SECURITIES MARKET STRUCTURAL ISSUES AND CHALLENGES

An Address by

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INTRODUCTION

I have been asked to speak on the structure of securities markets in the light of previous work IFC has done in the area of institutional structure and securities market development. As most members of the Federation have collaborated with us on this work, earlier findings will be dealt with only briefly. The emphasis here will be on the principal current market structure issues facing Stock Exchanges and their members.

As to this previous work, various tables and diagrams†, extracted from previous IFC papers speak for themselves.

It has been our thesis that securities markets in countries which have at least semi-industrialized economies, tend to be more efficient, deeper, more liquid and better able to meet the financing needs of firms at lower or fairer transaction costs where there is mainly specialization of function and a high degree of competition between and amongst securities market firms on the one hand and banking entities on the other, than in those countries where banking entities tend also to operate in and dominate the securities markets. Under the former circumstances, savers also tend to be better served by being able to choose, based on more objective information, between a wider variety of liquid instruments with more diverse risk/reward opportunities.

However, structure is but one factor bearing on the relative effectiveness and efficiency of securities markets. Political and economic circumstances, legislative and regulatory frameworks conducive to investor protection and fiscal and monetary policies are also important. Further, size, depth, liquidity and intermediation cost efficiency are only some of the measures of securities market effectiveness. The important objectives are efficient savings mobilization and allocation of capital.

Speaking on this subject in Canada, it is appropriate to make reference to the Canadian "Four Pillars" concept of financial institutional structure and specialization and note that the above-mentioned statistics refer to only two of these, namely banking and securities markets. Insurance and trust companies are not discussed.

With this background in mind, it is apparent that one of the most pressing issues concerning most Stock Exchanges and their members now is proving that the securities markets are, in fact, important and functioning efficiently in the public interest.

Particularly in Canada and the U.S., the main challenge for the securities industry is the current trend towards public support for the further reduction of regulated separation of functions, or specialization, and the consequent greater encroachment of banking institutions into the securities market arena.

It is interesting to note that in Europe, which has a long history of banks participation in and even domination of securities markets, there may be, at least in some countries, the beginning of a trend towards a more specialized institutional structure. For example, in Holland independent brokers have emerged specializing in commercial paper and private bond placement, as well as stock market activities. This may suggest that in Holland some small specialists are more efficient than large universal banks.

Equally importantly, the limitations of various equity markets in providing adequate risk capital are beginning to be recognized. It would not be surprising if ultimately this also led to measures to strengthen the securities market as an independent and strong part of the financial sector in some of these countries.

† Interested readers may contact the S.I.A. Federal Office to obtain copies of diagrams correlating market sizes, and outstanding shares to per capita GNP trends.

In Germany, some small industrial companies are now raising new equity directly in the U.S. market, as mentioned in the July 18, 1983 issue of "Business Week". This is an interesting extension of a long standing practice whereby principal owners of German companies who wished to sell have often turned to listed U.S. companies for share exchanges. Because of the liquid U.S. equity market, this gave them a better cash price than could have been obtained at home.

In the U.K. and France, the problems of equity financing for smaller businesses have been such as to cause the development of new initiatives by the stock exchanges to make new issues of, and secondary market trading in, the stocks of smaller companies easier and less expensive.

In France and Sweden, starting in the 1970s, and backed by the current administrations, government concern over weakening equity markets and increasing corporate debt/equity ratios led to the provision of generous tax incentives for shareholders which made the tax rates on income from equities in many other countries, including the United States and Canada, look high by comparison.

In many developing countries, similar concerns are emerging. Countries such as Chile, Brazil, Mexico, Turkey and Thailand are increasingly focusing on the potentially dangerous interlocking between major corporate and bank interests and the impact this is having on the solvency and efficiency of the financial system. There appears to be a growing awareness amongst the policy makers of many developing countries with growing industrial sectors of the importance of promoting strong, independent equity markets. Many have established securities commissions or like entities and have passed legislation which emphasizes developing and promoting the securities markets as equally important as regulating them. Some, including particularly Brazil and Korea in the late 1960s and early 1970s, established income tax regimes which have encouraged in a very positive way the flow of savings into equities, and the removal of previous tax regimes which tended to favor investments in government bonds and/or bank deposits through tax exemption of interest on these instruments. In order to avoid bank dominance of the securities markets, a number of them have established a legislative framework conducive to specialized securities market institutions and encouraged their development, notwithstanding political and economic factors which might have worked against this.

CURRENT SITUATION

The current status of the U.S. and Canadian debates on the subject of deregulation versus continued regulated specialization is well known.

However, it is important at the outset to note that the deregulation movement in the U.S., which has been building momentum for some years, starts from an institutional structure which is the most competitive in the world in terms of the number of banks and securities firms. It emerged within a strong legislative and regulatory system enforcing separation of functions, between commercial banking and corporate underwriting, between different types of banking activity, and also restricting interstate banking.

Also, with the extremely high level of competition already existing within the banking system and between banks and the securities market, and with an equally strong anti-trust regulatory framework in place, concerns about the risk of reducing competition, increasing concentration of financial and economic power, and possible abuses of such power, have not been seen recently as serious problems.

Surprisingly, what is overlooked in the current debate in the U.S., is the underlying reason why regulated separation of functions between banking activities and corporate securities underwriting was originally instituted and to what extent the reasons may still be valid today. Put simply, the reasons for the various sections in the Glass-Steagall Act of 1933 dealing with separation of functions and the particularly strong stand on this point were concerns as to the previous adverse consequences of concentration of power in the light of the abuses of the 1929-33 period, and risks entailed in allowing banks to continue to increase their dominance of the corporate underwriting business. There was particular concern that this would further over-stimulate the market with more speculative issues, more easy customer financing and less investor protection.

In the debates, legislators indicated awareness of the real social and financial costs of identified abuses of power. These concerns started around the turn of the century with an important aspect being the ability of state-licensed banks to engage in investment banking, while federally-licensed banks could not. This led to the latter doing so indirectly through affiliates and, by the late 1920's, to substantial bank domination of the corporate bond underwriting market. The 1929 crisis led to some significant bank failures and, thus, legislative pressures to reverse the trend. Interestingly, one major bank withdrew voluntarily from the securities business at this time because of concern over the effect of such scandals. An article entitled "The Divorce of Commercial and Investment Banking: A History" by Edwin J. Perkins in the June 1, 1971 issue of "The Banking Law Journal" is an interesting summation of these events and debates.

In the U.S., the banking regulatory agencies including the Federal Reserve, the Comptroller of the Currency and the Federal Deposit Insurance Corporation are supportive of the banking system. On the other hand, the U.S. SEC, the principal agency of government concerned with the securities market, traditionally has been concerned mainly with protecting investors and preventing abuses by brokers. This is not surprising given the events leading to its establishment. The resulting differences in levels of government support and the costs of regulatory compliance is clear. The banking system benefits on balance.

Another example of the resulting "favored treatment" of banks is deposit insurance, which protects the nominal value of savers' deposits. The premiums are paid by the banks and, thus, in theory, it is self-financing. However, the U.S. FDIC has access to government funds as a last resort. The same general principle applies for the securities industry insurance scheme. But the latter only protects the investor from loss of cash or securities held by a broker in liquidation. It does not insure the nominal value of his investments. The U.S. legislative debates of the early 1930's questioned the logic of having government insure the funds banks raised to finance their inherently more risky securities businesses and other commodity-type trading activities on the same basis as their more conservative conventional secured short-term lending business. The FDIC is raising this valid concern again now.

Because of their strength, the banks have great "lobbying" power which they use very effectively in furthering legislative and public support of their policies. In the U.S., banks and their National Associations are reported to expend some ten times the funds for direct lobbying of legislators for their various positions as does the securities industry. Further, state bank associations are believed to expend an amount equalling the national associations for the same purposes.

In comparison, few Stock Exchanges have made major organized efforts to promote support for securities markets. "Where are the Customers'Yachts?", an amusing book published in 1960, made the point humourously but directly that only the brokers seemed to benefit from stock market activities.

There are few books or articles published to explain the useful role of securities market activities, but many discussing money and banking. Then, the former are at best only descriptive, whereas among the latter many can be found which are analytical and supportive of the importance of the banking system. That banking has so much professional support is not unreasonable. Banking is important. But so are securities markets. They have not had this support in many cases because the securities industry has not really tried to foster it in the professional, pragmatic way bankers have. Writers on finance are concerned principally with macro-economics and financial theory. Few have had direct business experience and consequently few have direct knowledge or understanding of the importance of equity finance or the operational dynamics of financial institutional activities. Thus, so far, the debates in the U.S. and Canada have some aspects of "David and Goliath" contests, with the banking interest and many governmental policy makers and academicians in the latter role. In this connection, it should not be surprising that legislators, staffs of Ministries of Finance and of Central Banks tend to be more supportive of the banking system. They are not against securities markets; they simply gravitate naturally toward their most visible constituencies and are left with little time to "think through" the implications of a financial structure without a securities market.

DEALING WITH THE FUTURE

If the Stock Exchanges, individually or as a Federation, wish to make a stronger case for "equal time" with the public and more "equal treatment" from government authorities, they must start a willingness to channel more resources into the effort needed to build a rational platform which demonstrates that securities markets are important.

To develop a rational position, it is necessary to clarify the issues in order to put them in perspective.

Two of the fundamental ones to be dealt with are:

1. Should there be a securities market?
2. If so, is specialization between securities and banking activities important?

By focussing on these issues, the subsequent comments on what Stock Exchanges might do to justify their role can be put in their proper perspective.

Firstly, is there a need for a securities market? The answer is clearly yes on both theoretical and empirical grounds. On theoretical grounds, a securities market which complements and competes with the banking market broadens opportunities for both savers and users of capital. Broader choices of instruments maximizes return opportunities to the former and provides more efficient financing for the latter. Further, and possibly more importantly, a securities market moves funds more directly from savers to users through securities markets intermediaries, thus broadening the scope and reducing the costs of financing arrangements. The intermediation costs of securities market firms are lower than that of banks as the latter must pass on their additional costs as term and credit risk intermediaries.

An important case for a securities market, especially the equity component, has been the age-old one of providing risk capital. An equally compelling one is the obvious consequence of not having a strong securities market. That is, over-dependence on short-term, often floating-rate, bank financing. It is painfully evident that many of the problems of recent corporate and national defaults can be traced, at least in part, to financing long-term fixed investment projects with too much of such floating rate bank debt and too little equity. As the table below indicates, companies in developed countries with weak equity markets may face the same risk, even if a large, if diminishing, proportion of their debt is long-term fixed-rate bonds.

The argument for specialization has been made since Adam Smith and is being emphasized again in both the academic and popular literature, promoting the merits

DEBT/EQUITY RATIOS OF NONFINANCIAL COMPANIES FOR SELECTED COUNTRIES, 1970-1981*

Year	Canada	France	Germany	Japan	Sweden	U.K.	U.S.
1970		1.9:1			2.7:1	1.1:1	0.8:1
1971		2.0:1			3.0:1	1.1:1	0.9:1
1972	0.9:1	2.1:1	2.3:1	3.0:1	3.1:1	1.1:1	0.9:1
1973	0.9:1	2.2:1	2.4:1	3.0:1	3.2:1	1.2:1	0.8:1
1974	1.1:1	2.4:1	2.5:1	3.3:1	3.1:1	1.3:1	0.9:1
1975	1.1:1	2.5:1	2.4:1	3.6:1	3.0:1	1.1:1	0.8:1
1976	1.1:1	2.5:1	2.5:1	3.6:1	3.2:1	1.1:1	0.9:1
1977	1.1:1	2.6:1	2.5:1	3.3:1	2.8:1	1.1:1	0.9:1
1978	1.1:1	2.2:1	2.6:1	3.2:1	2.7:1	1.1:1	0.9:1
1979	1.1:1	2.1:1	2.7:1	2.9:1	2.7:1	1.1:1	1.0:1
1980	1.1:1	2.2:1	2.8:1	3.6:1	2.7:1	1.1:1	1.0:1
1981	1.1:1		3.7:1	3.4:1	2.8:1		1.0:1

* A line indicates a significant break in data comparability with preceding year data.

It should be noted that for most countries the composition of corporate debt has shifted in the decade to more short-term debt, and that more long-term debt is likely to be floating interest rate.

of small, more dedicated productive units which, through avoiding large administrative "tails", can concentrate on quality of product and service to consumer, and thus "compete" effectively with large companies both in quality and price, if given a fair chance. A recent book "In Search of Excellence" by Thomas J. Peters and Robert H. Waterman, Jr., makes these points well. This book discusses the failure of the 1960's trend toward "industrial conglomeration". Could it perhaps be a danger signal of the risks of "financial conglomeration"?

The key issue here is whether regulated separation of functions between the banking sub-sector and the securities market sub-sector is desirable.

The well-known "Chicago School" approach suggests that, if all financial institutions are "unfettered" and restrictive regulations removed and if they can thus offer all or any types of financial services in a perfectly free market, maximum competition and efficiency will come about. Specialization will emerge automatically if the market needs it and if entrepreneurs see opportunities to develop a special niche.

On the other hand, there are fears that such an approach may not work often in practice because no markets are really perfect and because excessive competition can also lead to concentration, as has occurred in some cases, rather than more competition. It is thus felt that, if the banks can compete freely in the historically weaker and smaller securities markets, competition might decline within the securities market and almost certainly would between the banking and securities markets, leaving both savers and users of capital with less choices.

Supporters of this latter view thus feel that, if there are justifiable reasons to be concerned about concentration of power and possible abuses of that power (as there usually are) there is little reason to spurn regulated separation of functions on purely theoretical grounds when it can provide a form of consumer protection if it is needed.

This may be especially the case in those countries where laws and regulations already favor the banking system over the securities market medium of finance. The important consideration is to ensure that regulation is done fairly and efficiently, advancing the public interest in general, and not benefiting one group at the expense of another.

PROPOSALS

Following are some suggestions for building an acceptable rationale to win greater understanding of and support for strong, independent, securities markets from legislators, regulators and the public. This is simply an articulation of the points raised earlier, put in a format of preparing and presenting specific studies or "policy positions" which might justify and produce this support.

Firstly, the key argument made for a securities market is that it is an efficient mechanism for allocating capital in a rational risk/reward linked way. There are no professional studies demonstrating that this is, or is not, the case. One should be done.

Secondly, there is a need for a systematic study that focusses on the relationship between healthy corporate balance sheets and healthy securities markets. This should not be a difficult task, and it is important that it be done. The many recent examples of corporate illiquidity brought about by high short-term floating-rate debt burdens demonstrate this. In this connection, the effect on debt/equity ratios (and distribution of ownership) of interlocking industrial/banking interests would also be worth studying as part of this subject.

Thirdly, the importance of securities markets in facilitating the growth of small business and "modernizing" the economy should be articulated. Such research in the past has been done mainly by governments and small business associations from the point of view of developing support. These studies have shown that small businesses tend to produce more value added, more new employment, more innovation and more tax revenue per dollar invested than big businesses. What has not been provided outside of the U.S. is a sound case that securities markets can be a major source of finance for small businesses. This goes beyond seeking tax advantages for venture capital companies, etc., and far beyond supporting the "roulette" type of promotional mining stock issues.

Each of the above subjects deals principally with the justification for a securities market as such. Only indirectly do they deal with the other principal point referred to earlier — the merits or otherwise of specialization and separation of functions. The papers IFC has produced in the past and the current U.S. and Canadian debates on the Glass-Steagall Act and the "Four Pillars" concept offer some evidence on the merits of specialization under certain sets of circumstances. In the opinion of some, the evidence is not conclusive even under the circumstances enunciated. On the other hand, there is no factual evidence to the contrary. There is thus merit to a Stock Exchange-sponsored study of this subject by an independent,prestigious research institution, whose findings would be considered authoritative by all concerned, designed to provide a case as to what extent the "Four Pillars" concept and the Glass-Steagall Act approach should be strengthened, or modified.

CONCLUSIONS

In many countries, the securities markets have served the national interest well in terms of meeting the conventional objectives expected of them, including their contributions to "democratic capitalism".

The wealthier nations should and can afford to experiment with new ways to make improvements to their securities market structures to keep the system healthy and responsive to national needs. The cost of mistakes would be low and, if dealt with quickly, remedied easily. More importantly, the benefits could be substantial, especially for those countries where the securities markets are performing less efficiently than they should be.

For the developing countries with only emerging securities markets, the experiences of the larger countries continue to be instructive. There are many different models for success which they can adapt to their individual needs, as well as many examples of mistakes which they can avoid. On structural issues, the current debates in both the U.S. and Canada are particularly useful examples.

For all countries, this recent period of recession and financial crises has emphasized the importance of strong securities markets, and especially equity markets. This bodes well for the acceptance now of well reasoned proposals to strengthen them, as governmental authorities are now acutely aware of the need to reduce debt burdens.