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Expansion of Bank Securities Powers: A Personal View

Presented

by

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to

American Bankers' Association
Investment and Funds Management Conference

San Diego, California
February 17, 1988

Good morning ladies and gentlemen. It really is a pleasure to come to the warmth of southern California to discuss an even hotter topic: the expansion of commercial bank powers.

It seems likely that this year will see significant changes in banks' securities powers. Last year's moratorium on the expansion of powers was a stop-gap measure that was satisfactory to no one -- bankers, regulators, the competing interests in the securities industry, or, most importantly, consumers of financial services. Yet there is little agreement on the shape that reform should take. New legislative proposals seem to appear almost daily and differ significantly in their features.

The issue of expanded bank powers _is_ a conceptually tough one and it deserves careful deliberation. But I also feel that it is important to move ahead on expanded powers. The financial world is changing rapidly, and we cannot always wait for perfect answers to all of our complex questions before accepting change.

I am convinced that we can move ahead safely with full securities powers for banks. Banking organizations should be allowed to provide underwriting services, operate investment funds, and provide full brokerage services -- all of the products of an investment bank. My proviso is that expanded powers should be accompanied by significantly greater reliance on capital in banking organizations. Institutions unwilling to rely more heavily on capital should not be permitted to expand their activities.

Let me share with you some of the observations that have led me to this point of view.

The Market Wants Banks with Securities Powers

First of all, I believe that important economic benefits are being lost by excluding banking organizations from securities activities. Many of the functions that banks perform are used in underwriting, investment fund management, and other securities services. It is logical and more efficient for one firm to provide both types of service. Most importantly, consumers of financial services would benefit from lower costs and greater convenience.

Current restrictions on banks' securities activities clearly run counter to market forces. Banks have been involved in the securities markets from the earliest days of our nation's history. And when the National Bank Act restricted the right of national banks to underwrite securities in 1864, the banks sought a way to avoid the restriction by establishing state-chartered securities affiliates. By the late 1920s, these affiliates participated in the underwriting of over 35 percent of all new corporate issues. In 1927, because of a change permitted by a feature of the McFadden Act, national banks themselves were once again underwriting securities and continued to do so until the passage of the Glass-Steagall Act during the reforms of the Great Depression.

We also observe banking combined with securities activities in other countries, mostly in the so-called "universal banking" systems of Europe. In

Germany, banking powers are particularly broad. Banks can underwrite securities, operate investment funds, control (or be controlled by) commercial enterprises, and provide general lines of insurance, brokerage, and virtually every other financial service. Such broad powers admittedly are the exception in world banking circles. The universal banking experience does suggest, however, that placing banking and nonbanking activities in the same organization can be successful and does not cause draconian problems for the banking system or the economy.

Expanded Powers and Conflicts of Interest

Let me also say that I find the case *against* expanding banks powers less than compelling. The case against expanded powers seems to turn on two issues -- first, the problems of conflicts of interest and, secondly, exploitation of the banking safety net. Let me address these in turn.

Critics of expanded powers claim that combining commercial banking and investment banking would create broad opportunities for conflicts of interest. Banking organizations, it is argued, would not behave prudently if they owned or underwrote corporate securities. It is alleged that self-dealing, insider trading, and other abuses would occur as the bank exploited its relationship to one set of customers to the benefit of another. Proliferation of such conflicts of interest could even lead to a loss of confidence in the banking system as a whole and, therefore, be a source of instability for the banking system. This is a variation of the arguments made before the Senate Banking and Currency Committee in the early 1930s. Instances of stock price manipulation by bankers and other actions involving conflicts of interest *did* occur in financial markets during the Great Crash. Recent examination of these events, however, finds them to have been quantitatively trivial and assigns them no blame for the instability of the banking system that ensued.

More importantly, much has changed to make conflicts of interest much less of an issue today. Important gaps in securities regulation were filled in the 1930s, such as those that grew out of the Securities Act of 1934. And existing securities regulations could be bolstered, if it is deemed necessary, by additional legislation. The Proxmire- Garn proposal, for example, contains special prohibitions against conflicts of interest and self-dealing.

Just as importantly, however, conditions in the marketplace have changed to provide an increasing degree of self-discipline. The ability to collect and disseminate financial information, for example, is considerably improved today. The result is that conflicts of interest can be more easily detected and the reputation of an offending firm is more difficult to shield. This fact discourages undesirable behavior from occurring in the first place.

A high level of competition in the investment banking services industry also is important to controlling conflicts. The more competitive the industry, the greater are the market's sanctions against abuse of customers. A discontented customer simply can leave and use an alternative provider of the services. Indeed, one of the positive features of allowing banks to enter the investment banking business is that it may increase effective levels of competition. Given their opposition to the expansion of bank securities powers, the securities industry obviously also feels that this would be the case.

Expanded Powers and the Bank Safety Net

The more serious objection to expanded bank powers is that broader powers will lead to exploitation of the bank safety net. I believe that our current system of deposit insurance and our behavior toward insolvent financial institutions _does_ pose serious problems that should be addressed immediately. It gives managers of insured institutions an incentive when their capital is low to "bet the bank" on risky ventures. This is because they have a chance of some gain, and very little to lose. After all, the insurance fund picks up the pieces in the event of bankruptcy.

The concern, of course, is that expanding bank powers into the securities area will provide additional opportunities for expanding risk. Critics of expanded powers cite, for example, that the income of securities firms is more volatile than banks' income and thus that securities activity is riskier than banking. This line of reasoning misses the point, however. First, the riskiness of securities activity *per se* does not mean necessarily that it would add to overall bank risk. These activities may offer diversification opportunities, with the result that a bank with securities powers is _less_ risky than either a pure bank or a pure securities firm.

More importantly, however, any activity can provide opportunities for risk taking if a bank has an incentive to seek them out. For a bank in a weak capital position, _any_ expansion opportunity -- a new activity or even a new loan -- can be an opportunity for increased risk taking. More important than the specific powers offered by bank reform proposals, therefore, is the regulatory mechanism used to contain risk taking.

Corporate Separateness

Looking over the various banking reform proposals, it is clear that the primary mechanism proposed for controlling risk taking is to "separate" bank from nonbank activities in different corporate entities. The idea is to allow expansion of bank powers without expanding risk by building "firewalls" around the securities activities of banking enterprises. These firewalls theoretically would protect the bank and its depositors and insurers from any risks generated by nonbank activities.

To construct such firewalls, most proposals would isolate the nonbank activities in nonbank affiliates, rather than allowing the bank to perform them directly. In addition, transactions between the bank and nonbank affiliates would be restricted.

The Proxmire-Garn bill, for example, would allow a securities subsidiary of a bank holding company to engage in securities underwriting. But it would prohibit virtually all credit transactions between the bank and securities affiliate. It even would restrict indirect transactions, such as bank lending to buyers of securities underwritten by the affiliate. The Graham-Wirth, Cranston-D'Amato and Dreier-Roth bills would permit transactions between affiliates, but only under restrictive conditions.

I see two problems with reliance on corporate separation to address the bank risk issue. First, I wonder if it is possible to achieve meaningful corporate separation without losing most of the advantages of the affiliation. If financial transactions between bank and nonbank affiliates are severely restricted, so too may be the advantages of combining these activities within a single organization.

Second, reliance on corporate separation may lull us into a false sense of security about the insulation of the bank from risk. There are many ways for two organizations to exchange resources and share risk. Ways will be found to breach the firewall if the incentives are strong enough to do so.

Managing Banking Organization Risk

I do not believe that the answer to the problem of controlling bank risk is simply to build a better firewall or to allow only "low risk" nonbanking activities. Rather, much of the answer lies in reducing the incentive of a banking organization to take on risk in the first place. And this is best achieved by greater reliance on capital in banking organizations.

As I have said already, the incentives to exploit the bank safety net increase as capital positions deteriorate. Conversely, organizations with strong capital positions will be less inclined to use their nonbanking activities to increase risk. Therefore, if capital regulations can be strengthened, there is considerably less risk in expanding banks' powers into securities or other activities. It also means that if less restrictive firewalls can be used, then more of the advantages resulting from combining banking and securities activities can be realized.

Capital regulation, of course, poses its own regulatory challenges. The measurement and monitoring of capital positions is no easy task. And banking organizations see capital as a very expensive source of funds. Also, some would argue that the stringent regulation of the capital of a banking organization would put it at a competitive disadvantage in the securities business.

But <u>not</u> relying on capital has disadvantages as well, for then the only alternative to controlling risk is to build thick firewalls. These firewalls may require such stringent regulation on interaffiliate transactions that any potentially profitable combinations would be crippled. The advantages of a combined banking and securities firm could be significant enough that it could compete effectively with pure securities firms despite capital requirements.

I am convinced, moreover, that even imperfect capital regulation is superior to attempts to restrict transactions or regulate risk directly. With enough of its own capital at risk, a bank becomes its <u>own</u> monitor, and market forces -- instead of being at odds with the public interest -- can be a source of stability.

A Proposal

My proposal to you regarding expanded securities powers thus is quite simple. Banking organizations willing to maintain strong capital positions should be granted broad securities powers. Since it is capital, rather than corporate separation, that provides the main protection against excessive risk taking, transactions between bank and nonbank affiliates need not be restricted severely.

Regulatory and monitoring considerations probably do dictate that securities activity be placed outside the bank in a separate affiliate. However, experience may eventually indicate that -- with sufficient capital -- there is no need for complete financial isolation of the affiliate. The organization then could enjoy the benefits of truly integrated banking and securities activity.

Banking organizations in a weak or insolvent condition on a market value basis should not be candidates for the right to expand their powers. This principle would serve, first, to avoid placing expanded risk taking opportunities in the hands of those most likely to abuse them. But it also would give these institutions an incentive to repair their capital positions in order to acquire the powers of their competitors.

It is interesting to note that all of the pending bills on Glass-Steagall reform rely primarily on corporate separation, giving little attention to the role of capital in controlling risk taking. The Proxmire-Garn bill contains a capital "bear-down" provision that would allow the Fed to intervene if a bank were being operated in an unsafe and unsound manner as part of a larger, financial services holding company. The Cranston-D'Amato proposal permits regulators to require greater bank capital in a Depository Institution Holding Company if it has securities activities. The sentiment of these provisions is correct, but they are a far cry from a call for greater reliance on capital as a *quid pro quo* for greater powers.

How Far to Expand Powers?

I have spoken today mainly about expanded securities powers. But the public discussion of bank powers -- and some of the bills before Congress -- looks to expansion of insurance, real estate, and commercial powers as well. The Wirth-Graham proposal, for example, would permit expansion into virtually any financial business, while the Cranston-D'Amato proposal would allow affiliation with non-financial enterprises as well.

Much of the debate over the limits on expansion of bank powers is a fight over turf. But there is also debate over whether a particular activity is "too risky" or offers "too little synergy" to be associated with banking. From my vantage point, the debate should focus instead on whether the levels of capital in the conglomerate banking organization can be measured, can be monitored, and are adequate.

In this respect, securities and some insurance activities probably pose the fewest problems from a capital regulation standpoint. Integration of commercial firms and banks, on the other hand, poses a more significant surveillance challenge.

Bankers Beware

It should be apparent that my sentiments lie with those who feel that an important affinity exists between banking and securities activity. I would like to conclude my remarks, however, with a cautionary note to my friends in the banking community.

It is easy to blame deteriorating earnings performance and market share on limited powers. But expanded securities powers will not be a panacea. The problems of low ROA and ROE, and loss of customers to direct placement markets and investment funds can also be found in countries with universal banking.

The time has come to eliminate the bulk of the restrictions against bank participation in securities activities. But it should not be seen as the long-sought opportunity to shore up weak banks. On the contrary, to extend the opportunity to poorly capitalized and poorly run banks would be a public policy blunder. Broad powers to expand into the securities area should be reserved for banks willing to put their own capital at risk.