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BANKING REGULATION: ITS IMPACT ON SECURITIES

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

Practising Law Institute's Seminar on
Banks and the Securities Laws 1975

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I am happy to have this opportunity to address this session of the Practising Law Institute on the subject of the impact of bank regulation on securities, and to be able to do so on the same platform with Irving Pollack. In particular, I welcome the opportunity to address this audience because it invites a discussion both of some of the fundamentals of bank regulation and their application to the new disclosure requirements being developed by the SEC and the bank supervisory agencies.

Banking is perhaps the most regulated industry in our country. Bank regulation runs the gamut from the Glass-Steagall Act to the bank holding company legislation, from the National Banking and Federal Reserve Acts to the wide range of State banking laws. This massive

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The views expressed herein are my own and do not necessarily reflect those of the Board of Governors or the Board's staff.

legislative effort has given the United States a banking system quite unlike that of any other major country, with a large number of banks and a relative paucity of bank branches.

The principal reason for extensive regulation of banking has been the legislative concern with the safety of banks. The banks are the carriers of the nation's monetary mechanism. They have a fiduciary responsibility for funds deposited with them, which are insured only in part. The supply of credit flowing through the banking system is essential for jobs, prosperity, and growth. Problems of particular banks may have large adverse externalities. Experience shows that a lack of confidence can spread rapidly, can affect the ability and willingness of banks to lend, and thereby affect the overall economic situation.

Bank legislation and the actions of regulators under this legislation also has aimed at maintaining competition among banks. Without control over mergers and bank holding company acquisitions, our banking system might well follow the path trodden by the banking systems of other large countries -- toward increasing concentration. Small banks are quite capable of competing with large, but strong banks are likely to absorb less strong ones unless the law, the regulators, or the Department of Justice interpose.

In the area of securities, the principal piece of bank legislation has been the Glass-Steagall Act. By drawing a firm dividing line between the banking business and the securities underwriting business, it has sought to shield banking against the risks inherent in the underwriting business as well as against the perhaps even greater risks flowing from the conflicts of interest that arise when the two activities are tied together.

One can say with some assurance that the Glass-Steagall Act has accomplished its purpose. What is not clear is the possible cost at which this objective has been attained. This evaluation depends on the effectiveness with which the investment banking community has been able to meet the demands of borrowers for access to open market credit.

It is frequently pointed out as a defect of our financial system that small firms, or firms lacking in strength, have difficulty gaining access to the open capital markets. If the banks had remained in the underwriting business, through their security affiliates, would the access problem have been solved more effectively? Would a larger number of firms have entered the securities markets? Would the economy have grown more rapidly in consequence?

The rapid growth of Germany beginning in the late 19th century was aided, according to some, by the character of the German banking system which combines credit and underwriting. On the other hand, the history of the German banking system, as well as of our own, shows the great risks inherent in this combination that tend to materialize during financial crisis. Perhaps the growth of the American economy would have been more satisfactory during the first 30 or 35 years following the enactment of Glass-Steagall had that law not been passed. Perhaps the troubles of Wall Street that emerged in recent years would have been mitigated by closer involvement of the banks. But in the conditions that banks and their holding companies have confronted since 1974, it was obviously a great advantage to them not to be burdened by the capital requirements, market fluctuations, and other problems inherent in the securities business. It may have taken 40 years for Glass-Steagall to pay off, but of late it surely has.

The role of banks in aggregate financing activity has no doubt been reduced by Glass-Steagall. Their role as intermediaries, however, may well have been enhanced. If exclusion of the banks from underwriting has in fact reduced the flow of funds through the open capital markets, it has very probably increased the flow of funds through intermediaries, including the banking system. The net effect of Glass-Steagall, however, may well have been to reduce the aggregate flow of credit while giving us a safer banking system.

The last word about the role of banks in the securities business probably has not yet been spoken. There are always marginal issues, such as the question whether banks should be allowed to underwrite State and local revenue bonds, in addition to the general obligation securities that Glass-Steagall has always permitted. Furthermore, there looms ahead what many fear may be a general capital shortage, although the evidence is not conclusive. Under such conditions it might be difficult to assert that there might not be some benefits from bank activity in the underwriting field, provided the risks can be satisfactorily controlled.

Banks can become involved in the securities markets in other ways, as investors and dealers in particular types of securities, as issuers of their own securities, and through their trust departments. I shall examine some of the major markets from this point of view.

Bank holdings of Federal Government securities reached a range of $60-90 billion toward the end of World War II and have held approximately at the $60 billion level for the succeeding 30 years. Meanwhile the rise in their other assets has reduced the proportion of governments to total bank assets from about 50 per cent to less than 10 per cent. Unlike banks in some countries, U.S. banks have not, by tradition or regulation, been required to hold government securities. The concept of a secondary liquidity reserve for which short-term governments might be particularly appropriate, is not well defined in American banking. Some demand for governments is created by the Treasury's requirement that its deposits with banks may be secured with government bonds, and by the Federal Reserve's acceptance of government securities as collateral for member bank borrowings from the System.

The principal impact of bank regulation on demand for government securities occurs through the Federal Reserve reserve requirements; the member banks currently carry about $35 billion of reserves in the form of deposits with the Federal Reserve or of vault cash. The Federal Reserve holds government securities against these. If the banks were free to invest these funds for their own account, probably only a very small part would be allocated to government securities. Required reserves therefore are an important factor strengthening the demand -- on the part of the Federal Reserve -- for government securities.

A small number of large banks also enter the government securities market as dealer banks. This is a valuable service particularly in periods of heavy government financing but it does not bear importantly upon the impact of bank regulation on government securities.

Banks play a crucial role in the market for the obligations of State and local authorities with holdings of approximately $100 billion, equal to almost one-half of the total of such securities outstanding. The reason is, not bank regulation proper, but the tax law. Tax exemption makes banks, together with upper bracket individuals, the principal holders of "municipals." Few other investors have an interest in them. The result has been a heavy dependence of State and local borrowers on banks. The supply of bank credit has been far from stable, reflecting partly the pressure of competing demands upon banks and partly also the varying pressure of monetary policy. Though hardly attributable to bank "regulation" in the narrower sense, this characteristic of the flow of credit to State and local borrowers is related to the banking system and clearly does not represent an ideal arrangement.

The impact of bank regulation on the equity market is diffuse but nonetheless traceable. With very minor exceptions, banks are not allowed to hold equities. There are countries, such as Germany and Japan, where such holdings are permissible. In the United States, suggestions for some minimum volume of equity holdings have periodically come to the fore, of late in the proposed Financial Institutions Act. The amount envisaged here, of 3 per cent of total bank assets or $27 billion, which moreover would be limited to securities of community welfare projects, is quite small relative to the total volume of equities outstanding in the American economy which amounted to approximately $525 billion at the market values recorded at the end of the 1974 (households and nonprofit institutions). It would not be quite so small, however, with respect to bank capital, which totaled $72 billion at the end of 1974.

From the point of view of the banks, ability to hold equities would have several aspects. In the first place, in a period of inflation, equity holdings might provide some long-run protection against the erosion of bank capital, along with probably increased short-term risk. In the second place, authority to hold equities might give added flexibility to the way in which banks could structure their financial relationships with customers, for instance in work-out situations. The wide gyrations of the equity markets in recent years make clear, however, that the equity investments of banks, should they ever be authorized, will have to be regulated in a very conservative manner.

The relationship of banks to the equity markets has been liberalized quite substantially, however, through the bank holding company device. Banks do not, with limited exceptions, hold equities, but bank holding companies can make equity investments in bank-related lines of activity. This is perhaps better viewed as a way of broadening the scope of banking than as an authorization for equity investment, since the range of permissible bank-related activities is extremely limited and since a bank holding company usually, though not always, acquires 100 per cent of the new affiliate's common stock.

Many of these affiliates, moreover, are of a size too small to permit listing on a national exchange. Nevertheless, bank holding company purchases constitute an infusion of funds into the equity markets, and in that sense influence the level of equity prices throughout the economy. Of course, to the extent that bank holding companies themselves finance through the equity market, there is a corresponding drain.

In this connection it is worth noting, however, that the raising of equity or subordinated debt capital by a bank, representing in effect a conversion of the buyers' demand deposits into common stock or long-term debt, does not reduce the total supply of capital. If the central bank, as it normally does, maintains the money supply constant in the face of such conversions, the lending power of the banking system will be maintained through these open market operations and the total flow of funds will not be diminished by the creation of additional bank capital.

The main direct impact of banks upon the equity markets occurs through their trust departments. The total volume of equity funds held in trust departments was estimated at $171 billion at the end of 1974. The activities of banks through their trust departments are largely unregulated as regards investment decisions, although subject, of course, to the laws governing fiduciary relationships and conflict of interest situations. Shifts of trust funds into or out of equities are important for the market allocation of resources. Concentration of investment in a relatively small number of stocks, such as was becoming fashionable in the early 70's, likewise has important allocatory effects. It should be noted, however, that these effects are independent of whether the funds in question are controlled by banks, or by independent trust companies, or by their actual or beneficial owners.

The regulation of margin requirements by the Federal Reserve represents another instance of the impact of bank regulation on securities. The purpose behind margin requirements is the control of credit-financed stock speculation. The experience of the past, which gave rise to this legislation, seems to document its wisdom, even though speculation may meanwhile have found some new avenues. The net effect, in all probability, is a less vulnerable stock market but also a somewhat lower average level of stock prices.

Banks also play a role in facilitating securities purchases by pension funds and mutual funds, by providing custodian services, clearing facilities and depository services. Some of these activities are to be regulated under the terms of the Securities Acts Amendments of 1975, the purposes of which will be implemented jointly by the SEC and the Federal Reserve Board.

I now turn to some general aspects of regulation. The first is what I would like to call regulatory illusion. This applies in particular to the regulators' effort to limit the risk exposure of banks.

The regulator is apt to think that, when he induces a bank to have more capital, or to limit its foreign exchange risk, or to respond to some similar restraint, he has reduced the overall risk run by the bank. Of course that is not necessarily so. The banker is free to accept or avoid risks on many different fronts: his capital position, his liquidity, his foreign exchange position, the quality of his loans and investments, his reliance on purchased funds, and so on. If the regulator requires him to cut back on one, he is free to accept greater exposure in some other direction and thus maintain his overall degree of risk exposure.

That overall exposure he will choose in the light of the optimum combination of risk and return which, as portfolio theory teaches us, he is seeking to establish. Ordinarily he will do so by adjusting his risk on all of its margins. If the regulator, by limiting one kind of risk, has blocked him from attaining this optimum, he will choose a suboptimal position. Unless the regulator is able to make the banker limit all his risks, he is in some danger of simply driving the banker into a position of perhaps no smaller but less profitable risk.

The tendency of the banker to shift from one risk to another may actually be promoted by the prevalence of regulation. The banker may come to substitute the judgment of the regulator for his own. He may conclude that, if the regulator has not prohibited or counselled against some particular risk, the regulator must consider that risk a fairly safe one.

There is one good remedy against regulatory illusion: the discipline of the market place. For banks, this is exerted mainly by investors in bank securities, suppliers of federal funds, and holders of large deposits and CDs. The market may well be able to see what the regulator has overlooked or been unable to cope with. This is a strong argument for maintaining in effect the discipline of the market in the banking field. Then, banks taking excessive risks will find their depositors -- only a modest proportion is needed -- taking their funds elsewhere. When the bank tries to market securities, it will encounter a high cost of capital or no takers at all.

This kind of discipline can best be exerted by the market, of course, if the market is adequately informed. Disclosure of relevant facts is an essential component of market discipline. This must be the first response of an economist to the question whether regulation and supervision can take the place of disclosure. For moral and legal reasons, it is in any event difficult to argue against disclosure.

The bank regulatory agencies have argued on occasion that certain information, if disclosed, could be misleading and could thereby produce repercussions upon the disclosing banks that would go beyond a desirable discipline of the market. One reason is the short-term nature of most bank liabilities and their consequent high volatility, which in some circumstances can cause deposit losses that would be quite out of proportion to the true information conveyed and to any risk premium that could be paid to overcome it.

This becomes apparent by contrasting an uninsured deposit or a 90-day certificate of deposit (CD) with a 30-year bond. A bond, say one carrying an A rating, might have been sold recently with a coupon containing a risk premium above the Aaa rate of one percentage point. Over the life of the bond the holder would receive 30 per cent of face value as a risk premium which is not a bad rate of compensation if the obligor in fact never gets into difficulties. If he does get into difficulties, the bond will drop in the market, and the holder will lose, temporarily if he holds and the bond works out, permanently if he sells or if the obligor ends up paying less than 70 cents on the dollar.

An uninsured demand deposit, and even a 90-day CD, offers no such protective mechanism. There is no reasonable risk premium that could induce a rational holder to keep his money in a bank that he thinks has even a very small chance of failing.

Even the appearance of a very modest degree of risk, therefore, can create problems for a short-term debtor such as a bank. If this appearance is acted upon by depositors, the difficulties that the depositors at first falsely suspected may become real. Even perfectly rational creditors may be impelled to act because they may fear that others may act less rationally.

Total disclosure of potentially misleading facts might call for major changes in banking arrangements. A system of full deposit insurance, in lieu of our present partial insurance, would reassure depositors, and would only require about a 1 per cent increase in the present FDIC assessment rate if historical ratios persist. However, 100 per cent deposit insurance would eliminate much market discipline. Moreover, even full deposit insurance might not be sufficient to protect stockholders and holders of subordinated bank debentures, who could still be wiped out unless the insurer were to subordinate the claims he had acquired in paying off depositors to the claims of the stockholders and debenture holders. Full asset insurance would be required to protect the latter under any other system.

Limitation of bank assets to virtually risk-free loans and investments would be another way of providing protection. Such a system, however, would be very damaging in an economy in which risk must be borne by someone. The bank with the best loss experience is not necessarily the best-run bank and may be far from rendering the best service to its community.

Particularly at the present time, when an expansion of bank credit is needed to restore prosperity, actions that would limit the ability of the banks to contribute can seriously slow the recovery. Resort to the open market, if bank credit should not be available, is not an alternative except for the strongest firms. In fact, firms that used to have access to the open market now are being denied and must depend on banks. If the banks cannot, because of disclosure requirements, improve their capital position, and if they must therefore further tighten their lending standards the recovery will move more slowly. Needed is a degree of information that will give maximum effectiveness to the discipline of the market, without making that discipline so severe as to impede the normal functioning of the banking system.