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GLASS-STEAGALL -- WHO SHOULD DECIDE?

ADDRESS BY

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Executive Committees
of Bank Investments and
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I appreciate this opportunity to be with you today to discuss several current banking issues. At your request, some of these matters deal with disclosures by bank holding companies which are subject to Securities and Exchange Commission regulatory jurisdiction. I will also address one particularly controversial issue over which the Commission does not presently have regulatory authority--the interpretation of laws dealing with securities activities by banks. Let's deal with the disclosure issues first.

Earlier this year the Commission adopted revisions to the financial statement requirements and industry guide disclosures for bank holding companies. The most controversial aspect of these revisions was the requirement that bank holding companies present their gains or losses from investment securities as a separate component of other income before tax expense. Previously, these gains or losses had been reported as a separate net of tax item after a caption entitled "income before securities gains or losses."

Commentators set forth many reasons for not making this change, including the following:

(1) The prior format was well understood by investors and other financial statement users. Thus, there was no compelling reason to make the change.

(2) Income before securities transactions was a better measure of profitability of banking operations.

(3) The change would require adjustments to historical data bases without improving the usefulness of the information and these adjustments would be difficult to make absent full disclosure of the tax impact of securities transactions.

(4) The change would inhibit appropriate investment portfolio adjustments for fear of penalizing current operating income, or, conversely, would promote inappropriate transactions in order to enhance the bottom line.

Nevertheless, the Commission was persuaded to make the change for the following reasons:

(1) A uniform net income approach was long overdue. The reporting format used by bank holding companies should conform to that used by virtually all other entities, thereby eliminating much of the confusion concerning the actual earnings of bank holding companies.

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(2) There was no adequate conceptual basis for reporting investment transactions in a manner that implies that gains or losses therefrom represent something other than operating income.

(3) The existing reporting method was inconsistent in that securities losses were excluded from operations, while the interest on the replacement security, which generally exceeded the interest on the previous security, was included in operating income.

(4) Those who wanted to would still be able to calculate from the income statement earnings prior to inclusion of investment transactions.

(5) The Commission has existing disclosure requirements concerning the content and yield of securities portfolios and the nature of all special, discretionary or non-recurring items having a material effect on results of operation. Such disclosures should provide investors with necessary information about investment policies and strategies, and with adequate indications of whether management is using the one-step format to manipulate earnings.

I would add that the Commission's action is not contrary to the inclination of private sector regulators, who are promoting the adoption of one-step income statements for the entire banking industry. Such action would have broader application than the Commission's rule which only applies to bank holding companies required to make filings with the SEC. After the Commission's revisions were adopted, the AICPA Banking Committee issued an exposure draft which endorsed the one-step reporting format, including a restatement of prior interim and annual financial statements to conform with the one step format, and recommended that net investment securities gains or losses be reported on a separate line if material in the "other income" section of a bank's income statement. In addition, a task force of the Federal Financial Institutions Council is expected to revise bank call reports, which are submitted to bank regulators, to require that earnings be reported in a one-step format.

I further note that concerns within the banking industry regarding the one-step format have substantially subsided since the Commission's actions. In fact, many bank holding companies have already implemented this reporting approach, although it is not required until year-end 1983 reports.

One aspect of the new format which has raised some questions is whether the securities transactions must be disclosed on a separate line item in quarterly reports as opposed to showing one amount for "other income." It is the SEC staff's position that although separate line item treatment is not specifically mandated by the new rule, quarterly reports

should generally follow this format, and, in any case, securities transactions should be fully described in the Management's Discussion and Analysis if they have a material effect on reported results or trends reflected therein.

Another aspect of disclosure by bank holding companies receiving recent attention by the Commission is that of loans to foreign countries which are experiencing liquidity problems. Last October, the staff issued Staff Accounting Bulletin ("SAB") No. 49 which generally calls for bank holding companies to disclose exposures in foreign countries in which the current political or economic conditions may cause borrowers to have difficulty in obtaining the necessary currency to make timely interest or principal payments. Although SABs are not Commission rules they do represent interpretations and practices followed by our staff with Commission approval.

In January, the staff issued SAB 49A which requires disclosures about certain foreign countries that are negotiating with or have entered into agreements with U.S. lenders, foreign banks, international lending agencies or others to restructure existing sovereign debt or to obtain additional new borrowings. Reporting companies must also disclose the impact of these negotiations on the maturities of existing debt principal and on unpaid interest, commitments of the registrant to extend additional borrowings, and other arrangements such as agreements to maintain deposits with government banks. SAB 49A further indicates that there are complex considerations involved in evaluating whether such loans should be classified as non-performing. The staff emphasized that it is the registrant's responsibility to make these difficult determinations based on a careful analysis of the facts and circumstances, but that it would closely monitor developments and raise questions when the registrants' determinations appear to be clearly unreasonable.

In April of this year, the Commission proposed to amend portions of its Industry Guides for Statistical Disclosures by Bank Holding Companies. One amendment would codify a staff disclosure interpretation concerning loans to borrowers located in countries experiencing liquidity problems as originally set forth in SAB 49. However, whereas SAB 49 provides for two alternative disclosure approaches, the Industry Guide proposes only one.

The amended industry guide would require identification of each country in which total private and public sector outstandings payable to the registrant exceed one percent of registrant's total outstandings, and the aggregate amount of these outstandings. This codification would omit the alternative approach permitted by SAB 49 whereby such information need only be disclosed "[w]here conditions in a country give rise to problems which may have a material impact on the timely payment of interest or principal on that country's private or public sector debt." The majority of commentators have objected to

eliminating the more flexible approach permitted by SAB 49 and fear that the listing of countries not experiencing payment problems could be very misleading to investors when reported together with countries which are having liquidity problems. I would note, however, that for 1982 year-end reports, nearly half of the 20 largest bank holding companies utilized the approach proposed in the industry guide. This would seem to belie the argument that this method presents an unduly negative impression.

There has also been substantial opposition to a requirement in the industry guide that all significant industry concentrations be reported as a risk element in loan portfolios. Some commentators believe that concentration per se is not a risk. They argue, for instance, that it makes little sense from a risk standpoint to lump under the category of energy loans both loans made to Exxon Corporation and to oil well wildcatters. These commentators believe that other elements require to be disclosed adequately convey the risks involved.

Now let me comment on some aspects of what has been a perennial hot topic.

This month marks the 50th anniversary of the signing into law of the Banking Act of 1933, which is more commonly known as the Glass-Steagall Act. A major goal of this legislation was to substantially separate the banking and securities industries. Many people believed that bank securities activities significantly contributed to the unprecedented rate of bank failures in the early 1930's which in turn were a factor in our nation's Great Depression. One of the provisions of the Glass-Steagall Act to protect bank solvency was to prohibit banks from underwriting most securities, a practice with inherent risks.

For years, Glass-Steagall provisions separating banking and securities firms have been circumvented, and some would say pierced, with growing frequency. The accelerating convergence of these two financial sectors has become an area of increasing concern. This was evident at a reception held two weeks ago by the Securities Industry Association and the Investment Company Institute to celebrate the 50th anniversary of the Glass-Steagall Act becoming law. The reception featured a large cake divided by a wall of red sugar wafers. On one side of the wall were logos of several major brokerage firms, while the other side had logos of major banks. Ladders could have gone over the wall from both sides, but being that this reception was sponsored by the securities industry, a ladder was set up on the banking side extending into the securities side. This cake might well symbolize a recent action by the Federal Deposit Insurance Corporation ("FDIC") which many people believe would enable the greatest encroachment of Glass-Steagall boundaries in recent years by permitting certain banks to enter the previously restricted domain of underwriting.

More specifically, last month the FDIC proposed for public comment amendments to its regulations which would establish guidelines to govern securities activities, including underwriting, by subsidiaries of FDIC insured non-member state banks and such banks' transactions with affiliated securities companies. Among other matters, the proposed regulations would (1) require the subsidiaries to be operated as "bona fide" subsidiaries; (2) place a limit on bank investment in these subsidiaries; and (3) limit the underwriting by such subsidiaries to "best efforts" offerings, top rated debt securities and shares in money market funds.

The adequacy of these guidelines has been subject to much debate. In response to a Congressional request, the Commission recently testified before a subcommittee of Congress regarding apparent deficiencies in the guidelines. However, at least as controversial as the guidelines themselves is the codification of the FDIC's determination that insured non-member banks are not prohibited by the Glass-Steagall Act "from establishing an affiliate relationship with or organizing or acquiring a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing stocks, bonds, debentures, notes, or other securities."

The reaction of many people to the FDIC's interpretation of Glass-Steagall and its proposed guidelines is that the agency has improperly usurped Congressional prerogatives by taking actions which effect major changes in the relationship between the banking and securities industries. As a result, it has been suggested that Congress impose a moratorium to prohibit agencies like the FDIC from making such decisions. Such a moratorium purportedly would enable Congress to decide larger fundamental issues, including whether the basic purposes of the Glass-Steagall Act have outlived their usefulness, while avoiding potentially damaging ad hoc decisions by a variety of government agencies. In Congressional testimony, Chairman John Shad, on behalf of the Commission, responded to these concerns. I would like to use this opportunity to expand on that testimony with some of my views on these matters.

Initially, I note that these issues are not of recent origin. For instance, the FDIC has dealt with indirect bank involvement in securities activities since 1969 when it began issuing opinions premised on its conclusion that the Glass-Steagall Act does not prohibit a non-member state bank from being affiliated with companies engaged in securities activities. In so doing, the FDIC did not arbitrarily set out to define the parameters of the Glass-Steagall Act. Rather, it was responding to direct inquiries concerning the scope of application of its deposit insurance. Several recent developments caused the FDIC to address more formally the safety and soundness of securities activities by bank subsidiaries.

Among those developments was action last year by the SEC regarding the School Street Mutual Fund's registration as an investment company under the Investment Company Act. The Fund also submitted a registration statement under the Securities Act of 1933 which, if effective, would permit the Fund to sell its securities to the public. The Fund involved a novel arrangement in which wholly-owned subsidiaries of the Boston Five Cents Savings Bank, a state-chartered mutual savings bank under the FDIC's jurisdiction, would act as investment adviser to the Fund and as distributor of Fund shares. This relationship raised concerns regarding compliance with the Glass-Steagall Act.

Last July, the Commission considered an application by the Fund to declare its Securities Act registration statement immediately effective. A majority of the Commission determined not to grant this relief absent a determination that the arrangement complied with the Glass-Steagall Act. Our staff was thereupon instructed to formally request the FDIC's opinion as to the lawfulness of the proposed arrangement under the Act, even though two months earlier the FDIC Board of Directors, by a unanimous vote, had declined to consider a petition by the Investment Company Institute to declare the Fund's arrangement a violation of the Glass-Steagall Act. The majority of Commissioners also raised the possibility that if an opinion was not forthcoming, the SEC might make its own determinations regarding the banking law issues. My own view was that the Commission has neither the authority nor the expertise to decide Glass-Steagall issues. Moreover, having dealt with bank regulatory agencies for many years, I was satisfied that the FDIC's refusal to take action to halt the proposed arrangement, despite being specifically requested to do so, indicated that they did not believe that it constituted a Glass-Steagall violation. Thus, I voted to grant the Fund's request for acceleration.

Rather than comment on the specific School Street proposal, the FDIC responded by issuing a broader statement of policy setting forth its opinion as to the applicability of the Glass-Steagall Act to the securities activities of subsidiaries of insured non-member banks. This statement formally affirmed the FDIC's position that our banking laws do "not prohibit an insured non-member bank from establishing an affiliate relationship with, or organizing or acquiring, a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing [securities] at wholesale or retail...." I might add that there appears to be a consensus by experts in the field that, as a technical matter, the FDIC's interpretation of the Glass-Steagall Act is correct. While it can be argued that the spirit of the Act may be contrary to the FDIC's determination, traditionally the Glass-Steagall Act has been interpreted in a very technical fashion. Such was the case in two Supreme Court decisions which allow banks and bank holding

companies to advise and sponsor closed-end investment companies, but not to sponsor open-end investment companies more commonly known as mutual funds. This was also true in the case of discount brokerage services offered by banks and when various government regulators determined that money market funds with check writing privileges are not deposit accounts for Glass-Steagall purposes. In my view, it is quite appropriate to narrowly construe restrictive statutes such as the Glass-Steagall Act which prohibit otherwise natural market developments or relationships.

It bears emphasizing that the FDIC did not invent or discover what many have called the "loophole" in Glass-Steagall's armor which is the basis of the FDIC's interpretation. Rather, it was discovered by private sector financial institutions seeking to take advantage of gaps in the statute's language. The FDIC does not have the authority to close such so-called loopholes. Had it done so here, I believe the complaint that it had exceeded its authority would be justified.

In its response to the Commission, the FDIC also indicated that it would consider proposing a rule designed to ensure the safe and sound operation of FDIC insured banks which seek to engage in the securities activities at issue. The FDIC made good on its word by proposing the regulations which are now out for comment. It appears to me that having concluded that, as a matter of existing law, bona fide subsidiaries can engage in broad securities activities, the FDIC acted in a very responsible fashion by proposing various limitations to such securities activities aimed at promoting the safety of FDIC insured state non-member banks. Reasonable people can understandably differ as to whether various aspects of the proposal are adequate, but that is one reason that rules are proposed for public comment. In fact, FDIC officials have indicated to me that they are anxious to receive constructive criticism regarding their proposed restrictions. Moreover, absent the adoption of such a rule, banks would be less restricted in their securities activities than would otherwise be the case. Furthermore, I disagree with those who say that while acting within its authority, the FDIC would have been better off dealing with each application on a case-by-case basis. Such a lack of guideposts would do little to deter bankers from probing the maximum limits of their field of play.

In short, I do not think that the FDIC is overstepping appropriate administrative boundaries or usurping Congressional prerogatives. Rather, I believe it is attempting to respond to specific matters that are within the scope of its legislatively mandated responsibilities. While others debate the future of the Glass-Steagall Act, bank regulators such as the FDIC are required to interpret and apply the Act as it exists today in various specific fact contexts.

Admittedly, the FDIC's actions could accelerate the profound changes taking place in our financial system. Thus, it is certainly proper for members of Congress and others to be concerned with the impact of banks engaging in the securities activities set forth in the FDIC's rule proposal. It is also in the public interest for Congress to consider the broader Glass-Steagall issues raised by this proposal. I believe the FDIC proposal serves the useful purpose of focusing the attention of Congress on these issues and the FDIC is on record as "welcom[ing] Congressional guidance as to the appropriate activities of our financial institutions." However, as I noted earlier, the Glass-Steagall questions being raised today are not new. Nor is the request that Congress deal with this controversial area. In a 1973 speech referring to securities activities engaged in by commercial banks notwithstanding Glass-Steagall restrictions, I commented that: "There have been serious questions as to whether the line drawn by Congress between commercial and investment banking permits these activities or whether the line has become so eroded that it is completely illegible." I also stated that clarifying the Glass-Steagall Act was a Congressional responsibility; that there should be comparable regulation for similar investment products; and that all securities activities should be subject to Commission jurisdiction. That was ten years ago, and I have reiterated those positions many times. Moreover, I was not alone in requesting Congress to clarify the Act. Others had been seeking Congressional action for years.

My personal view at that time was that competition among financial institutions "is desirable, as long as it does not lead to anti-trust problems, involve unacceptable conflicts of interest or jeopardize bank safety and solvency and, perhaps most important from the vantage point of the Commission's regulatory perspective, as long as this bank competition is not fostered at the unnecessarily high cost of sacrificing needed investor protections and safeguards...." I am still of the same view, and believe that it would be in the public interest to deal with these specific problem areas rather than to prohibit competition among financial institutions. Unfortunately, Congress has not adopted clarifying amendments to the Glass-Steagall provisions which set the boundaries between securities and commercial banking industries. I do not construe this Congressional inaction to constitute either a ratification or rejection of the current trend of events. Rather, I see it as a failure to achieve a consensus on the proper course to follow in a very controversial, politically charged area. This inaction, however, does indicate that Congress has not thus far been sufficiently concerned about what is happening to take action to stop it. Moreover, despite the renewed interest in these problems by particular Members of the House and Senate, I question whether Congress has the resolve needed to approve comprehensive reforms to the Glass-Steagall Act in the near future.

Absent quick clarification of the Glass-Steagall Act by Congress, it has been suggested that Congress or government regulators should impose a moratorium on any further changes to the status quo. Some regulators clearly oppose the idea of a moratorium. The FDIC, for one, has indicated its desire "that [Congressional] guidance, rather than an ineffective and inequitable moratorium, be forthcoming in the not-too-distant future." On the other hand, some regulators have endorsed the moratorium approach. In April of this year the Comptroller of the Currency announced a moratorium on the chartering of so-called non-bank banks through the end of 1983. This action applied to applications by non-banking companies to obtain national bank charters for subsidiaries which would not be subject to Bank Holding Company Act regulation because they do not offer both demand deposits and commercial loans. Approval of such applications enables corporations in any line of business to own and operate a bank, and thereby raise money other than through demand deposits while at the same time engaging in commercial lending.

The Comptroller's action was precipitated by his belief that Congress is now prepared to debate the full range of bank deregulation issues, and that a moratorium "would help foster free and open debate . . . [and] reduce the pressure created by escalating marketplace innovations at the national level that could outpace Congressional deliberations." Just last week legislation was introduced in Congress, at the request of Chairman Volker and the Federal Reserve Board, that would essentially codify the Comptroller's moratorium and would also limit certain new activities, such as the sale of insurance, by state-chartered depository institutions. This latter action is aimed at two South Dakota laws which have the effect of allowing an out-of-state bank holding company to buy a South Dakota bank and to use that bank to engage in other activities, such as insurance, in the other 49 states. The moratorium proposed in the Senate legislation would terminate at the end of this year. Noting that "it is unrealistic to expect Congress to act on comprehensive legislation" in such a short period, an otherwise identical bill has been introduced in the House providing for a moratorium through the end of 1984.

I have serious reservations about such moratoriums. One of my concerns is the inherent unfairness that occurs. For instance, prior to the declaration of its moratorium, the Comptroller had already approved approximately a dozen applications permitting non-bank banks. These charters will remain effective and several other applications, which were filed prior to imposition of the moratorium, will be processed in the normal course. Applications received after the moratorium's imposition, however, will not be processed. Thus, the moratorium will insulate those who have already sought the requested relief from having to compete with like situated non-banking companies that want to exercise the same privileges.

Another unsettling aspect of the Comptroller's moratorium is its one-sided nature vis a vis the banking and securities industries. This moratorium serves only to buffer the banking industry from competition by non-banking companies. Thus, the Securities Industry Association has taken the position that, in the name of fairness, the Comptroller should extend the moratorium to attempts by banks to move into securities activities. I find the logic of this argument to be compelling. It leads to the conclusion that to achieve fairness, there would have to be a moratorium on all changes to the traditional perceptions of Glass-Steagall boundaries. However, I foresee several problems with such an approach.

First, considering the ingenuity of those in the securities and banking industries, I seriously question whether such a moratorium could be effectively implemented and enforced. But my foremost concern is that such a broad-based moratorium will stifle the development of innovative financial services and products that could benefit investors. It has been said that recent changes are not so much innovations as they are clever actions by attorneys attempting to circumvent established public policy. Certainly there are clever actions by attorneys, but I agree with the statement of Senator Garn when he introduced the Federal Reserve's moratorium legislation, that: "In sum, participants in the financial marketplace are continuing to pursue aggressive and innovative business strategies which reflect technological and other contemporary advancements which were not even known or imagined when [the] laws [at issue] were enacted." In recent years these innovations have included money market funds, sweep accounts, integrated brokerage accounts such such as Merrill Lynch's Cash Management Account, and discount brokerage services offered by banks. Thus, if a so-called Glass-Steagall moratorium had been implemented several years ago on all changes to the traditional perceptions of the Act's boundaries, these and other popular services and products, which apparently meet investor needs without causing the problems which led to enactment of the Glass-Steagall Act, would not have been available.

Moreover, the imposition of a moratorium, be it time limited such as the Comptroller's or the Federal Reserve's proposed legislation, or be it open-ended, is no guarantee that Congress will act. Indeed, a moratorium may well ease the pressure on Congress to make the difficult and controversial decisions which it has avoided for many years already. On the other hand, because the Administration is reported to oppose a direct legislative moratorium, its chances for passage are probably dim. Thus, this proposal may serve the useful function of further concentrating attention in important Glass-Steagall issues.

In sum, I am led to the conclusion that the proper course of action in the Glass-Steagall area is not to criticize banking agencies which are making good faith efforts, as required

by their statutory mandate, to grapple with the innovative attempts of businessmen to probe the limits of an often ill-defined statute. Nor is the answer to arbitrarily freeze the status quo, absent evidence, which I do not find, that the current state of affairs will better serve investors and the economy than the anticipated innovative changes. Rather, it is time for Congress to confront and decide the politically difficult Glass-Steagall questions. While some of these questions deserve further study and debate, others can and should be resolved quickly. Such a step-by-step approach may not be as attractive to some as an all-inclusive solution. However, if significant changes are to be made, as I think they should be, the step-by-step approach enables businesses and regulators to adjust their activities in a responsible manner and to evaluate the consequences of their actions. In any event, the time for Congressional action is long overdue.

It has been reported that later this week the Treasury Department will send newly drafted legislation expanding beyond last year's proposal the ability of banks to enter into related financial activities through holding company affiliates. I have not had an opportunity to review the administration proposal, but I understand that upon enactment it would require the divestiture or termination of any acquisition or activity begun by a covered entity after the date on which the legislation is introduced in Congress if the activity is not performed in a separate holding company subsidiary.

The Commission supported the Administration proposal last year which permitted banks to engage in certain securities activities through a holding company affiliate which would be subject to our regulatory requirements. Until I have studied the expanded Treasury proposal, I cannot predict our reaction to all of its provisions, but I do hope that Congress will have the courage to act on Glass-Steagall legislation this year.