

## FINANCIAL SERVICES – AN INSIDERS VIEW

### PERSONAL INTRODUCTION

My name is David Spina. I am 66 years old and live with my wife in Wayland, Massachusetts. We have two adult children. I am retired.

I came to Holy Cross in September, 1960. I came under the NROTC program. Upon graduation in 1964, I entered the US Navy. I served 3 years on ships in the North Atlantic, spent a year on a SWIFT boat in Viet Nam and had a year of ‘shore duty’ in Boston when I worked in a Navy Office building in South Boston.

After my discharge from the Navy, I worked for one year at State Street Bank in Boston, and then entered the Harvard Business School. After earning my MBA, I accepted an offer to return to State Street as a commercial lending officer in 1972. Five years later, I was named CFO, a title I kept for 17 years. In 1995, I was named President and Chief Operating Officer and in 2000 CEO. In 2004, following heart bypass surgery, I retired and have been leading a private, stress-free life ever since.

My lengthy tenure in senior management at State Street covered a span of time in which a remarkable transformation took place at the bank. In the mid-1970, State Street would have been properly described as a regional commercial bank. It engaged in a normal array of banking activities, leading to businesses and individuals, servicing individual depositors with a branch network, trust and investment management services and a few, small specialized services for large institutional investors.

During the time of deregulation and heightened competition, State Street built businesses in which it had competitive advantages and exited business segments in which it had nothing special to offer its clients. This proved to be a ‘winning strategy’.

Today, the company is a focused, niche player. It is one of the world’s largest trustee/ custodian of investment assets of mutual funds, pensions, endowments and the like and the largest institutional investment manager. With over \$17 Trillion of assets in its care and approximately \$1.5 Trillion of assets under management, State Street is a large-scale player in the global financial services marketplace. It has operations in over 25 countries and has an aggregate market value in excess of \$15 Billion dollars. (In the mid-1970’s, when I was new at the company, the aggregate market was just under \$50 Million.

I explain all this by way of explaining the relevance of my experience in thinking about what is a bank, how does it need to operate to be successful, and how the dynamic world in which we live is causing bankers, regulators, public policy makers to reexamine the role of banks in our society

## ORGANIZATION OF MY TALK

Like Gaul, my talk is divided in three parts. The first is a brief review of the evolution of banking, particularly in the US in the 20<sup>th</sup> Century. In this part, I try to highlight the policy and economic context for the economic calamity of 2007-2009. The second part is my explanation of the immediate causes of the calamity. This is like an 'instant analysis' with narration from a banker instead of the narration of politicians or news commentators. And in the third part, I will make some suggestions about how we might move ahead to recast the banking system to support our national and personal economic goals.

## EVOLUTION OF BANKING AND FINANCIAL SERVICES

Banking activities, especially safekeeping, payments and lending are linked to economic activity throughout history and throughout the world. While most of the long history of banking is not relevant to today, it is helpful to think about how the functioning of economic systems reflected the different cultural and religious norms of different societies. Indeed, there is no standard, global model for banking today, but a wide variety of different national forms of how the same banking and savings functions are performed around the world. Banking is an expression of cultural and social norms.

There were two separate paths of development of banking in the US. One path dealt with what we now refer to as central banking and/or monetary policy. This deals with how much money is in circulation, who is authorized to print money and who stands behind the money. An important concern of a 'central bank' is how its government will finance its policies. This was of great interest to the Founding Fathers, since there were 'bills' in circulation in the 1780's that were issued to finance the revolutionary war and the holders of those 'bills' wanted to get paid. After a lot of political squabbling, the First Bank of the US was formed in 1791. This bank was owned and operated by the new federal government and its charter was allowed to lapse in 1811. A second national (central) bank was established in 1816, but that, too, was allowed to expire in 1828. The US operated without a central bank until the Federal Reserve Act was passed in 1913.

The second path of development is what I will call private sector or private banking, which included deposit, payment and credit services to individuals, families and corporations. States have chartered private sector banking companies since the start of the country. The present 'dual banking' system was enshrined in the National Banking Act of 1863, under which both the federal government and state governments may charter banks. Banks were to be regulated by the Comptroller of the Currency (Federal) or by State Banking Authorities.

So at the start of the 20<sup>th</sup> century, the US financial affairs were conducted by a large number of privately owned banks and other companies. Remember, there was no central bank in the United States. While the country experienced a long period of economic expansion and growth, it was not without its financial problems. Liquidity panics in 1873, 1893 and 1907 were disruptive. In each case, investors lost money, banks failed, companies went out of business, and employment and economic activity shrank. By today's standards, the business practices of the fledgling securities industry were fraudulent. Following the Panic of 1907, both government and private sector interests supported the creation of the Federal Reserve System in 1913. Notable in the design of this central bank, was the need to accommodate both local and national interests, and to shield the new institution from political interference as much as possible.

With the stock market crash of 1929, and the onset of the Great Depression, the US entered an era characterized by far reaching and persistent government efforts to make the financial sector fair and safe. Rather than go into the background of each act, let me list of a sample of the major laws shaping the financial services sector in the US today.

Glass-Steagall: 1933 – separates commercial banking and investment banking

National Banking Act of 1933: - establishes FDIC

Securities Exchange Act of 1933: - establishes requirement for disclosure about securities

Securities Exchange Act of 1934: - establishes SEC to regulate securities industry

FHA: 1934 – insures home mortgages

FNMA: 1938 – created government 'bank' to improve mortgage market liquidity

Trust Indenture Act of 1939: - codifies the issuance and distribution of debt securities

Investment Company Act of 1940:- defined and regulated investment companies

Financial Institution Deregulation and Monetary Control Act of 1980: -expanded Fed control over non-Fed members; lifted interest rate ceilings

Gramm-Leach-Bliley Act of 1999: repealed Glass-Steagall

There are some general points to take from this litany of legislation that shaped most of the financial services market place in the US for the last 70 years. First, unlike other countries, our federal government never took-over or nationalized the banks. Thus we continue to have a financial system supported and sustained (driven?) by private capital.

Second, the policy of separating more risky functions from less risky segments was employed for 50+ years, but ultimately rejected.

At the start of the 21<sup>st</sup> Century, the US was home to a large, dynamic financial services industry. There is a wide variety of enterprises, from narrow specialists (e.g. mortgage bankers or commodities traders), to broad, multi product, and multi national giants. Information technology was changing the face and form of financial services at a frenzied pace and the amount and intensity of global cross-border financial activity was increasing. These enterprises were highly competitive with one another and were driven by the need to earn a competitive return on capital.

While there was no unified public policy framework in which these activities took place in the US, there were common themes of prudential oversight and protection of depositors, borrowers and investors. Specific types of investment securities, such as bonds, were tightly regulated. Certain kinds of institutions (commercial banks) were tightly regulated. But much of the innovation and growth in financial activity was taking place outside any policy umbrella, such as in mortgage companies and hedge funds.

(Notable by its absence is any mention of the insurance industry. Life insurance, in particular, overlaps heavily with the savings and investment functions of many banks and securities firms. There is little federal oversight and policy regarding these companies; rather, Congress has deferred to the states, leading to a more complex policy environment.)

## ECONOMIC UPHEAVAL 2007-2009

In addition to the ‘rugby scrum of the financial sector’, I need to highlight just a few more environmental factors that contributed to the economic upheaval.

With the growth of world trade, and the persistent trade surpluses and trade deficits, there are huge pools of financial assets floating around the world seeking an adequate financial return. The growth in retirement savings around the world is similarly creating such enormous pools and the related flows of cross-border investment transactions.

The US experienced an incredible housing price bubble. The sharp increase in house prices led to a significant expansion of mortgage credit and home construction.

Most financial companies and financial regulators grew more comfortable with ever higher levels of financial leverage. Firms were allowed to increase their risky investments using borrowed funds.

And finally, interest rates in the US were low by historic standards, in the belief that such accommodation was needed to help economic expansion. The low interest rates made borrowing easier.

As we all know, the housing market hit the wall and the financial world went into its own form of deep shock. After a year of intense national anxiety, significant direct federal support of selected financial companies and enormous expansion of Federal Reserve credit into the private economy combined to stem the economic contraction and financial collapse in the US.

The cost is enormous. The direct fiscal cost to the US government is likely to exceed \$1 Trillion. Personal wealth and personal income declined sharply. The face and form of the banking and securities industries has been permanently altered. Levels of employment, production and trade all remain below 2006 levels.

So, from a national perspective, where do we go from here?

## BIG PROBLEM/LITTLE PROBLEMS

My business management experience leads me to take a large, messy problem and disaggregate it into parts. While the analysis of a problem is interesting and will satisfy my curiosity, the business reason for analysis is to lead to effective action. Usually, it is easier to both analyze problems and design effective solutions within the narrower scope of a part of a problem.

The three segments I believe lend themselves to analysis and hypothesis are the private sector, the regulatory apparatus and the public policy formulation..

## PRIVATE SECTOR

During the drive to expand home ownership in the US, the private sector was a willing enabler. Unfortunately, the development of faulty products, the increase in aggressive (predatory) sales tactics and the easy access to credit all contributed to the calamity.

Many of the faulty products (subprime mortgages, adjustable rate loans, securitized bonds) and aggressive sales tactics occurred outside the penumbra of federal regulation. The growth of the 'non-bank' sector undercut the effectiveness of much of the financial regulation put in place in the 1930's. So while banks are not blameless for

their behavior and decisions, the non-banks were putting enormous competitive pressure on the regulated banks to expand the newer riskier products and services.

As mentioned earlier, all financial firms grew more comfortable with higher levels of financial leverage, increasing solvency risks throughout the system. Higher capital and lower financial leverage lead to greater stability in turbulent markets. Clearly, some institutions went too far and could not recover in the face of significant declines in the value of their assets.

The development of risk management regimes within large securities and banking companies did not keep pace with the innovations in the financial market place. While there was great intellectual ferment around the new, bigger, faster trading and investment processes, it is pretty clear that the senior managements of the large firms didn't adequately judge the severity of the risks to which they were exposing their institutions. Nor did they empower risk managers with sufficient power to implement their risk control programs.

(It is important to note that what I now see as deficiencies were wide spread and were common to many enterprises. During the middle part of the decade, large profits were developed from many of these practices and general managers had to balance risks against the need to preserve their competitive positions. It is difficult to tell a board of directors your firm will willingly forego profit opportunities.)

The egregious behavior and certain firms and individuals needs to be counteracted by aggressive and vigilant self-regulatory actions. Expansion of internal audit functions and support of industry self-regulatory bodies is needed.

The private sector survives by adapting to changing environments. I expect it will adapt reasonably quickly to a new world, of comprehensive risk management, tighter regulation and stringent consumer protection.

## REGULATORY

Financial regulation is fragmented and unequal. This leads to some financial firms seeking the 'path of least resistance' – i.e. creating a corporate structure that will minimize the costs and limits of regulatory edicts. AIG is the 'poster child' for this behavior, and all large financial conglomerates indulge themselves to some degree. The unequal environment wasn't created and can't be fixed by the regulators. It is linked to

our public policy making process. In the past, each new policy initiative has led to a new regulatory body, with insufficient attention to the whole regulatory environment.

The rapid globalization and employment of information technology (including telecommunications) throughout the financial services sector leaves the regulatory community in a permanent 'catch-up' mode. While the expansion of 'resident examiners' is a useful response to this need, it needs to be augmented with more staffing flexibility.

The regulatory approach to capital standards is ineffective. Correctly, most regulators tried to migrate from qualitative standards of capital adequacy to more quantitative, predictable standards. Fifty years ago, bank regulators would tell executives privately to increase the capital in their banks. (The regulatory approach to capital adequacy in the 1950's and 1960's can be compared to the famous quote about pornography....'I know it when I see it....') Today, there are elaborate, complex quantitative protocols to determine the adequate level of capital. It is clear that there is a 'disconnect' between the highly theoretical world of global capital standards and the harsh realities of day-to-day decision making in financial markets. Past efforts to evolve from the most simplistic quantitative approaches to more sophisticated ones failed miserably. A middle path needs to be found quickly.

Within the prevailing public policy framework, I would encourage financial (bank) regulators to increase capital standards (even simplistic ones) and to establish liquidity standards for all depository and savings institutions.

I would encourage regulators to redouble their efforts to harmonize rules and practices to minimize differences between and among financial enterprises.

## PUBLIC POLICY

The biggest public policy question is to decide if we want to continue our national approach of serial, piecemeal and unequal financial regulation or whether to create a broader, more cohesive and more uniform public policy to regulating financial activity. This is manifest today in the policy deliberations around the 'too big to fail' issue. Some argue to arbitrarily limit the size of all financial institutions so the failure of any one would not damage the economy broadly. Others argue that this would make US based financial institutions too small to compete globally. Another group would divide 'basic banking' from riskier trading and securities activities. Essentially, this would revive Glass-Steagall and create a universe of safe, lower earning, tightly regulated banks that would not be allowed to fail and a large variety of financial firms involved in securities investment and trading which would be allowed to fail. Whatever path is chosen in

formulating a new policy, changes in competitive positions and financial returns will be altered.

Our national housing policy of encouraging home ownership has run too far. The housing bubble was enabled by easy access to credit, lowering of credit standards and inadequate underwriting standards. The insolvency of FNMA and Freddie Mac demonstrate starkly that there can be 'too much of a good thing'. A more neutral housing policy, with equal support for renters and homeowners is appropriate for our social goals and more sustainable economically. In a low inflation economy with an adequate stock of multi-family housing, renting is often a more advantageous long term financial strategy than owning residential real estate.

Our federal tax code favors debt over savings and capital formation, skewing private sector decision-making toward excessive use of debt. Again, a more tax neutral policy seems indicated.

The last 50 years are replete with examples of congressional involvement with regulatory processes. Perhaps the most egregious surrounded the savings and loan crisis of the 1980's and the lax oversight of large government sponsored housing 'banks' in this decade. Regulation works best when it is insulated from the vagaries of short-term political forces. Of all the financial regulators we have created in the US, the one with the most independence of action is the Federal Reserve System. From its inception, it was designed to make decisions that would be politically unpopular. In my opinion, efforts to make the Fed more accountable to Congress are misguided and would inflict severe harm to the US financial system. While Congress is clearly the right institution of policy deliberation and formulation, we need to convince Congress to entrust the implementation of policy to the executive branch or to more independent agencies.

## CONCLUSION

If nothing else, I hope I've illustrated how big and confusing our financial system is! We shouldn't lose sight of the fact that the US, with the largest economy in the world. We didn't get to this position without an ability to organize our financial resources – to provide a place for safe payments and savings; to provide investment capital for economic development and to finance our government programs.

The 225 year evolution of our democratic republic has produced a 'cluttered closet' of public policy – in health, in agriculture, in national security and in financial services, just to name a few.

My prescription is to embrace the policy problem to try to get as close as possible to universal financial regulation. The bank vs. non-bank syndrome and the shopping for



the easier regulator have lead to costly problems and economic stagnation. We must hold our government accountable, even if it means turnover in Congress. Getting the policy 'right' is our biggest and most important problem.

Our regulatory community needs more support. They probably have been 'short funded'. We need our best and brightest and we will have to compensate them accordingly. Focus on immediate increases in capital and liquidity standards is essential to avoid repeating the crisis scenario we hope is behind us.

The private sector will adapt, as it always has. Most senior management teams will be changed in relatively sort order. Newly appointed executives will 'get religion' about financial stability as the price of instability increases.