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**Regulatory Change: A Step in the Right Direction**

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Congress is currently validating change that has already occurred. However, there are very important questions of structure that remain. The most important question, I think, is the reality of firewalls. I believe in firewalls, but as both a lawyer and a regulator I have a healthy respect for their limitations. I have some concerns about their efficacy, born largely of my personal experience in coming to Baldwin United when the walls began to crumble and the company began to fail. In a confidence business, which is the business all financial institutions are in, it is very difficult to control the effect of adverse events anywhere in the system. Containment of damage is possible, but there is reason to proceed carefully and to assess the effects of our experience as we go along. We must gauge the effects of the condition of Texas banks on public confidence, and the effects of Continental Illinois. We have to learn from those lessons.¹

The pace of change is extremely important. Congressman Barnard is surely right: we ought not be afraid of change. In fact, in this area it does not do any good to be afraid of change because change happens anyway. The markets change, institutions change, and financial institutions and instruments change. The real issue is never whether change is going to take place, but whether the regulators, the Congress, and public policymaking are in the driver’s seat when change happens. Historically,

they have not been in the driver's seat. In effect, legislative and regulatory action is the conservative course here.

The interrelationship among financial markets is so complex that it is virtually impossible to predict the results of change. There are dramatic examples of acting that appeared to be very small changes. There is probably no better example than Rule 415.\(^2\) I was a Securities and Exchange Commission Commissioner when Rule 415 was adopted. I remember very clearly the staff saying that Rule 415 was a technical change designed to permit issuers access to markets even more quickly than the two or three days that the improved procedures then permitted.\(^3\) At that time, we were still in a period of extremely volatile interest rates. As it turned out, Rule 415 absolutely revolutionized the securities industry. It led to a degree of concentration in the underwriting of debt securities that no one had imagined.

Money market funds are another example of dramatic change. The invention of money market funds revolutionized the banking business. It was the primary engine of disintermediation in the 1970s and, more importantly, it had a dramatic effect on the relationship of depositors to financial institutions.\(^4\) I remember very clearly a banker saying to me, "Never in our wildest dreams did we imagine that people would take their life savings and put them in an envelope and send them off in the mail to someone they had never met." But that is the nature of banking today.

While change is important, in addition to a measured pace of change, affirmative action and legislative action are also very important. The real challenges do not lie in the area of new banking powers. If you go back and look at the new powers, it is hard to imagine what all the excitement was about. The new powers include distributing mutual funds, underwriting revenue bonds, and underwriting corporate debt.\(^5\) There is virtually no risk in underwriting mutual funds. Have you ever heard of a security firm that failed—or almost failed—because it underwrote mutual

\(^2\)17 C.F.R. § 230.415 (1988) (allowing certain securities to be registered for an offering to be made on a continuous or delayed basis, provided the registration statement meets certain requirements).


funds? Second, banks already underwrite many kinds of revenue bonds. Third, what banks do everyday is parallel to underwriting corporate debt, but much riskier because they retain the debt on their books. Therefore, it is hard to imagine an intellectually respectable argument that underwriting corporate debt is a dangerous activity for banks. The same is true of underwriting equities. I used to believe that banking had become a riskier business than the securities business, but the events of October 19, 1987 have given everyone pause.6

With regard to the market crash, it is significant that there was no major failure by any securities firm in the face of a very dramatic loss in value and enormous strains on the system. At the same time, there is a lot that needs fixing. Anyone who went through that period can pinpoint areas of extreme danger in which, had things gone in a slightly different way, there would have been enormous stresses on the system. But those were stresses for the financial system as a whole, not for individual securities firms.

In short, I believe that the real challenges to banking regulation are in the area of traditional banking activities. Over the past ten years, while all of the legislative effort and the debate has been focused on the Glass-Steagall Act and securities powers—and more recently on insurance powers—dramatic changes have been taking place in traditional banking.7 These changes have significantly increased the risk in the banking system. For example, there has been a very curious and largely unexamined series of excesses in traditional lending over the last ten or fifteen years: excessive lending to the real estate industry in the early 1970s, lending to less developed countries, petrodollar lending, and lending to the oil patch.8

In a sense, the problems of the savings and loan industry are really another aspect of this problem of excess. Occasionally one sees newspaper articles that attribute the problems of savings and loans to the

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deregulation of asset powers. In my view that is a wrong-headed position to take. In the early 1980s, the savings and loan industry was in a crisis because of volatility of interest rates and inflation, rampant disintermediation, short-term liabilities, and long-term fixed-rate assets. They were simply unable to cope with the financial facts of their existence. The deregulation providing for more flexible asset powers was a response to that. How savings and loans used those powers, and how their use was regulated, are quite different questions. The whole area has been inadequately explored and is certainly inadequately understood.

There has been an increasing disparity in the mix of assets of different kinds of banks, large and small, that is making the traditional ways of regulating those banks obsolete. There is probably no better example than the new capital rules. There is general agreement that the new capital rules are important. Indeed, they are one of the more impressive regulatory accomplishments of the past decade. But the notion of treating all assets of a given kind—all loans for example—in the same way is deeply flawed. It illustrates the limits of regulation. How is it possible for a Comptroller of the Currency, the Federal Reserve, or the FDIC, to develop rules that apply to the rich diversity and complexity of our banking system? Those capital rules may be as good as they can be, but they are still not adequate for the range of risks and challenges that the banking system poses. Fundamental questions have been raised in the last few years about the role of deposit insurance in this environment; for example, the possibility of risk-based deposit insurance has been explored. These questions go deeply to the nature of the risks that are individual to particular banks.


11See Virtually Identical Risk-Based Capital Proposals Issued for Comment by Agencies, 50 Banking Rep. (BNA) 382 (Mar. 7, 1988). Since the time of Mr. Friedman’s speech the Basle Committee has also released its risk-based standards. See Basle Committee Issues Final Risk-Based Capital Standards, 51 Banking Rep. (BNA) 135 (July 25, 1988); Final International Risk-Based Capital Standards Adopted by the Basle Committee on Banking Regulation, 51 Banking Rep. (BNA) 143 (July 25, 1988) (text of Basle Committee’s final accord).

A few years ago, Tamar Frankel, a faculty member of the Boston University School of Law, and I developed an idea that would model capital rules on the approach chosen by the Congress in the Foreign Corrupt Practices Act.13 The Act imposed a heavy burden on the board of directors of a company to develop systems of internal controls that were appropriate for that company. This led to a mini-industry that grew in the accounting firms, which developed and tailored packages of internal controls that were appropriate for particular companies. This is a possible approach. There may be others, but some fundamental rethinking has to be done in this area.

There is significant increased risk in the banking system. The public markets, particularly the commercial paper markets in the short-term, and the debt markets in the longer term, have taken away the highest credits from the banking system.14 The maturities of loans have increased progressively.15 Thus, what we have are higher risk, longer term loans that have changed the kind of risk a bank takes. Banks have begun to respond to that through the development of securitization, which poses the risk as to investors.

Certainly since the early 1970s there has been increased volatility in all our markets.16 Traditional bank trading activities, trading government bonds and currencies, represent a level of great magnitude of risk in trading. Some of you may have noticed that last year's Banker's Trust Fourth Quarter Report showed very high profits that were due to currency trading activities.17 That is wholly different from the level of risk assumed by most securities firms in trading for the accounts of their customers.18

Globalization is discussed a great deal. However, few people understand the extent of the impact of globalization. A former senior staff

officer at the Federal Reserve said at a meeting the other day that he believes there is no academic exposition anywhere that describes, in a reasonable and accurate way, global securities markets. During the two weeks after October 19, 1987, there was an extraordinary linkage between international markets—between the markets in London, New York, and Tokyo.19 There is no particular reason why there should be such a linkage. Each of those equity markets is based in a different economy with different strengths and different economic forces, but the linkage was very direct. What is the significance of that? Why did it happen? What are its implications? The fact is that when the markets are broader than the reach of the regulator, regulation is fundamentally impossible and the potential for abuse is enormous.

In addition, I would simply sound a note on the limits of regulation. I think it is significant that there is a linkage between the nature and extent of regulation and the degree of flexibility that you give to market participants. The willingness of the society and the Congress to tolerate abuse is a key variable. If we are unable to tolerate abuse and our objective is to avoid problems, we inevitably end up with a highly coercive, highly inflexible set of regulations. The two most successful examples of financial regulation, in the sense of avoiding problems, are the Investment Company Act and New York’s Insurance Regulation in the twentieth century.20 They are also the two most inflexible, most difficult, regulatory regimes. They have also proved to be the most inappropriate for this environment. If regulation does not go in that direction—and I think it would be a dreadful mistake to do so—if we opt for flexibility, then some degree of abuse, and of failure, is inevitable. This places a new emphasis on enforcement. In the securities business, where flexibility has been very important and the Securities and Exchange Commission has been loath to interfere with innovation, there has been very heavy reliance on enforcement as a means of controlling improper


behavior. Although there are indications that this approach is beginning to be taken in banking regulation, further evolution toward more vigorous enforcement would be a very new development.

Lastly, and related to the limits of regulation, it is important to recognize that regulating financial institutions is a very tough business. These are complex markets. Watch the activity on the floor of the Chicago Mercantile Exchange, which, I am told, has more math PhDs than Northwestern University. You will see, immediately, how far ahead of the regulators they are. That is true in every financial industry. It is just more palpable in Chicago.

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