

Banks and the securities markets: the controversy

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Commercial banks have tried hard over the past decade to expand their currently limited role in the securities markets. Firms already in the securities business have been determined to prevent any enlargement of that role. The confrontation could escalate into one of the most bruising legislative battles in recent years.

Some banks have argued that they should be allowed to underwrite municipal revenue bonds, as well as general obligation bonds, to offer commingled investment accounts (essentially, mutual funds), and to engage in the retail securities brokerage business. Federal banking law either prohibits banks from engaging in these activities or, as in the case of brokerage activities, is ambiguous.

The issues underlying the controversy date, at least in embryonic form, back to the beginnings of American banking. The role of banks in the securities markets, curtailed since passage of the Banking Act of 1933, is understandable only in terms of what was going on when the act was passed.

This article examines the controversy over securities activities by tracing the history of the involvement of banks in securities markets and describing their current activities. A later article will try to sort out the problems of public policy, separating those inherent in bank securities activities from those that were due to abuses since cured by legislation or changes in business ethics.

Commercial loan theory of banking

From its inception, American banking was based on the English model. Like their English brethren, American bankers professed to subscribe to the commercial loan theory of banking—the *real-bills doctrine*,

which held that the characteristic role of a commercial bank was to make short-term, self-liquidating loans for the purpose of financing industry and trade. The term “real bills” derives from the bills serving as evidence of indebtedness to a bank; the bills were real in the sense that they were secured by real goods moving to market.

The theory held that a bank could ensure its solvency and liquidity by confining its lending to this kind of short-term, self-liquidating loan. The theory held further that adherence to such a policy would result in just enough money and credit to support the prevailing level of economic activity, or “needs of trade.” It would stabilize prices.

Though the subject of controversy for years, the real-bills doctrine survived well into this century. It was even incorporated into the Federal Reserve Act by the requirement that credit extended to commercial banks by the Federal Reserve banks be secured by *eligible paper*, meaning paper evidencing short-term loans similar to those envisioned by the real-bills doctrine.

The real-bills doctrine has since been relegated to the dustbin of the history of economic thought. Long before the doctrine was thrown out, however, the demand for credit in a vigorously developing country produced important departures from its dictates. With few other financial institutions—and no organized securities markets to meet the enormous requirements for new fixed investments—banks were called on very early to supply a large part of the long-term credit business demanded.

It was apparent as early as the 1830s that American banks were heavily into the business of making long-term loans secured by fixed assets. It is estimated that, by the

beginning of World War I, a substantial proportion of commercial bank credit was going to finance fixed capital. In addition to extending direct loans, banks were heavy purchasers of corporate and government securities.

Moreover, although data are scant, banks appear to have been leading participants in the underwriting and distributing of securities in the first half of the nineteenth century. Failure of the Second Bank of the United States following its conversion to a state charter was widely blamed on the bank's involvement in investment banking. This criticism was forgotten in the 1860s, however, as demands for credit during the Civil War set off another burst of bank underwriting of securities.

By the turn of the century, the role of commercial banks in investment banking had become a matter of controversy. In 1902, the Comptroller of the Currency ruled that the National Banking Act prohibited national banks from underwriting and distributing equity securities.

To get around this restriction, national banks, led by the First National Bank of Chicago in 1903, organized state-chartered affiliates to carry on their securities business. This response was similar to the earlier organization of state-chartered trust companies to get around the National Banking Act's prohibition of trust activities to national banks.

In 1912, the Pujo Committee, a subcommittee of the National Monetary Commission, recommended that national banks also be prohibited from underwriting corporate bonds. The role banks were to play in distributing government securities in World War I, however, would soon allay criticism of bank securities activities.

Banking in the twenties

The 1920s saw a further blurring of the distinction between commercial banking and investment banking, occasioned by a sharp shift in business demand for credit. Largely as a result of waves of mergers, first around the

turn of the century and then in the twenties, large corporations had become dominant in American business. Having easy access to the emerging national credit market, corporations often found it better to raise long-term funds by selling securities than by borrowing from banks. This tendency was reinforced in the twenties by the growing popularity of stock ownership, even by those with modest incomes.

Corporations cut back on their short-term borrowing from banks even more because, after several years of rapid growth in earnings, they were flush with funds. Many companies, in fact, entered money markets as lenders in competition with banks, particularly in call loans for carrying stocks on margin.

To put funds derived from their rapidly growing deposits to profitable use, banks sought alternatives to the shrunken market for short-term commercial loans. One alternative was to increase their term lending to business—loans with maturities of more than a year. Despite this shift in emphasis, commercial loans declined from over 50 percent of banks' total earning assets in 1923 to 39 percent in 1929. As a proportion of total loans, commercial loans declined from 71 percent in 1923 to 54 percent in 1929.

Within the bounds of regulatory constraints, banks also increased their purchases of corporate, utility, and municipal bonds and expanded their participation in consumer and mortgage lending. As two eminent banking authorities wrote in 1933, “. . . American banks ceased to a large extent to be commercial banking institutions and became instead investment trusts.” But for all their efforts to compensate for the loss of their traditional lending business, banks' share of total credit fell from 25 percent in 1923 to 22 percent in 1929.

To maintain their preeminence among financial institutions, banks relied more and more on their securities activities, either directly (the McFadden Act of 1927 explicitly authorized national banks to underwrite investment securities) or through securities affiliates. They were so successful that by 1929 banks and their affiliates were underwriting

over half the new issues reaching the market. Banks appeared to have made the transition from narrowly focused short-term business lenders to general-purpose financial institutions.

The banking crisis

Then the bottom fell out. The crash of 1929 and the ensuing Depression and banking holiday brought to grief not only most of the banking system, including some large banks and their securities affiliates, but also many depositors and small investors. After the banking crisis in 1933, when some 4,000 banks failed, Congress conducted several investigations of the banking system and passed banking reform legislation.

The most sensational of the Congressional investigations was conducted by Ferdinand Pecora, counsel for the Senate Banking and Currency Committee. This investigation focused on the securities activities of banks and their affiliates in the 1920s. Abuses by several banks, especially one of the largest New York banks, and their officers and affiliates captured the public's imagination and aroused its indignation in a way not seen again until the Watergate affair.

Among these abuses were the investment of deposit funds in speculative foreign bonds, the promotion of securities sales on behalf of affiliates, excessive lending to affiliates, speculation by affiliates in the stock of parent banks, a bank president selling the stock of his own bank short—and making a fortune in the process—and indirect payment of huge salaries to bankers through their affiliates. The responses of the government and the public were limited at the time to expressions of outrage. None of the activities was strictly illegal. But it is clear that revelations coming out of the hearings had a great deal to do with the kind of banking reform legislation that was adopted.

The Banking Act of 1933

The centerpiece of banking legislation of the thirties was the Banking Act of 1933. Often

called the Glass-Steagall Act after its sponsors, Senator Carter Glass and Representative Henry Steagall, this act was later reenacted with significant revisions as the Banking Act of 1935.

Although the act dealt with a host of banking matters—including the size and composition of the Federal Reserve Board, membership in the Federal Reserve System, and branching by national banks—the two key provisions of the act were the establishment of federal deposit insurance and, of most interest here, the separation of commercial banking from investment banking. Section 16 of the 1933 act as amended restricts investments of national banks. The section reads in part:

. . . The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, that the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe . . . As used in this section the term “investment securities” shall mean marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term “investment securities” as may by regulation be prescribed by the Comptroller of the Currency. . . . The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof . . .

Section 5(c) of the 1933 act applied the same restrictions to state member banks. Section 20 outlaws bank security affiliates:

After one year from June 16, 1933, no member bank shall be affiliated in any manner described in subsection (b) of section 221a of this title with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . .

Section 21 of the act forbids individuals and companies in the investment banking business from engaging in deposit banking, and vice-versa.

Whatever the merits of the case against the securities activities of banks, the Banking Act of 1933 unequivocally restricted them. But the separation of banks from securities markets was not complete.

Banks were expressly permitted to buy and sell securities, including equities, at the order of customers for their accounts. Banks were also allowed to purchase some types of debt securities for their own portfolios and to underwrite Treasury issues and general obligation bonds of state and local governments. The act did not explicitly mention the authority of banks to serve as advisors to investment companies or other institutional investors or prevent bank trust departments, as fiduciaries or agents, from managing the assets of individuals or corporations, including the purchase and sales of both debt and equity securities. In a recent suit brought by the Investment Company Institute, however, a federal appeals court held that bank holding companies were prohibited by the Bank Holding Company Act from acting as investment advisors to closed-end investment companies and strongly hinted that banks were prohibited from such activity by the Banking Act of 1933.

Reentry into the securities markets

For many years after the banking crisis of the thirties, banks were generally content with the restrictions, an attitude reinforced by the depressed state of securities markets. Not until the early sixties—when the economy and the stock market had both recovered from the Depression and banking was becoming more competitive under the stimulus of reviving loan demand and, in at least some respects, a more relaxed regulatory environment—did banks begin to test the limitations put on their securities activities in 1933.

Municipal revenue bonds. One of the first tests of these limitations came with an effort by national banks to underwrite municipal revenue bonds. Revenue bonds are debt securities with repayments that depend on revenue from a particular source, such as highway tolls. The authority of banks to underwrite general obligation bonds, generally construed to mean bonds backed by the general taxing power of the municipality, was expressly recognized in the Banking Act of 1933.

The Comptroller of the Currency, in a somewhat strained interpretation, ruled that the term “general obligation” had not been used in a strict technical sense in the act. In view of the alleged ambiguity and in light of studies showing that commercial bank entry into underwriting would increase competition and reduce borrowing costs for state and local governments, in 1963 the comptroller authorized national banks to underwrite certain bonds issued by the state of Washington that were previously considered ineligible. He followed this ruling with others that broadened still further the definition of general obligation.

As a result, the comptroller was sued by an investment banking firm in the business of underwriting revenue bonds and in 1966 the ruling was overturned. Since then, banks have lobbied for statutory authority to underwrite revenue bonds. For the first time, they may be close to succeeding.

Commingled investment accounts. The

Comptroller of the Currency tested the limits of the Banking Act of 1933 with another ruling in 1963. In this case, the comptroller approved the application of First National City Bank of New York to serve as investment advisor to a commingled managing agency account—essentially, a bank-sponsored mutual fund operated by the bank's trust department.

Authority for banks to commingle individual trust accounts, pooling funds for investment purposes, is well established. Similarly, their management, in an agent's capacity, of large individual accounts is universally accepted as permitted under the law. What had not been tried before was the combination of these two powers—management of commingled accounts on an agency basis.

In a landmark decision, the Supreme Court upheld the district court decision (reversed by the Court of Appeals) that found the Comptroller of the Currency had exceeded his authority in ruling that national banks might engage in this combined activity. The court held that the collective investment fund violated both sections 16 and 21 of the Banking Act of 1933.

Automatic investment services. Competitors believe that the particular manner in which banks have expanded into some otherwise legal activities violates the act. Some banks, for example, have interpreted their authority under the act to buy and sell securities, "upon the order, and for the account of customers," to mean they are free to enter the retail securities brokerage business.

As a move in that direction, banks have obtained permission of the Comptroller of the Currency to offer automatic investment service (AIS) accounts. Through these accounts, customers authorize the bank to deduct regular amounts from their checking accounts every month to buy a number of preselected stocks. The list of stocks a customer can choose from is usually limited, as for example to the 25 stocks on the New York Stock Exchange with the largest capitalizations.

To hold down commission costs, funds from all the banks' AIS accounts are pooled so the stocks can be bought in large blocks. The

price a customer is charged for a stock is usually the average price paid for the stock that month. It is not the price paid in any one transaction.

The appeal of these accounts is their comparatively low commission costs and the convenience they give customers, many of whom might not otherwise invest in stocks. But the accounts have not come up to expectations. Originally expected to attract a large number of accounts and a great volume of funds, AIS plans have not been as widely accepted as banks had hoped. Several banks have dropped the service. At least two large banks are now negotiating with Merrill Lynch, the country's largest brokerage firm, to serve as agents in offering its Sharebuilder program—which is similar to an AIS plan—to customers of the banks.

Nevertheless, in offering AIS plans in the first place—and despite making all sales and purchases of stock through established brokers or dealers—banks raised the spectre of their eventually entering the brokerage business on a full scale. Indeed, Chemical Bank of New York has gone so far as to offer the general public brokerage services on an agency basis. This has raised the opposition of those already in the business, who argue that such services may be offered only as an accommodation to existing customers, and only at a price at or below cost.

Dividend reinvestment plans. More successful has been the banks' introduction of dividend reinvestment plans (DRP). Under these plans, stockholders authorize companies in which they own shares to send their dividend payments directly to the bank. There, the dividends of all participating stockholders in a company are pooled to buy more shares. Some plans allow stockholders to commit funds in addition to their dividends.

As many as 500 companies participate, including many of the largest in the country in terms of market value of outstanding shares. Ordinarily, 5 to 12 percent of the shareholders of companies represented in the plans participate. The number of participating shareholders, estimated at over a million, is

expected to grow.

Private placements. Also growing rapidly—but seen as much more threatening by the securities industry—are the private placement activities of banks and their affiliates. A private placement is a negotiated sale of securities to private investors that is exempt from the registration requirements for public issues of securities. The investors, often large insurance companies or other institutions, are sophisticated.

The bank advises the issuer on such details as the appropriate interest rate, maturity, indenture provisions, and timing of the sale. It helps locate potential investors and may help in negotiating with them.

Private placements are becoming important as an alternative to both public issues of securities and direct bank loans. According to estimates, bank-assisted private placements have increased from \$129 million in 1972 to \$1.5 billion in 1977.

Although most private placements are assisted by financial institutions other than commercial banks, mostly investment banking firms, the commercial bank share of the dollar volume of assisted placements rose from 1.8 percent in 1972 to 7.3 percent in 1975 and 1976 before declining to 6.7 percent in 1977.

Five large banks accounted for an estimated 77 percent of the dollar volume of bank-assisted private placements in 1977. The largest of these, however, ranked only twelfth among advisors in solo private placements, as opposed to private placements co-managed by two or more institutions. It was the only bank in the top 20.

The situation could, nevertheless, change dramatically if banks aggressively seek to expand their role in private placements and are allowed to do so.

Current controversy

Controversy has grown out of the recent incursions banks have made—or tried to make—into securities activities they had either neglected or thought prohibited to them by the Banking Act of 1933. Securities

brokers and dealers, investment bankers, and their trade associations have countered inroads by the banks in some cases with litigation and in others with appeals to bank regulatory agencies for rulings restricting bank securities activities. In at least one case—that of Merrill Lynch's Cash Management Account—the securities industry has struck back with a plan that, because it allows customers to write checks against the balance in their accounts, is perceived by bankers as unauthorized entry into banking.

More broadly, they and other individuals and groups concerned with the expansion of banks into securities markets are pressing for a general review of the role of banks in these markets. The ultimate goal appears to be the enactment of clarifying—and presumably, more restrictive—legislation.

To some extent, the securities industry's opposition is simply the predictable response of an industry threatened with new competition. Unless there are compelling arguments to the contrary, protection from competition has not been considered a suitable goal of legislation.

Bank involvement in the securities markets, nevertheless, raises several legitimate issues that need to be examined before public policy can be made. These issues include, but are not limited to:

- The likelihood of conflicts of interest when banks (1) lend to companies in which they buy stock as agents for their customers or (2) arrange private placements of securities for companies that use the proceeds to pay off loans to the bank.

- The effect on bank solvency of the failure of an investment company the bank serves as an advisor.

- The effect of bank managing agency and trust activities on the institutionalization of the stock market and market liquidity.

- The possibility of “voluntary tie-ins” in which, to increase their chances of obtaining a loan, customers use other services of a bank without regard for their own merits.

- The dangers to investors of banks not being subject to the broker examination, “suitability” requirements, and prompt ex-

ecution standards the SEC imposes on other brokers.

- The danger of increased concentration of resources from banks exploiting the competitive advantages of their exclusive charters.

Some of these issues have little substance. Others have been handled by legislation. Some, however, particularly those involving actual or potential conflicts of interest, are real and have not been dealt with adequately. In those cases, it is still open whether regulation can provide an adequate remedy or whether a structural solution such as divorcement is needed.

But bank entry into securities activities offers potential public benefits as well as possible dangers. Where entry is free and existing firms are exposed to new competition, the result is often better service, more innovation, a greater variety of services, and lower prices than where new competition is excluded. Consequently, a review of the securities activities of commercial banks should consider not only the need for forging new restraints but also the possibilities for loosening some old shackles. A subsequent article will discuss some of these issues and the costs and benefits of proposed remedies in more detail.

