STATEMENT BY

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MERRILL LYNCH CAPITAL MARKETS

BEFORE THE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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Morgan Guaranty Trust Company

Cory N. Strupp

The Morgan Bank

To: Rick Carnell

Here's the statement that I mentioned to you on the phone today.

Corey

My name is John G. Heimann, Vice-Chairman of Merrill Lynch Capital Markets.

I greatly appreciate the opportunity to testify today. We believe that the investment by Sumitomo Bank Ltd. in Goldman, Sachs & Co. highlights fundamental issues relating to the health, stability and worldwide competitiveness of the U.S. financial system. We assume that this transaction is legally permissible and, therefore, will and should be approved. We also believe, however, that this and other applications before the Board should prove a catalyst for a fundamental review of the legal and regulatory framework that defines the roles of the providers of financial services in our country.

In our judgment, this framework is increasingly unresponsive to, and incompatible with, the global financial services marketplace. As this case and the pending bank securities affiliate applications reflect, the structure of the U.S. financial system is being reshaped piecemeal by a series of administrative and judicial decisions. The result is a spiral of inconsistency. The failure to act in a comprehensive, procompetitive and coherent fashion has had, and will continue to have, increasingly detrimental effects on the competitiveness and wellbeing of our financial system.

While I am currently an officer of Merrill Lynch, I view these matters from another perspective as well. I served for some six years as a bank regulator, first as Superintendent of Banking of the State of New York and subsequently as Comptroller of the Currency and Acting Chairman of the FDIC.

When I left the government some five years ago, we all anticipated that there would be great changes in the financial system, both domestically and internationally. We knew that these changes would be driven by a combination of fundamental forces, including technology, internationalization, institutionalization of savings, deregulation of financial markets, and rapid shifts in interest and exchange rates, which increase the volatility in all financial markets. What no one then anticipated was the rapidity and depth of the change that would occur. Nor could we anticipate fully the distress that would befall certain depository institutions. What now seems commonplace was, in 1981, virtually unthinkable.

In the United States, mergers and diversification have produced combinations that were once unimaginable. For example, since 1981 American Express has combined Shearson and Lehman Brothers to form the second largest American investment bank. It also owns two international banks, insurance companies and three nonbank banks in the United States. Sears, Roebuck and Co. has purchased Dean Witter Reynolds, as part of a financial services network strategy which includes major insurance companies, a national real estate firm, two nonbank banks, a savings bank in California and a major new credit card operation. Within the last year, Ford Motor Company, which already owned the over $24 billion Ford Motor Credit Company, acquired a $10 billion savings and loan, First Nationwide.

Outside this country, new combinations and alliances have also been formed. In 1984, Sumitomo acquired a majority interest in the Swiss Banco del Gottardo, which has authority to underwrite securities. American commercial banks, notably Chase Manhattan, Citibank and Security Pacific, have purchased British stockbrokers in preparation for the deregulation of the securities markets in London. Vickers da Costa Securities Inc., a New York affiliate of Citicorp's London securities subsidiary, is continuing its U.S. activities despite its ultimate ownership by Citicorp.

Earlier this month, the Bank of England granted a commercial banking license to Nomura, Japan's largest securities house. Nomura has also applied to become a primary dealer in U.S. government securities and, if approved, would become one of the fewer than forty primary dealers.

At the same time, there has been rapid development of the Euro and other international markets. Multinational stock offerings in Europe have increased from $117 million in 1980 to an estimated $4 billion during 1986. The secondary market in Japan has also expanded substantially. Since 1980, foreign purchases of Japanese equities have tripled, and Japanese investment in non-Japanese equities had increased sixfold.

This process has been accelerated by government actions abroad that have liberalized laws restricting the financial services industry. Most notable, perhaps, is the impending opening up of the securities markets in the United Kingdom, the so-called "Big Bang." With slower, measured steps, Japan is removing barriers to access to its capital markets. The Canadian government has proposed to allow Canadian and foreign commercial banks to acquire significant minority interests in domestic securities firms. Australia, Germany, Italy, the Netherlands, Switzerland, France and the Scandinavian countries have also acted to deregulate laws governing their financial markets.

Taking place simultaneously has been the development of a new array of financial products and services. Made possible by technology and driven by customer needs, these changes are equally profound. The recent study of financial innovation published by the Bank for International Settlements examines this phenomenon in detail.

The accelerating development of securities substitutes for traditional bank loan products has been the most dramatic. Commercial paper now accounts for over half of all short-term commercial credit in this country. Mortgage securities likewise represent a growing share of mortgage financing. Securitization of automobile loans and credit card receivables has begun and presumably will gather momentum. This trend is also apparent in Europe. The market for Euro-commercial paper and collateralized paper allows high quality corporate and sovereign issuers to raise capital more cheaply than borrowing through the banks. Cross-border hedging permits better risk-management. Around the world, corporate treasurers have a qualitatively different array of cash management and financing tools than they had in the 1970's.

These changes have had profound effects on the American banking and financial system. Although there continue to be many highly profitable U.S. banks, by almost any measure, the profitability and global standing of the American banking industry has declined markedly. A recent study by the Federal Reserve Bank of New York has examined the apparent decline of bank profitability during the last 20 years.

Internationally, the relative size and standing of American banks have declined significantly. Just five years ago, only one Japanese bank ranked among the top ten. Today, seven of the world's ten largest commercial banks, and the top four, are Japanese. Only one is American. These results are dramatic even when one takes into account exchange rate fluctuations.

Simultaneously, the growth and penetration of non-U.S. investment banking firms in world securities markets has been striking. In the Euromarket, where there is free and open competition among financial intermediaries, in the first nine months of 1986 the top ten underwriters comprised four U.S. firms, three Japanese, one Swiss, one German and one French. Of the total volume of $144 billion, 21.6 percent was issued by U.S. corporations.

As we indicated at the outset, the foregoing developments are the consequence of many factors. We should also point out that the Bank Holding Company Act and the Glass-Steagall Act have denied all financial intermediaries the flexibility to adapt effectively in the U.S. marketplace. Commercial banks have made piecemeal incursions into the securities and investment banking businesses -- some of which have been sustained in the courts and others not. Securities firms have made similar incursions by offering bank-like products. These developments have a number of significant implications.

First, the blurring of distinctions among the providers of financial services has taken place far beyond the wildest expectations of the drafters of the pertinent legislation. The evolution is not orderly and is fraught with political and legal uncertainty. Businessmen are forced to choose second- and third-best strategies to achieve their goals and then live under a sword of Damocles in fear of an unfavorable development in the courts or Congress.

Second, although U.S. law has created unequal opportunities for financial firms in this country, all are constrained. Commercial banks are still excluded from providing certain financial services, as are other nonbanking financial companies such as Merrill Lynch and American Express. Ironically, foreign banks may acquire U.S. commercial banks -- and have done so; yet U.S. nonbanking financial companies cannot, even in a distressed situation.

Third, it is painfully clear that the failure to restructure our laws governing financial providers in a comprehensive, fair and procompetitive manner is severely damaging the position of both U.S. financial institutions and our financial and capital markets. A paper prepared for the Group of Thirty on the globalization of equity markets recently summarized the present dynamic:

> The response of any individual government is affected by actions in other countries. If any specific market begins to lower its barriers to participation and capital movement, others must follow or potentially suffer a dearth of capital and investment opportunities.

This is happening in our country today. We are lagging behind the other principal players in the world financial markets in moving to rationalize our financial services system. Our present legal and regulatory structure was developed in 1933 when the world was fragmented and the American economy was largely isolated. Now we live in a highly competitive and integrated international economic system. Yet, as a result of laws enacted in a different era, no U.S. company can offer the complete range of financial services in this country. When we go abroad, we are less constrained. American law thus gives us all incentives to expand abroad at the expense of our own financial marketplace.

The cost may be great. Historically, the American capital markets grew to international preeminence because of the size and strength of our economy, the relative freedom of our markets, and the creativity of our institutions. The American capital markets are still the largest, deepest and, from the standpoint of investors, the most free. This country has reaped the benefits of more direct access to capital. In terms of innovation and sheer availability of capital, American business has been well-served by our position as the world's most efficient and vibrant financial center. This position and our role in the world financial system are threatened by our failure to conform our legal framework to the realities of the global marketplace.

Accordingly, we must move expeditiously to modernize our financial system to insure the long term worldwide competitiveness of American firms. We agree with the Board when it stated in a release issued last February that "Congress is the appropriate forum for resolution of the public policy consideration involved in proposals . . . that would dramatically alter the framework established by Congress in the Glass-Steagall Act for the conduct of the commercial banking and investment banking business." Nevertheless, it is our job and yours to convey to our elected representatives that this is an urgent task affecting our national interest, not just a turf struggle.

The principles that should govern that reexamination may be simply stated. Change must be comprehensive, procompetitive and fair to all providers of financial services. It must maintain the safety and soundness of our banking and financial system and prevent conflicts of interest. It must ensure that consumers are provided conveniently and efficiently with the widest array of financial products and services in a truly competitive environment. It must accommodate innovation, technological change and the workings of the marketplace. The law should provide no institution a competitive advantage. Regulation and taxation should follow function, not form.

The agenda that flows from the principles is a comprehensive one. As we have emphasized, we must reexamine and modernize the laws which constrain U.S. providers of financial services. Although I believe that these structural questions logically must be addressed first, we must also review the role of deposit insurance, insure the reliability of the payments system, reevaluate the role of lender of last resort and other mechanisms for problem and crisis management, prevent undue concentration of economic power, and decide the issue of who regulates whom and for what purpose.

We recognize that accomplishing this task in a reasonable timeframe is difficult -- intellectually and politically. Yet, if we have one message, it is to convey a sense of urgency. Time is of the essence. The Board's constructive leadership is critical. Merrill Lynch stands ready to work with the Board to achieve these difficult but crucial ends.