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A SEAMLESS WEB: BANKS, NEW ACTIVITIES AND DISCLOSURE

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Once Upon a Time

Those with a liking for logic might suggest that we should start with a clear understanding of what a bank is before attempting to talk meaningfully about the expansion of bank securities activities and bank disclosure obligations, the topic of this two-day gathering. That's why my comments could be called a "once-upon-a-time" story. Once upon a time, when we were children, we all knew what a bank was. It was a ceramic, flowered pig where our pennies went for safekeeping. It had a limited function, that of safekeeping funds, and its integrity and inviolability were not subject to doubt. The fact that this flowered pig had only a limited function wasn't viewed as a shortcoming; in fact, it added to its special significance. As we grew older, our views did not change significantly. Pennies became dimes or quarters; perhaps the pig got bigger, or became a toy cash register or other mechanical device; but it remained essentially the same -- a totally safe place having a clearly defined and limited purpose.

When we grew old enough to take the money from the piggy bank to the local bank, our ideas remained relatively unchanged. The goal of safekeeping continued, with perhaps some modest idea of earning interest. But earning interest was almost an afterthought. Appropriately, the local bank was a solemn, serious place, with a Greek revival facade, much marble and hardwood in the interior, and an air much like that of a church. Safety continued to be the key characteristic, and the prominently displayed main vault underscored that characteristic. Perhaps we came to appreciate that only a select few of the most conservative and trustworthy citizens could acquire a charter, which made you a real bank.

But things generally are more complex than we perceive as children, and banking is no exception. ~~But~~ additional forces have been at work in the world of banking. Today, it's not always called banking, and certainly those who engage in it are not limited to persons having a charter formally denominating them as a bank. Instead, it's called the financial services industry, and its array of products baffles many customers and frequently the regulators. Now well-known is the transition from a simple mix of checking and savings accounts offered by depository institutions to NOW accounts, Super-NOW accounts, money market deposit accounts, money market certificates, repurchase agreements, reverse, retail, and overnight repurchase agreements, cash management service, and on down the line.

Non-depository institutions, such as Merrill Lynch, will take your money and invest it in money market funds, business development companies, insured savings accounts, certificates of deposit, and, even occasionally, old-fashioned stocks and bonds. Some of the investments you buy through Merrill Lynch are even covered by federal deposit insurance. And by no means does Merrill Lynch have a monopoly. American Express does international banking, issues credit cards and travelers' checks and, through Shearson/American Express Inc., provides full-line investment banking, money management, securities brokerage and commodities services. Sears, formerly a place to buy clothes and tools, now offers consumer credit through Sears, insurance through Allstate Insurance, real estate through Coldwell Banker, securities brokerage, commodities, investment banking and various money management services through Dean Witter Reynolds, and de facto banking through Allstate Savings and Loan. Little distinguishes these non-depository companies from banks, even though they lack a charter which denominates them a bank, they disclaim that they take deposits, and they engage in commerce in addition to "banking."

~~But, then,~~ One might ask, "So what?" So it's difficult to tell what a bank is. Does it matter? Well, for one thing, only banks are supposed to accept "deposits," an activity Congress has declared to be affected with a public interest. And if banks have a monopoly on certain activities such as taking deposits, yet are precluded from others to assure that banks are operated safely and soundly and do not fail, the inescapable conclusion is that banks remain special, if not unique.

That is why the status of banks under the federal securities laws, whether the discussion focuses upon the permissible range of bank activities and the appropriate amount of diversification and risk-taking or upon disclosure issues, is so complex. And frustrating logical analysis is the fact that the issues of permissible range of activity and disclosure cannot be discussed as separate issues. Indeed, they are the proverbial two sides of the same coin. Developments on the structural front affect disclosure considerations. As disclosure becomes more accepted for banks and their affiliates, that may well lead to a cry for banks to have the authority to engage in yet a broader range of activities. That is my principal thought for today.

We all have heard various calls for changes in the regulatory structure to permit banks to compete with other financial service providers. "Level playing field," a catchy phrase now shop-worn, remains the goal of many. But the old tension between two firmly-entrenched regulatory schemes -- one adopted for banks and having a "protect-the-enterprise-and-system" theme, and the other having a full disclosure and "protect-the-investor, even at the expense of the enterprise" theme -- interfere with creating that level playing field. Seemingly missing is a full appreciation of the extent of that tension and conflict. Some reason that banks should be free to compete and take risks, but that banks nonetheless are special and must be protected. Yet that reasoning undermines efforts to make logical decisions about the proper range of bank activities and appropriate disclosure requirements.

Protectionism and Disclosure

From 1933 to at least recently, any discussion of banking regulation was on shaky conceptual ground if it did not recognize that, first, last and always, came the safety and soundness of the banking system. Public interest demanded it. History demonstrates why. Between 1820 and 1930, our economy was characterized by successive cycles of growth, boom, speculative frenzy, and financial panic and bust. During a panic, any hint of instability in a bank led to a run and frequent collapse of the bank, as depositors withdrew their money. From 1913, when the Federal Reserve Act was adopted, through 1933, 15,502 U.S. banks failed, more than all banks existing today. From 1929 to 1933 alone, more than 9,000 banks collapsed. Little wonder that Congress adopted the Banking Act of 1933 and established the Federal Deposit Insurance Corporation.

Federal deposit insurance promoted monetary stability and public confidence by absolutely guaranteeing depositors that they could always obtain their money with no loss of principal. That achievement has been characterized as "the change most conducive to monetary stability since state bank note issues were taxed out of existence immediately after the Civil War." Although 4,004 banks failed the year before the FDIC was created, only 62 failed in the following year, nine of which were insured. One economist and historian has observed:

> "The FDIC was what the Federal Reserve had not succeeded in being--an utterly reliable lender of last resort, one that would immediately and without cavil come forward with whatever money was needed to cover the insured deposits."

So successful has federal deposit insurance been in fostering public confidence that some now complain that depositor and bank management complacency is a by-product of federal insurance.

The Banking Act of 1933 was designed to promote safety and soundness of banks in other ways too. Banks were barred from activities perceived to be potentially troublesome. With certain minor exceptions, they were forbidden to underwrite or deal in securities and were permitted to engage only in those activities "necessary to carry on the business of banking." Interest was prohibited on demand deposits, interest rates on time deposits were regulated, and bank examiners were given additional powers. The result was a partnership between the federal government and the banks it regulated, with the government as a senior partner. And predating the Banking Act of 1933 by twenty years was the Federal Reserve Act, which focused upon a sound central monetary policy.

So by 1933, a pervasive scheme of federal regulation of banking was firmly in place, which I would characterize as having three principal objectives. The first objective was a sound and stable monetary policy. The second was the promotion of public confidence in the banking system. The third was the promotion of public confidence in individual banks. The combined effect was to encourage people with available capital to deposit it and leave it in banks, with assurance that nothing adverse would happen to the institution and, in the unlikely event it did, they were nevertheless insured. If my characterization of the three principal goals is correct, then subjecting banks to a full disclosure spotlight or allowing them to compete in risk-laden activities seems inconsistent with those goals. Either one, and certainly the two in concert, seem fully capable of producing contrary results.

The Securities Act of 1933 was adopted at the same time as the Banking Act of 1933, is essentially a companion piece of legislation, and even emanated from the same Senate Committee. In a larger sense, both regulate the investment process -- the process by which people entrust their investible capital to another -- and both proclaim that they are designed to promote public confidence in that process. But unlike the Banking Act, the Securities Act seeks to promote public confidence in a totally contrary manner, by mandating full disclosure, even of adverse information, and even at the risk of damage to the enterprise. Why are the basic themes of securities and banking legislation, both adopted at virtually the same time, so different, if not irreconcilably in conflict?

Perhaps as much as anything, the perceptions of the times and politics are the reason. In that respect, the Banking and Securities Acts are no different from other legislation. The number of bank failures before 1933 to which I alluded seems to provide some clear rationale for the protectionist theme of the Banking Act. As to the Securities Act, it has been said that President Roosevelt believed the moral offenses of investment bankers would be curbed by exposure to public scrutiny. Some historians contend that adoption of a disclosure scheme was influenced by the states' disappointing experience with merit regulation and a hostility to federal merit review by some, particularly Congressman Sam Rayburn, Chairman of the House Commerce Committee. But many of Roosevelt's principal campaign advisers also believed that the securities markets had partially caused the Depression by misallocating capital. They viewed a potential securities law as a means to allocate capital to specific, selected industries as part of an integrated industrial program.

But Roosevelt rejected direct regulation of capital allocation as the basic concept of the Securities Act:

> "Our draft remained true to the conception voiced by the President in his message of March 29, 1933, to the Congress, namely that its requirements should be limited to full and fair disclosure of the nature of the securities being offered and that there should be no authority to pass upon the investment quality of the security...We also provided for the passage of a period of time before a registration statement could become effective...It would give an opportunity for the financial world to acquaint itself with the basic data underlying a security issue and through that acquaintance to circulate among the buying public as well as independent dealers some intimation of its quality."

Notwithstanding a proclaimed disclosure objective, in an August, 1933 article in Fortune magazine, Felix Frankfurter, a key draftsman of the Securities Act, described the legislation as "a modest first installment of legislative controls to assure commerce and industry a continuous flow of their necessary capital...." Those terms suggest a latent capital allocation theory behind the Securities Act, at least in the minds of some.

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But regardless of any allocation theory that may have been in Frankfurter's mind, two regulatory schemes emerged simultaneously, each with a dramatically different approach to encouraging public confidence among those who would entrust their money to others. Logic suggests that the two schemes are flatly antithetical. The harsh spotlight of full disclosure creates a healthy skepticism and is prepared to sacrifice if necessary the enterprise to encourage public confidence. Safety and soundness regulation seeks to preserve the enterprise and assure the absolute safety of investment. That eliminates any need for skepticism. For those two regulatory schemes to co-exist peacefully, side-by-side, would seem to require that each scheme apply to separate, non-competitive economic activities. No wonder the sparks fly as the financial services industry consolidates and as regulatory lines are crossed by participants.

Drawing the Line on Function

As I observed, the line drawn in 1933 between a protectionist regulatory approach and a disclosure approach afforded banks a special status. Banks were precluded from engaging in certain potentially profitable activities, but were protected from competition from non-banking enterprises. I will not speculate whether that special treatment has any latent suggestion of an effort to allocate capital, as I suggested you might read into the history of the Securities Act. But, undeniably, at least an indirect effect was to allocate capital, in the form of deposits, by influencing the transfer of money into the banking system.

In the last five years, the historically neat separation of commerce and banking has simply collapsed. Each player in the financial services area wishes to be free to do anything that any other player is free to do. The use of any legal loophole to achieve that end is fair. Dollars, whether in the form of deposits or equity investments in the stock market, are fair competition from all quarters. These developments naturally have produced distortions and conflicts in the heretofore peacefully co-existing regulatory schemes.

The Department of the Treasury has recently proposed legislation to resolve some of these conflicts about proper function. Treasury's proposal would permit national banks to underwrite and deal in municipal revenue bonds; sponsor, manage, advise and distribute mutual funds; underwrite and sell insurance products; and develop, invest in and sell real estate. These activities and all other securities activities, however, would have to be carried out through a non-bank subsidiary of a bank holding company. The corporate separation of these activities would tend to resolve some of the regulatory conflict by placing the activity in entities that could be regulated separately by the appropriate regulatory agency.

The Relationship Between Function and Disclosure and Some Predictable Conflicts

Having briefly summarized Treasury's approach, let's return for a moment to my original thought that the proper range of activities of banks and questions of disclosure are related issues. With that thought in mind, let us reflect upon some already-existing and potential conflicts between the respective regulatory schemes.

The matter of federal deposit insurance comes first to mind. Deposit insurance has successfully promoted safety and soundness by fostering public confidence. What does federal deposit insurance have to do with the securities laws, securities activities of banks, and disclosure issues, and why is there any potential conflict? Historically, perhaps it had little relevance, and there was no potential conflict. But proposals abound for a number of changes in the insurance system. Some have suggested, for example, that the FDIC should not provide *de facto* insurance for deposits above $100,000 through mergers of failing institutions. Some have suggested that the insurance coverage should be reduced to $25,000. With reduced insurance coverage, depositors will be less complacent in choosing a bank because they may lose their funds. Bank management thus will be subject to "market discipline" in competing for capital in the form of deposits and in taking business risks.

Another suggestion is to base federal deposit insurance premiums on risk. Those banks that are high risk would pay more than low risk banks for equivalent coverage. Depositors will be more skeptical of the financial institutions they deal with, and management of banks will become more "business-like" to avoid paying high premiums, particularly as banks diversify into other activities.

Yet, if they come to pass, these two developments seem designed to raise doubts about banks, which is contrary to the original idea of fostering public confidence through federal deposit insurance. That is particularly so if securities law disclosure concepts are introduced. For example, what quantity and quality of disclosure, positive and negative, should be made to large depositors whose deposits are not insured and will not be protected in a "bail-out" merger? Presumably that would be more than large depositors traditionally have received, since full disclosure was largely irrelevant. Notwithstanding the Supreme Court's decision in *Marine Bank v. Weaver* that insured certificates of deposits issued by national banks are not securities, are large uninsured certificates securities? Furthermore, if risk-related premiums are instituted, should both depositors and equity investors be informed of the rating and the factors that went into the rating? That information certainly may be material under the securities laws. My point is that, once the bank is removed from a totally protected atmosphere and ostensibly subjected to market discipline, disclosure assumes much significance. The effect of either lower insurance coverage or risk-related premiums is some measure of market discipline.

Conflicts are on the horizon in the area of banks offering brokerage services. The quantity and mix of securities activities which may cause a bank to become subject to registration under the purposes of the Securities Exchange Act of 1934 remains to be precisely defined. Such registration would subject the bank to the Commission's examination authority, net capital requirements, and potential administrative proceedings. Perhaps immediate concerns about such matters can be eliminated or reduced if all brokerage activities are transferred to a separate corporate affiliate, as envisioned by the Treasury Department, which then registers. Only the securities affiliate becomes subject to the Commission's jurisdiction. But what if an examination of the broker-dealer raises issues which force the Commission to inquire into the inner business affairs of the sister bank, which, although publicly-owned or part of a publicly-owned holding company, is still cloaked with some form of safety and soundness regulation and resists full disclosure? In that case, has the conflict between the regulatory schemes been eliminated, or has the confrontation merely been postponed?

Reflecting further, some have suggested the repeal of Section 12(i) of the Exchange Act, which would transfer to the Commission the responsibility for overseeing the registration and reporting provisions of the Exchange Act as they apply to publicly-held banks, not just bank holding companies. If not an outright potential for conflict, this has at least the potential for some new experiences by publicly-owned banks. Such a transfer would give the Commission the effective authority to set accounting standards for banks, an authority we previously have had only for bank holding companies and an authority which includes broad power to define the information about bank operations which must be disclosed.

The traditional confidentiality of bank examination reports already has been the focus of conflict between the bank regulatory scheme and the securities laws. That conflict promises to be no less as banking and non-banking activities are further combined. In Securities and Exchange Commission v. Youmans, a federal district court held that a bank's officers violated the federal securities laws by failing to make public disclosure of criticisms contained in a bank examiner's report. Youmans concluded that adverse information contained in an examination report is not entitled to secrecy if that information is material under the federal securities laws. The potential impact on public confidence through compromising the confidentiality of the examination report was not controlling. As banks diversify into more and more non-traditional banking activities, it seems to me that the potential for further compromising the heretofore sacred confidentiality of the examination process is increased.

In terms of some specific disclosure developments, there have been recent changes, dramatic in the view of many, in the disclosure requirements for troubled loans of publicly-held banks and bank holding companies. These changes have come about even though the banks are conducting traditional banking operations and not new securities activities. Banks are now required to disclose more information about troubled loans. The effect of such disclosure, of course, may be to arouse some concern among depositors and the general public. Some contended that the very confidence bank regulation historically has promoted would be eroded or destroyed by these new disclosures. Obviously, those arguments were not persuasive to the regulators.

In addition, an apparently emerging preference, at least on the part of some banking regulators, for more regulation by "market discipline" should be noted. Some argue that this is contrary to traditional safety and soundness regulation; others argue that market discipline will promote long-term soundness. Regardless of which argument you find appealing, a preference for market discipline has potentially significant consequences. If market discipline is to become a truly effective regulator of banks, three factors must necessarily exist. First, banks must be required to make prompt, full disclosure of all material information, positive and negative, even at the risk of damage to or collapse of the enterprise. Second, banks must be allowed to fail just like other enterprises. Third, both stockholders and large depositors must be left to bear their losses. Only then will banks truly be subject to market discipline. As I said, if the bank regulators are serious about letting market discipline become the regulator, that is most a significant development. In that environment, all undoubtedly would concede the overriding importance of full and prompt disclosure.

My original premise was that the structural issue of the appropriate activities of banks and the general issue of disclosure are but two sides of the same coin. The relaxation of a strict protectionist attitude toward banks has tempted or encouraged banks to engage in non-banking ventures to realize greater profits. Many of those activities carry risks other than those to which banks are accustomed. The new enterprises and new risks in turn create a need for yet greater and more refined disclosure. And so the momentum grows.

Perhaps the question ultimately will be whether our society is willing to allow banks to engage in a wider range of progressively riskier activities, to subject banks to the spotlight of disclosure, particularly as they diversify, and to subject banks to the ultimate market discipline I have suggested. Whether that will occur remains to be seen.

But if that is not to occur, the only theoretically pure alternative is to go back, give banks an absolute monopoly on certain activities, remove them from market risks, and draw an iron curtain between banking and commerce. It's extremely difficult to believe that will happen. But unless we go to the other extreme, that of full disclosure and ultimate market discipline, a regulatory system with inconsistent and conflicting objectives will continue to exist. Certainly, the much sought-after "level playing field" will not have been achieved.

Conclusion

Certainly there is no balance between the two extreme approaches I discussed which will achieve universal acclaim. But most would agree that a clear relationship exists between a healthy banking system and a flourishing economy.

Our difficulties in striking a balance between the conflicting regulatory schemes I have discussed, however, may not be unprecedented. The prior experience of others may demonstrate how difficult the task is. In 1716, Louis XIV had just died and France was in appalling financial condition. In modern day parlance, there were cash flow problems, as expenditures were twice receipts. The Royal Treasury was chronically empty.

But John Law, an enterprising Scotsman, then arrived on the scene. Through high-born acquaintances, Law obtained the right to establish a bank with capital of about 250,000 English pounds. The bank was authorized to issue notes, which it did. The principal borrower was the French Crown, which used the notes issued by Law's Bank to pay off its creditors and declared the notes legal tender. The Bank notes loaned to the government and floating through the the system stimulated the economy. General optimism engendered by Louis' death furthered a substantial economic revival.

At this point, in the interest of full disclosure, I should pause and note that John Law's primary reason for being in France, where he was rapidly becoming that nation's central banker, was that he was fleeing a murder charge in England. He had been singularly successful in a duel. In addition, he had gambled his way through a considerable inherited fortune in his home country.

But back to the French banking system. All these events had such a beneficial effect that the Royal Regent proposed an additional issue of notes by Law's Bank. Law agreed, but even he was becoming concerned that the growing volume of notes in circulation -- now a form of paper currency -- was not backed by a sufficient reserve of hard currency -- gold coins in those days. Perhaps Law didn't call it public confidence, but that was his concern.

Even in 1719 banks apparently were restricted in what they could do, so Law had to look to ventures outside banking to realize profits and support the bank. So in 1719 Law established the Mississippi Company, later called the "Company of the Indies," which was to explore for gold in Louisiana. I suppose this could be called a separate corporate affiliate. The gold was to be minted into gold coins, which would back the notes or the soft currency issued by Law's Bank. The Company of the Indies also received an exclusive trading monopoly in India, China, and the South Seas, a monopoly on tobacco, and the right to coin money.

John Law also understood the hot issues market. His next step was to take this burgeoning financial services conglomerate public. It was truly a hot issue. The value of the initial shares rose phenomenally, and throughout 1719 more and more shares were issued, ostensibly to be used to find gold in the Louisiana wilderness to make the gold coins to back Law's Bank's notes.

But that was not the case -- in those days there were no full disclosure documents discussing the use of proceeds. Instead, the funds raised were loaned to the Crown. Only interest paid on those loans was available to the Company for its operations. One historian described it as follows:

> "Law was lending notes of the [bank] to the government (or to private borrowers) which then passed them on to people in payment of government debts or expenses. These notes were then used by the recipients to buy stock in the Mississippi Company, the proceeds from which went to the government to pay expenses and to pay off creditors who then used the notes to buy more stock, the proceeds from which were used to meet more government expenditures and pay off more public creditors. And so it continued, each cycle being larger than the one before."

But there were problems, of course, in the form of the notes and that small matter of public confidence. Early in 1720, a royal prince sent a batch of notes to the Bank to be redeemed in hard currency. This was the first suggestion of a lack of public confidence in the banking system. Others, then began to redeem their notes for the little gold which existed, which they spirited out of France. To demonstrate that formal disclosure documents are not required for effective disclosure, as word spread that the gold might not be there, the trickle of redemptions became a torrent. Finally, one fine Summer day in 1720, the mob in the Bank was so dense that 15 people were crushed to death. Law's legacy to France was broken fortunes, ruined businesses and an enduring suspicion of banks.

This story illustrates the value of a sound banking system and a stable currency. But it also demonstrates that public confidence in a banking system can be a fragile thing and that progressively greater risk-taking can affect the bank itself, even if done indirectly and not by by the bank itself, and for the best of motives. The impact of disclosure is also eloquently demonstrated by the story. Full disclosure of the use of the proceeds of Law's offering may well have stopped the scheme before it got out of hand. On the other hand, such disclosure would have undermined public confidence in the Bank, the Bank would not have gotten off the ground, and the French economy would not have been rejuvenated, albeit briefly. Indeed, it was disclosure which shook public confidence and brought the Bank down.

Whatever answers the panelists may provide about the appropriate activities of banks, the appropriate level of risk to which they should be subjected, and the role and value of disclosure, we should at least acknowledge that an abiding conflict between safety and soundness regulation and full disclosure, and the question of the proper range of bank activities, have been with us at least 250 years, thanks to John Law. I started this morning by saying that my comments could be labelled a "once-upon-a-time" story. We all should join in the hope that the John Law story will remain a "once-upon-a-time" story.

As a keynote speaker, I have been afforded the luxury of philosophizing and posing questions without offering answers. Needless to say, I have fully availed myself of that luxury. I leave to our distinguished panelists the task of providing the hard answers. They are most qualified for the task.

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