. These barriers are likely to continue to erode as financial institutions diversify and attempt to better serve their customers.

Various forms of competition facing commercial banks have driven banks to search for additional products to strengthen their relationships with their traditional corporate and individual customers. For example, the rise of direct issuer access to capital markets--such as the widespread use of directly placed commercial paper--is an innovation that enables large, high quality corporations to circumvent commercial banks in securing credit. Banks, faced with the loss of their best, highest quality customers want to be able to offer additional products to retain these customers. And they know that they need broader powers to do so. In the interim, however, banks are looking for any legal loophole by which to provide such services and products.

As mentioned earlier, financial institutions are facing unprecedented change yet regulation tends to follow rather than to shape such change. The compartmentalization of commercial and investment banking seems to be a case in point.

The merging of commercial and investment banking is limited by a bill passed in 1933. Given the banking collapse of the early 1930's, there is general agreement that the purpose of the 1933 legislation was to prevent a recurrence of that banking crisis by promoting the safety and soundness of the financial system. Yet several studies have consistently demonstrated that the securities activities of banks had little, if anything, to do with the severe banking problems of the period. Indeed, the principal, large New York banks engaged in security underwriting remained in business. Most banks that did fail during the 1920's and early 1930's were small and did not have large security affiliates. The evidence suggests, therefore, that this type of product or activity regulation may not have been necessary to protect the banking system even at the time it was passed.

But even if it was needed in 1933, the reality of events leaves little doubt that there have been vast changes in the marketplace that could not have been foreseen by the authors of the Banking Act of 1933. Both the changes in technology and the differences between the legal framework today and that which existed in 1933 are extensive. Most financial abuses of the 1920's, for example, would not be possible under the SEC and its modern security markets regulation. In short, not only is it questionable whether Glass-Steagall was needed in 1933, but there are many more reasons to question whether it is necessary today.

There are several reasons typically given as justification for the continuing separation of investment and commercial banking; namely, that (1) securities underwriting is too risky an undertaking for banking, (2) conflicts of interest may be important, and (3) a concentration of financial power may ensue. None of these arguments stands up well to a careful weighing of the facts including evidence from both European banks and foreign affiliates of U.S. banks operating under less restrictive legal structures. These institutions engage in investment and commercial banking activities without apparent signs of excessive risk or high costs in terms of the safety and stäbility of the financial system. In short, the evidence seems to suggest that the current statutory framework in the U.S. may be outmoded.

At the same time, customers increasingly want what banks cannot provide; banks are denied the opportunity to provide the products and services the market demands. It is well known, for example, that customers often prefer to obtain financial services at a single source. Accordingly, banks are losing customers to firms both here and abroad that can offer the products and bundles of services they prefer. This is manifest in losses of bank market share in critical credit markets as well as by weak bank profitability. In time, all of this may contribute to a weakening of both banks and the financial system.

It should be mentioned, however, that the Board of Governors has responded to this situation. Specifically, the Board has approved bank holding company applications involving investment advisory and brokerage services and the placement of commercial paper. Moreover, just last week the Board has approved several applications to underwrite limited amounts of debt securities including commercial paper, mortgage-backed securities, and municipal revenue bonds.

Remaining Issues

I have covered a number of concerns but I have not mentioned several very important issues that will probably be mentioned either by our panel or in the question and answer session.

<u>These include the following</u>:

- Are investment banking activities riskier than commercial banking activities?
- What are the benefits from product diversification?
- What is the evidence relating to concerns about conflicts of interest?
- What are the implications for the public safety net?
- With foreign competition, is the concern or fear about concentration of power overdone?

But there are also important issues relating to the failure to deregulate. Specfically, taking no action and maintaining current arrangements also carries risk. And this risk may be very significant. What are the nature of these risks and are they more important than the risks of deregulation?

I hope we can answer (or at least address) these important questions during this session.

Let me now introduce our distinguished panelists. Each of our speakers will have about 20 minutes for an initial statement, so we should have plenty of time for questions.