MANDATE FOR CHANGE

Restructuring the Banking Industry

Federal Deposit Insurance Corporation
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Contents

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Executive Summary

It has become increasingly apparent that our banking system is in need of major reform. The rapidly changing financial environment, in combination with the existing restrictions on banking activities, has resulted in the inability of banks to remain competitive players in our financial system. This has been characterized as a new form of banking crisis—not like the type that occurred during the early 1930s, but one that will slowly erode the viability of banks and ultimately lead to a weak and noncompetitive system.

Today's financial markets reflect several fundamental forces that have permanently altered the financial landscape over the past two decades. Among these forces are the significant advances in technology, the growing trend toward the institutionalization of savings, and the unprecedented innovation of financial products and services. These forces have had an adverse impact on banks and bank holding companies alike. In particular, they have eroded the traditional role of banks as the main providers of intermediation and transactions services.

There is almost universal agreement that something has to be done to allow banks and banking companies to become more competitive in a wider range of markets. However, there are widely divergent views as to what markets should be made available to banking, and what degree of supervision and regulation is necessary. The purpose of this study is to examine the issues that are relevant to determining the future role of banking and how governmental regulatory and supervisory activities should factor into the process. However, it should be stressed at the outset that the purpose of this study is not to redesign the bank regulatory system.

There are other important banking-related issues that are not addressed in this study. One of the most important questions currently facing the government is how to resolve the problems of the savings and loan industry. Whatever solution is devised, equity between banks and S&Ls must be achieved over the longer run with respect to supervisory and regulatory treatment. Another area that deserves careful thought is the appropriate role of deposit insurance; a brief discussion of some of the issues is presented in Appendix C.

Chapter 2 surveys the changes taking place in the financial-services marketplace, and their effects on the banking sector. It reviews changes in banks' relative market share in the financial sector, and examines the increasing importance of competition from various nondepository institutions and instruments. The discussion also addresses the effects these competitive developments have had on bank profitability and on the valuation of the equity shares of banking companies.

Historically, commercial banks' most important business has been commercial lending. However, banks have lost an important share of this traditional loan market, as the best customers of money-center and other large banks have turned to the cheaper commercial-paper market, Euromarkets and to foreign banks in the U.S. In just twenty years, between 1966 and 1986, banks' share of the commercial lending market declined from 88 percent to about 70 percent. The erosion of traditional lending markets is a source of particular concern because, in addition to the loss of profitable business, it may be driving bank lending into areas of substantially higher risk.

Chapter 2 also focuses on the declining profitability of the banking industry. By the end of 1986, aggregate return on assets of commercial banks had fallen to its lowest level since 1959, and return on equity was the lowest since 1968. The analysis indicates that despite the dramatic decline in profitability at small banks, in dollar terms it is the larger banks that account for most of the profitability decline for the industry overall. Moreover, the profitability decline is largely an asset-quality phenomenon.

In view of the declining market share and profitability of banking, it is not surprising that the securities markets appraise the future of banking pessimistically. The low valuation of bank holding company stocks relative to other industries means that banking companies may have difficulty raising the capital needed to compete effectively in the future. While it is not appropriate to ascribe all of the industry's problems to a changing financial environment combined with outdated restrictions on banking activities, some portion of the blame must be attributed to this source.

Chapter 3 examines, from an historical viewpoint, an issue that has become a fundamental part of the debate on bank reform: Should there be a "separation of banking and commerce"? American banking history has been used to support both sides of this debate. To a large extent, opposite conclusions have been reached based on divergent views of what is the appropriate banking entity. Some have looked to see if history supports the view that a "separation" has existed, using the bank itself as the relevant business entity. Viewed in this limited context, there is evidence that a separation of banking and commerce has existed in some form

during much of our history. However, the issue of greater relevance is not whether commercial activities should be conducted within the bank itself, it is whether they should be permitted within a banking organization. In other words, should banks and commercial firms coexist under common ownership? Viewed in this light, the evidence indicates that there has never been a complete separation of banking and commerce in the history of American banking.

The law has always permitted individuals to own controlling interests in both a bank and a commercial firm. During most of our history, nonbanking firms also have been allowed to own some form of a bank. It is only since the passage of the Glass-Steagall Act in 1933 that affiliations between commercial banks and securities firms have been restricted. Other affiliations between banks and nonbanking firms continued uninterrupted until 1956 when the Bank Holding Company Act became law. Even today, some commercial firms own banks.

Chapter 4 provides an overview of the reasons for passage of the Glass-Steagall Act. The chapter concludes that, to the extent the concerns expressed at that time were valid, the partial separation of commercial from investment banking mandated under the Act was not an appropriate solution.

It was demonstrated long ago, and in a convincing fashion, that the Great Depression in no way resulted from the common ownership of commercial and investment banking firms. The Glass-Steagall Act was largely the result of efforts by Senator Carter Glass, who was guided in his efforts by his belief in the discredited "real-bills" doctrine. Extensive Senate investigations into the practices of organizations that mixed commercial and investment banking functions revealed numerous abuses. However, many of these abuses were common to the investment banking industry; they had nothing to do with the intermingling of commercial and investment banking, and have been remedied in large part by the extensive securities legislation enacted in the 1930s. Abuses that were due to interactions between commercial banks and their securities affiliates were mostly conflict-of-interest situations which could have been controlled with less drastic remedies.

Until the 1930s, the securities affiliates of banks were not regulated, examined, or in any way restricted in the activities in which they could participate. Not surprisingly, abuses occurred. A certain degree of supervision and regulation and some restrictions on affiliate powers would have contributed significantly toward eliminating the types of abuses that occurred during this period.

Chapter 5 reviews conflict-of-interest and related concerns raised by bank participation in nonbanking activities. These include: (1) transactions that benefit an affiliate at the expense of a bank; (2) transactions that benefit a bank at the expense of an affiliate;

(3) illegal tie-ins; (4) violations of the bank's fiduciary responsibilities; (5) improper use of insider information; and (6) the potential for abuse due to a bank's dual role as marketer of services and impartial financial adviser.

Transactions that benefit an affiliate at the expense of a bank can be controlled acceptably through restrictions such as those contained in Sections 23A and 23B of the Federal Reserve Act; oversight and supervision by the banking agencies; and, perhaps, supplemental measures to strengthen existing safeguards. Some number of banks will always fail due to fraud and insider abuse, but this need not threaten the stability of the system, which is the primary public-policy concern.

Transactions that benefit a bank at the expense of an affiliate are of less concern. This is due partly to disclosure requirements and federal securities laws which deter abusive arrangements between banks and securities affiliates. More importantly, however, there are few safety-and-soundness concerns surrounding most nonbanking firms. In fact, one benefit of allowing banks to affiliate with other firms is that affiliates can be sold to raise capital for the bank in times of financial difficulty. This provides a buffer for the FDIC, helps to maintain a stable financial system, and need not adversely affect the interests of the nonbanking firm's shareholders, creditors or customers.

Tie-ins that present public-policy concerns result primarily from information problems or inadequate competition. Information problems generally are best handled by policies that encourage or require greater disclosure of costs, alternatives, and other pertinent facts. When inadequate competition is involved in perpetuating tie-in arrangements, this represents an antitrust concern. Rather than prohibiting firms from offering multiple products as a policy response to this problem, measures to foster greater competition would be more appropriate. Tie-ins that harm consumers cannot persist if consumers have options and are aware that those options exist.

Similar steps could be taken to guard against the abuse of insider information. Since banks have created an effective "Chinese wall" between their commercial lending and trust departments, it would seem plausible that they could take similar steps if they are permitted to engage in activities that grant them access to other types of confidential information. Should the level of abuse prove unacceptable, however, additional safeguards and stiffer penalties could be implemented without prohibiting efficiency-enhancing combinations of activities.

The focus of Chapter 6 is to determine if there should be restrictions on the activities of banking organizations due to the need to protect the safety and soundness of the banking system.

While it is acknowledged that maintaining the stability of the payments system is essential to maintaining stability in the financial system, it is shown that there are more efficient and more equitable ways to safeguard the large-dollar payments system than by maintaining restrictions on the activities of banking organizations. It also is suggested that the Federal Reserve would not be hindered in its efforts to conduct monetary policy if banking organizations were permitted to engage in a broader range of activities.

This is followed by a discussion of how to measure the riskiness of new activities and how to determine whether new activities would increase the overall level of risk-taking in the banking organization. While some possible new activities would pose few risks and could benefit the bank from a safety-and-soundness viewpoint, other activities might increase the overall level of risk if conducted within the bank. Thus, some activities may only be desirable if adequate safeguards exist to ensure that the bank is protected against excessive risks. However, since risk varies from activity to activity and from organization to organization, it is not possible to make sweeping generalizations; such as, for example, that "commercial" activities are riskier than financial activities.

Another safety-and-soundness concern is that, due to mispriced deposit insurance, banks have an incentive to take excessive risks. This incentive could be acted upon in markets newly opened to banks and would be extended directly to new activities if those activities could be funded with insured deposits. However, risk-taking in traditional bank activities is reduced due to governmental supervision and regulation. Risk-taking is also moderated by the fact that bank shareholders and management *do* face the prospect of total loss in the event of failure. Thus, incentives created by underpricing deposit insurance can be offset by controls on bank behavior and the threat of losses to shareholders and management. If new activities are conducted in entities outside of the reach of bank supervisors, then it is important there be safeguards to ensure that those activities are not funded with insured deposits.

Can banks be insulated effectively from the risks posed by new activities? The conclusion of Chapter 6 is that effective insulation is possible if new activities are placed in subsidiaries or affiliates of the bank. Subsidiaries and affiliates can be protected against legal risks if certain procedures are followed to ensure that the operations are conducted in truly separate corporate entities. While there are economic incentives to treat different units as part of an integrated entity, these can be controlled largely through existing legislation such as Sections 23A and 23B of the Federal Reserve Act and proper supervision of the bank itself, with appropriate penalties for abuses. The marketplace will view different units within an organization as distinct corporate entities if they are, in fact, treated accordingly by

the supervisory agencies. There is growing evidence that as bank supervisors make distinctions between banks and their holding companies and affiliates, the market will do the same.

In conclusion, new powers can be granted to banks, with appropriate safeguards to ensure that the banking system remains safe and sound. Some activities may be located within the bank if they pose no great risks. Others may be located in separate subsidiaries or affiliates, with safeguards structured to ensure that the bank remains viable regardless of the condition of the bank's affiliates and subsidiaries.

Chapter 7 discusses concerns related to equity, efficiency and concentrations of resources. One concern expressed by those who would limit bank involvement in nontraditional activities is that banks may possess unfair competitive advantages. These include certain tax benefits; access to the discount window, the federal funds market, and the payments system; and, most importantly, access to federally-insured funds. There is evidence that federal deposit insurance is underpriced in the sense that premiums do not accurately reflect the difference between rates actually paid on insured deposits and rates that would have to be paid in the absence of federal deposit insurance. This suggests that banks are subsidized, thus raising objections to new powers based on competitive inequities.

However, banks are subject to a wide variety of regulatory restrictions and controls from which other businesses are largely exempt. These include capital, reserve, and lending requirements; geographic and product constraints; and a host of other regulations. All of these impose costs on banks.

On balance, it is unclear whether banks possess a competitive advantage over nonbank firms. Regardless, equity can be obtained by allowing the same options to all. As banks are allowed to engage in nonbanking activities, nonbanks should be allowed into banking on the same terms as other banks. Given equal options available to all, there need be no concern about competitive equity.

Another concern is the possibility that new banking powers will transmit the distortional effects of underpriced safety-net privileges (especially deposit insurance) to other markets, thus resulting in a greater misallocation of resources. It is uncertain how large the cost to society could be from this type of inefficiency. In any case, controls are in place, and can be strengthened, to prevent banks from exploiting any fund-raising advantages in markets newly opened to banks. Moreover, the sources of this potential inefficiency should progressively disappear as deposit-insurance pricing systems are developed and banks are subjected to greater market discipline

through the refining of failure-resolution policies, bank-closure rules, regulatory accounting systems, and other aspects of bank regulation and supervision.

To the extent that expanded powers raise the potential for a greater concentration of banking resources, there are concerns that the outcome could include less competition, greater concentration of political power, and a more fragile banking system.

It is reasonable to assume that as geographic and product barriers in banking are lowered, there will be fewer, larger, and more diversified banking organizations. However, this does not mean there will be fewer banks or less competition in any given market. Technological advances have greatly reduced the cost of entry into new financial markets, and it is likely that they will continue to do so. This suggests that as excess profits develop in any market, they will be competed away, just as they are in today's highly competitive environment. As product and geographic deregulation further weaken entry barriers, this should increase both actual and potential competition in banking and ensure that even if the total number of banking organizations decreases, competition will remain strong.

While concentrations of political power may be undesirable, it is not clear that large organizations or highly concentrated industries are able to wield too much influence over government. In any case, the degree of concentration in banking is presently far below that of many other industries in which there is no apparent excess of political influence.

Finally, safety-and-soundness concerns need not be exacerbated by the development of a banking industry with fewer and larger entities than at present. A major reason why banks may grow larger is to take advantage of diversification opportunities, which should strengthen banks. Moreover, as the number of banks decline, there will be fewer opportunities for banks to slip through the cracks and avoid governmental supervision that can detect unhealthy behavior. Although there is not sufficient evidence to conclude that undue concentrations will arise if banking and commerce are allowed to mix, these concerns deserve careful consideration by Congress.

Chapter 8 lays out a set of rules that most likely would adequately protect the stability of the banking system and the deposit insurance fund if restrictions on affiliates of insured banks and the regulatory and supervisory powers of the banking agencies on these organizations were removed. It is pointed out that transactions between banks and nonbank affiliates currently are subject to very tight restrictions, and that few changes to existing law would be necessary to protect the system even if a very conservative approach were taken.

It is suggested that all banks with access to the federal safety net should be subject to the same rules. Thus, uniform restrictions on

dividends and lending limits should be extended to all insured banks. It is recommended that these same restrictions cover transactions and other dealings with direct nonbanking subsidiaries of insured banks, which are currently exempted from Section 23A-23B-type activities.

While direct regulatory or supervisory authority over nonbanking affiliates is unnecessary, there are limited areas where the bank supervisory agencies need to retain or be given authority. These include the power to audit both sides of transactions between banks and nonbank affiliates, and ensure that advertising and other promotional material distributed by nonbank affiliates are consistent with the maintenance of "corporate separateness" between bank and nonbank affiliates.

This set of rules most likely would provide a very effective "wall" between an insured bank and any affiliated organizations. However, these rules are restrictive and may diminish the attractiveness of affiliations between banks and nonbanking firms. On the other hand, these rules ultimately could allow unanticipated abuses to occur that fall within the rules. The only valid test is to subject them to the "market," and make necessary adjustments in response to events as they unfold. The process of liberalizing the powers available to any industry that has been regulated for decades must be approached with a combination of caution and flexibility.

Two related issues also are discussed. First, the issue of how to treat investment in subsidiary organizations in measuring capital adequacy probably is best resolved by differentiating between the activities performed by the subsidiaries. It is suggested that investments in subsidiary firms that perform functions that could be performed in the bank not be deducted from capital and the subsidiary be subjected to supervision. Whereas, equity investments in other subsidiaries should not count in capital-adequacy calculations.

The second issue relates to the so-called "source-of-strength" doctrine, *i.e.*, the ability of the regulatory agencies to force corporate owners to support subsidiary banks. From a practical standpoint, the best approach would be to use the normal applications process and supervisory activities to protect the deposit insurer from loss; this is the approach currently used in the case of banks owned by individuals.

The major conclusion of this study, as outlined in Chapter 9, is that insulation between banking entities and the risks associated with nonbank affiliates can be achieved with only minor changes to existing rules governing the operations of banks. Thus, systemic risks to the banking industry and potential losses to the deposit insurer will *not* be increased if activity restrictions and regulatory authority over bank affiliates are abolished.

The public-policy implication of this conclusion is that both the Bank Holding Company Act and the Glass-Steagall restrictions on affiliations between commercial and investment banking firms should be abolished. However, because of the importance of the banking industry to the economy and the high financial stakes that are involved, it is suggested that decontrol proceed in an orderly fashion to test these conclusions in the marketplace.

It is suggested that the provision of the Bank Holding Company Act pertaining to regulation and supervision of bank holding companies could be eliminated without undue risk to the system. Product liberalization then could be accomplished by an orderly legislative schedule first eliminating the restrictions imposed by Glass-Steagall then scheduling a gradual phaseout of certain provisions of the Bank Holding Company Act, with a specific sunset date when all limitations on affiliations would terminate.

This restructuring would be accompanied by a strengthening of the supervisory and regulatory restrictions on banks. The prudent supervision of banks would become more important, along with the need to monitor and limit risks posed by new activities conducted in the bank.

In summary, supervisory safety and soundness walls around banks can be built that will allow bank owners, subsidiaries, and affiliates freedom to operate in the marketplace without undue regulatory interference.

Chapter 1

Introduction

It has become increasingly apparent that our banking system is in need of major reform. The rapidly changing financial environment, in combination with the existing restrictions on banking activities, has resulted in the inability of banks to remain competitive players in our financial system. This has been characterized as a new form of banking crisis—not like the type that occurred during the early 1930s, but one that will slowly erode the viability of banks and ultimately lead to a weak and noncompetitive system.

Today's financial markets reflect several fundamental forces that have permanently altered the financial landscape over the past two decades. Among these forces are the significant advances in technology, the growing trend toward the institutionalization of savings, and the unprecedented innovation of financial products and services. These forces have had an adverse impact on banks and bank holding companies alike. In particular, they have eroded the traditional role of banks as the main providers of intermediation and transactions services.

We are now in a new era of finance. Instead of reliance on the traditional tools, the emphasis has shifted toward the securitization of financial assets and liabilities, the integration of financial products and the rapid globalization of finance. As a result, banking is threatened by the widening gap between the products and services demanded by financial-services customers and the permissible products and services that banking firms can offer. Many of the existing restrictions placed on the activities of banking organizations increasingly limit the extent to which banking organizations can fully and fairly participate in this new era of finance.

Banks face declining demand by both consumers and corporate customers for loans and deposit accounts. Increasingly, bank customers are showing their preference for the convenience of obtaining all of their desired financial services in one place. Other nonbank financial-services firms are permitted to provide the mix of products and services that these customers want, while banking companies do not have this ability. The result for banking is a declining market share, and it remains questionable whether banks will be able to remain profitable in the future.

Reform is necessary if banks and other financial-services providers are to be treated equitably and allowed to compete on a "level playing field." By allowing banking and commerce to "mix" in this manner (*i.e.*, to compete freely), both the financial-services customer and the public alike will benefit from an enhanced degree of economic efficiency. Through the operations of a more efficient banking system, direct benefits will accrue to individuals and society as a whole. Specifically, enhanced economic efficiency will result from increased competition among the providers of financial services, and the possible realization of economies of scale and scope. In addition, an improved level of safety and soundness for the banking system is a public benefit that can be expected to result from product liberalization.

There is little disagreement that banks must be permitted to expand their scope of operations to remain viable. However, there also is little agreement as to how this can be accomplished and what the future role of banking organizations should be in the financial marketplace. There are those who feel the activities of banking companies should be restricted, and that nonbanking affiliates of banks should be regulated and supervised by the banking agencies. In theory, current banking law is structured to achieve this goal.

Others feel that banking companies should be permitted to engage in any activity that is legal and, in the judgment of management, would contribute to the profitability and viability of the enterprise. In general, those who hold this view do not feel that direct regulatory or supervisory authority over nonbanking subsidiaries is needed.

How can informed observers have such divergent views toward the banking system? There are two parts to the answer. First, there is no disagreement that there are legitimate reasons to be concerned with risks in banks. For a variety of reasons, banks are considered to be crucial to the functioning of the economy; and stability of the banking system is important. For better or worse, banks have been afforded certain privileges not readily available to other organizations. Banks have access both to the payments system and liquidity from the Federal Reserve System and, perhaps most importantly, some of their liabilities are insured by a federal agency—the Federal Deposit Insurance Corporation. If for no other reason than the financial stake resulting from federal deposit insurance, the government has the obligation to control risks within the system.

The second part of the equation deals with banking companies—organizations that own and operate one or more banks as separate entities, as well as other, nonbanking enterprises. Herein lies the basis for the disagreement. Those who hold the view that banks cannot be operationally or legally separated from nonbank affiliates and subsidiaries feel that direct regulatory and supervisory author-

ity by the banking agencies over the entire organization is both appropriate and necessary. Those who believe that adequate separation can be achieved—that a wall can be built around banks—believe that the only legitimate role for the banking agencies is to regulate and supervise insured banks.

The purpose of this study is to examine the many issues that have been raised in the debate concerning the separation of "commerce" and banking. The topics involved in this debate are not simple and, most often, are not amenable to the usual empirical testing typical of economic research. Moreover, there are other important issues that cannot be separated completely from the topics treated in this study study—*e.g.*, deposit insurance reform, and the future role of the thrift industry. However, from the standpoint of the topics directly addressed by this study, the only critical assumptions are that the FDIC continues to handle failing- and failed-bank situations in a way that does not extend deposit insurance coverage to nonbank affiliates, and that the chartering authorities will close banks at or near the point of insolvency.

In Chapter 2, a review of the changing character of the financial-services industry and the performance of the banking industry is presented. Not surprisingly, the evidence indicates that banks are losing ground to nonbank competitors, and that this phenomenon is reflected in industry performance and market-value capitalization. While it is not appropriate to ascribe all of the industry's problems to a changing financial environment combined with outdated restrictions on banking activities, some portion of the blame must be attributed to this source.

Since a portion of the debate focuses on banking history, Chapters 3 and 4 recount the evolution of the U.S. banking system, and review the events that led to passage of the major banking legislation that currently governs bank operations. Chapters 5 through 7 evaluate the relevant factors relating to the separation of banking and commerce, and the need for the banking agencies to be directly involved in regulating and supervising nonbank affiliates. Finally, and perhaps most importantly, the final two chapters of the study present the FDIC staff's proposal for the future structure of the banking system and an agenda to achieve this structure.

As indicated earlier, there are important issues that are not addressed in this study. In particular, the role of other federally-insured depository institutions in a restructured financial industry is not considered. In the final analysis, there should be equity between banking and the savings and loan industry with respect to regulatory and supervisory treatment. How this can be accomplished, especially in light of the current problems facing the S&L industry, is unclear. This is a complex issue, fraught with public-policy, financial and political problems.

Another complex issue that is not adequately treated in this study deals with the appropriate role of deposit insurance. Appendix C discusses some of the issues regarding deposit insurance, but without pretending to provide any answers. As pointed out earlier, the existence of deposit insurance is one of the major reasons why there is concern about controlling risks in the banking system. However, there is another side to this coin. Deposit insurance has removed many of the concerns relating to the stability of the banking system. Thus, the concerns related to liberalization of banking powers can be viewed more as rules necessary to protect the deposit insurer from unacceptable losses. While this may be somewhat of an oversimplification, it does serve to focus the discussion.

Additionally, this study does not deal with the appropriate bank regulatory structure. Here again, there are numerous issues that need to be opened to discussion and ultimately resolved.

While no study is completely devoid of individual or institutional biases, an attempt has been made to make the analysis as objective as possible. In any event, it is hoped that this document will serve to enhance the quality of the debate surrounding the role of banking in the financial-services industry and that this debate ultimately will lead to a more rational structure for the industry.

Chapter 2

The Changing Marketplace

In the past, tradition and regulation determined which firms supplied which products in the financial-services marketplace. In today's market, tradition has given way to efficiency. Technological change has created a situation in which many different kinds of firms can provide the basic financial services individuals and businesses desire and need. At the same time, outdated regulations have severely handicapped the banking industry vis-a-vis other firms supplying financial services.

This chapter surveys the changes taking place in the financial-services marketplace, and their effects on the banking sector. It reviews changes in banks' relative market share in the financial sector, and examines the increasing importance of competition from various nondepository institutions and instruments. The discussion also addresses the effects these competitive developments and other factors have had on bank profitability and on the valuation of the equity shares of banking companies. While these competitive effects are not the sole cause of the recent changes in banks' relative market shares and profitability, they are, nonetheless, important factors.

Competition in the Financial-Services Marketplace

Banks no longer dominate their traditional financial intermediation and transactions services areas. Technological advances and economic developments have increased the financial-services needs of households and businesses, enlarging the market for financial services, and, at the same time, permitting the entry of many new participants into the marketplace. These forces have prompted market participants to innovate their financial-services product lines, in terms of both content and distribution, to meet growing customer needs more efficiently. Just as technological change has reshaped the demand for financial services, it has radically altered the most efficient means of supplying and bundling them. Banks have adapted to the changing market, but in part due to the activity restrictions faced by the industry, their competitive status has slipped, both at home and abroad.

Corporate Finance

Historically, commercial banks' most important business has been commercial lending. In recent years, banks have lost an important share of this traditional loan market, as the best customers of money-center and other large banks have turned to the cheaper commercial-paper market, Euromarkets and to foreign banks in the U.S. In 1966, banks supplied almost 88 percent of the short- and intermediate-term credit needs of domestic nonfinancial corporations. By 1976, the share was about 76 percent; in 1986, it was down to almost 70 percent. Much of this market share was lost to commercial paper.

Commercial paper, which for many borrowers is a close substitute for banks' commercial and industrial (C&I) loans, has accounted for an increasing proportion of outstanding nonfinancial corporate business credit over the past 20 years. The ratio of outstanding C&I loans to commercial paper dropped from 99-to-1 in 1966 to about 13-to-1 in 1976, and then to almost 6-to-1 by 1986. The trend toward substitution of commercial paper for commercial loans reflects the fact that direct loans from banks are a relatively more expensive source of funds for some borrowers. Increasingly, medium-sized businesses are joining large corporations as issuers of commercial paper; a trend that is likely to continue. As the commercial-paper market matures and becomes accessible to more borrowers, banks will face the continued erosion of one of their most important loan markets.

The declining role of banks in the wholesale lending market is attributable to a number of factors. As the quality of banks' loan portfolios has declined, many prime corporate borrowers have as good or better credit ratings than all but a few banks, so they have lower funding costs. The increased availability of credit information has greatly enhanced the market's ability to serve corporate borrowers without bank intermediation. Advances in communications and information technologies have significantly diminished any informational advantage possessed by banks in assessing the creditworthiness of potential borrowers, and this trend continues. Growth in nonbank sources of investment funds, coupled with the technology to provide highly sophisticated management of these funds, has presented banks with a significant lower-cost source of competition for the best business.

There are many reasons why banks have become increasingly disadvantaged as suppliers of wholesale credit. Costs imposed by federal regulation are an important one. Moreover, due to legal prohibitions, banks are forced to watch as other financial-services providers take their traditional customers to the credit market. Over the past decade, the market has been able to outcompete banks for high-quality wholesale credits.

The erosion of traditional lending markets is a source of particular concern because, in addition to the loss of profitable business, it appears to be driving bank lending into areas of substantially higher risk. As larger, prime borrowers deserted banks for the money markets, the notion of the "prime" borrower had to be revised. When the top tier of customers began to have their credit needs satisfied outside the bank, those companies in the next tier down became "prime" borrowers by default. During this adjustment process, the new "prime" borrowers saw their borrowing terms improve as banks sought to keep them, too, from deserting ship. Thus, marginally inferior credit risks began to receive marginally superior terms. More importantly, as credit standards were lowered and banks booked loans for customers who would not have received loans previously, bank asset-quality was impaired.

Consumer Finance

Banks face mounting competition in the consumer market from thrift institutions, nondepository firms and nonbank banks. Despite interest-rate deregulation, money market mutual funds controlled over $292 billion in funds as of year-end 1986, compared to less than $4 billion ten years ago. Although banks now offer deposit accounts with terms that are competitive with those of money funds, the companies that offer money funds often are able to afford their customers flexibility and convenience that banks are prohibited from matching. For example, some companies offer a variety of money market funds, including tax-exempt funds and accounts with transactions features. In addition, they can offer a wide range of debt and equity mutual funds, debit cards, lines of credit, investment advice, and even, by acting as deposit brokers, federally-insured deposits.

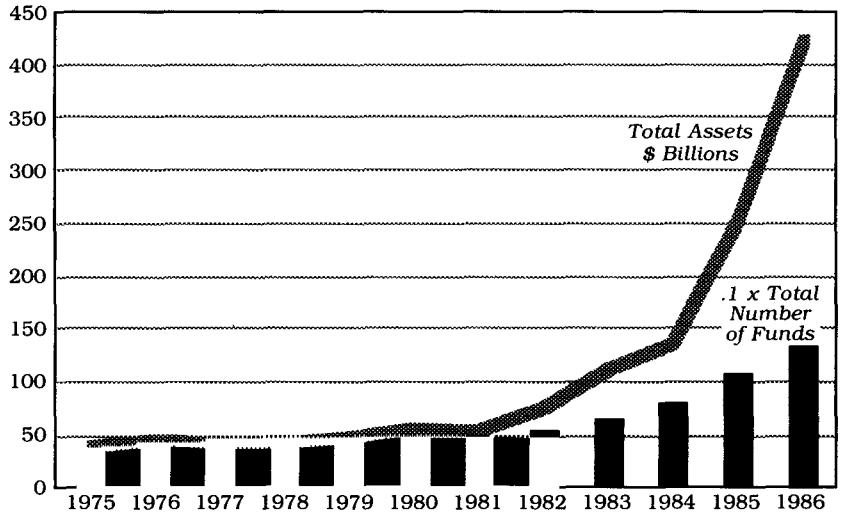
During the 1980s, mutual funds and money market mutual funds have experienced the greatest growth of any consumer investment medium. Charts A and B illustrate the exceptional growth of mutual funds and money market funds. These institutions have increased their share of financial assets within the private financial sector from 2.0 percent in 1976 to 8.3 percent in 1986. At the same time, commercial banks' share of those assets dropped from 37.9 percent to 31.5 percent.

Banks also are witnessing shifts in their consumer loan portfolios, as savings institutions and finance companies vie for what traditionally have been bank customers. Banks' share of the auto financing market declined from 60 percent in 1977 to 41 percent in 1986. Over the same period, finance companies more than doubled their market share, from 18 percent to 38 percent. The growth of finance companies owned by the automobile manufacturers, due largely to their willingness to offer highly competitive terms, has

Chart A

Equity, Bond, and Income Mutual Funds

Number of Funds and Total Assets

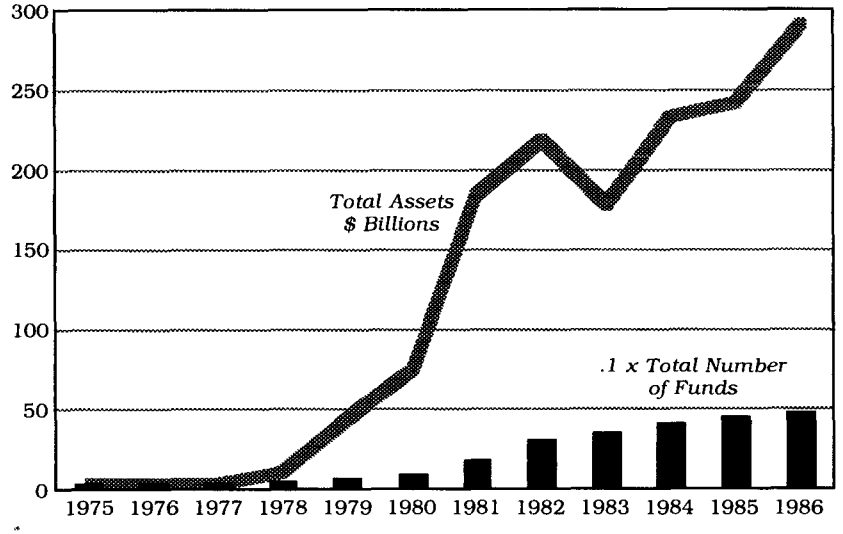


Source: Investment Company Institute.
1986 Mutual Fund Fact Book.

Chart B

Money Market and Short-Term Municipal Bond Funds

Number of Funds and Total Assets



Source: Investment Company Institute.
1986 Mutual Fund Fact Book.

been the most important factor in this development. That these firms have the ability to trade off between the price of manufactured goods and the price of the financing without diminishing their credit standing, while banks do not, is another example of banks' competitive disadvantage.

In some lines of consumer lending, banks' market share is increasing. Banks' share of the revolving-credit market grew from 47 percent in 1977 to 63.5 percent at the end of 1986. Still, this improvement failed to offset the loss in their auto financing share. In part this is because auto financing receivables were $110 billion greater than revolving-credit receivables ($245 billion versus $135 billion) at the end of 1986; thus, banks have a shrinking share of the larger market, and an expanding share of the smaller one. Additionally, auto loans are secured credits, while revolving credit is unsecured. Credit pricing reflects this difference, but it still means that banks find themselves with a higher risk profile in their consumer loan portfolios. Prospects are good for captive finance companies to continue to increase their auto financing share at the expense of banks. They probably will surpass banks in market share by the end of 1987. At the end of 1986, the three largest finance companies were GMAC, Chrysler Financial and Ford Motor Credit.[1] At the same time, growth and market-share trends in the revolving-credit market appear favorable for banks.[2]

The prospects for the securitization of consumer receivables also dim the outlook for most banking companies in these markets. Recent advances in information technology and reductions in transactions costs have shifted the underlying cost advantage away from the traditional forms of intermediation toward direct funding in the securities markets. The potential for continuing securitization of bank lending markets is best exemplified by the growth of mortgage-backed securities, which accounted for less than 8 percent of total outstanding residential mortgage receivables in 1976, and over 32 percent in 1986.

In recent years, the operation of the mortgage market has changed rapidly as mortgages increasingly have been "packaged" and sold in the securities markets. Mortgages are held temporarily by the mortgage bankers and depository institutions that originate them, but their long-term funding is accomplished through various types of mortgage-backed securities sold to investors of all types. In many cases, securities based on mortgages are bought for investment purposes by depository institutions, but the traditional system of financing mortgages through direct intermediation by banks, savings and loans, and other direct lenders is being displaced.

The trend toward securitization is spreading into other areas of bank lending. For example, securities have been issued backed by auto loans, consumer receivables, and student loans. Other areas of

lending may soon be affected by this trend as the the basic nature of important bank lending markets continues to change. To the extent banks are prohibited from directly bundling and selling loans they originate in the securities markets, their profit potential is diminished by foregone fee income. In summary, banks' traditional lending markets are shrinking, while banks are precluded by law from participating fully in the emerging markets.

Foreign Competition

Foreign banking institutions are playing an increasingly important role in both U.S. and foreign markets. Their growing market share has been gained largely at the expense of U.S. commercial banks. One reason is that foreign banks are exempt from many of the regulatory restrictions imposed on U.S. banks' activities.

The number of foreign bank offices in the U.S. has increased steadily in recent years; as of year-end 1986, there were 487 such offices, compared to 155 ten years earlier. The impact of the increased domestic presence of foreign bank offices can be seen in their growing share of financial assets within the U.S. banking system. Between December 1976 and December 1986, domestic financial assets held by foreign bank offices were up about 400 percent, more than double the increase of domestic banks. As of year-end 1986, foreign bank offices held 6.6 percent of the $2.6 trillion in aggregate bank domestic financial assets.

Business loans at foreign bank offices grew at an average annual rate of over 14 percent between 1976 and 1986, while domestic bank business loans grew at only a 9 percent rate. Much of this growth at foreign bank offices resulted from foreign bank purchases of business loan participations sold by domestic banks. These sales are the result of several factors; the disparity in regulatory capital standards between domestic banks and their foreign competitors is probably the most significant. Exemption from the finance-commerce separation requirements imposed on U.S. banks are afforded to foreign banks under certain circumstances, permitting them to engage in activities in this country that are not open to U.S. banks. These additional lines of business give foreign banks a more diversified earnings base with which to strengthen their capital position.

U.S. banking companies may engage in a much wider range of activities overseas than at home, principally because Glass-Steagall prohibitions are not applicable to overseas activities. For example, foreign subsidiaries of U.S. bank holding companies may underwrite debt securities, manage mutual funds, broker insurance, perform consulting services, and with some limitations, underwrite, distribute and deal in equity securities. The Federal Reserve Board decided to permit these activities in foreign markets to allow U.S. banking organizations to compete effectively with foreign financial

institutions. Many large bank holding companies have engaged in some or all of the permitted activities without difficulty for many years.

Nonbank Banks

The 1980s have witnessed the emergence of another type of competitor: domestic companies that have succeeded in breaching the barrier between banking and commerce. The ownership of "nonbank banks" insured by the FDIC extends to a wide variety of firms, including securities brokerage firms, insurance companies, manufacturers, retailers and diversified nonbank financial firms. Curiously, this has been a one-way street, whereby nonbank firms have been able to enter banking, while banks have been prohibited from diversifying into the same businesses in which their "nonbank bank" competitors' parents are engaged. It is curious, too, that some call these new competitors "limited-service banks." Considering the size, strength, product mix and orientation of their parent companies and the overall organizations, commercial banks would appear to be the more "limited-service" banks.[3]

Profitability

Commercial bank profitability has steadily declined during the 1980s (Table 1). The measures taken recently by many of the nation's largest banks to add billions to their allowance for loan losses promise to make 1987 the banking sector's least profitable year since the Great Depression.

Table 1

Commercial Bank Profitability

	1970-80	1981-85	1986
Average return on assets	.80%	.70%	.64%
Average return on equity	12.51	11.67	10.23

Of course, the largest banks significantly affect these aggregate statistics and some might think that most banks have been able to maintain their profitability. However, in a marked departure from the historical trend, the smallest banks have suffered the most severe deterioration in earnings in recent years. From 1970 through 1983, banks with assets less than $100 million had an average return on assets (ROA) of 1.02 percent. In 1984, ROA was .81 percent, dropping to .70 percent in 1985 and to .53 percent in 1986; in these same years the median bank return on assets fell below 1 percent for the first time since 1977, falling to .61 percent in 1986. Additionally, the proportion of small banks that booked annual net

losses jumped from 5 percent in 1981 to 22 percent in 1986. Along with the decline in small-bank profitability,[4] there has been a dramatic increase in the number of bank failures.

Despite the decline in profitability at small banks, in dollar terms it is the larger banks that account for most of the profitability decline for the industry overall.[5] The decline in profitability is largely an asset-quality phenomenon. Throughout the decade, banks have allocated increasing shares of income to provide for possible loan losses.

Table 2

Provision for loan losses as a percentage of adjusted pretax net operating income
U.S. Commercial Banks[6]

1979	1980	1981	1982	1983	1984	1985	1986
17.6%	18.8%	20.3%	30.8%	36.1%	40.0%	42.4%	49.0%

These provisions have exceeded net loan charge-offs, and the allowance for loan losses has grown from .99 percent of loans in 1979 to 1.62 percent at the end of 1986, indicating the caution among bankers aware of the deteriorating quality of their loan portfolios.[7] Despite the fact that in 1986, banks charged-off 1 percent of their loans, nonperforming assets still grew nearly 13 percent.[8]

The declines in bank earnings may understate the magnitude of the problem. Net income in 1986 was only slightly below year-earlier levels, but operating earnings dropped by more than 17 percent, as a $2.4 billion increase in realized securities gains offset a good portion of the $4.2 billion increase in loan-loss expense. Gains of such magnitude cannot be counted on in 1987 and later years. Large banks have been able to balance declines in interest income from traditional sources with increasing noninterest revenues from their growing off-balance-sheet activities. Recently, many banks have bolstered income from noninterest sources of a one-time nature, such as asset sales. Again, this cannot be counted on to continue to contribute to earnings as much as they have in recent years, which further clouds the industry's profitability picture. With nonperforming asset levels still on the rise, the outlook is for continued low income levels, as loan-loss provisions continue to act as a drag on earnings, with no significant relief from other operations.

Market Valuation of Banking Companies

In view of banks' declining market share and profitability, it is not surprising that the securities markets appraise the future of bank-

ing pessimistically. Under the burden of direct and indirect regulatory costs peculiar to their form of organization, banks have labored with only limited success to provide returns on equity sufficient to attract investors. Chart C demonstrates that, compared to market averages, prices of bank holding company stocks have been low relative to earnings during the last two decades.[9] This low valuation makes it difficult for bank holding companies to raise the capital needed to compete effectively in the future.

Uncertainty about the actual values of assets held by banks also may have dampened market enthusiasm for bank holding company securities. Compared to banks in other nations, U.S. banks have been slow to reserve against debt to less-developed countries. Banks in some foreign countries are considered to be stronger than their balance sheets show, due to conservative reporting practices. The market capitalization of large foreign banks far surpasses that of U.S. banks, in part reflecting this assessment.[10] Moreover, the market value of large U.S. financial firms exceeds that of large bank holding companies. For example, as of March 31, 1987, the market capitalization of American Express was greater than that of Citicorp and J.P. Morgan combined.[11] Chart D shows that, until recently, the market value of U.S. bank holding company equities has not even matched stated book value. The average market-to-book value ratio for the S&P 500 index was nearly 192 percent at year-end 1986, and has been above 100 percent in each of the past six years.

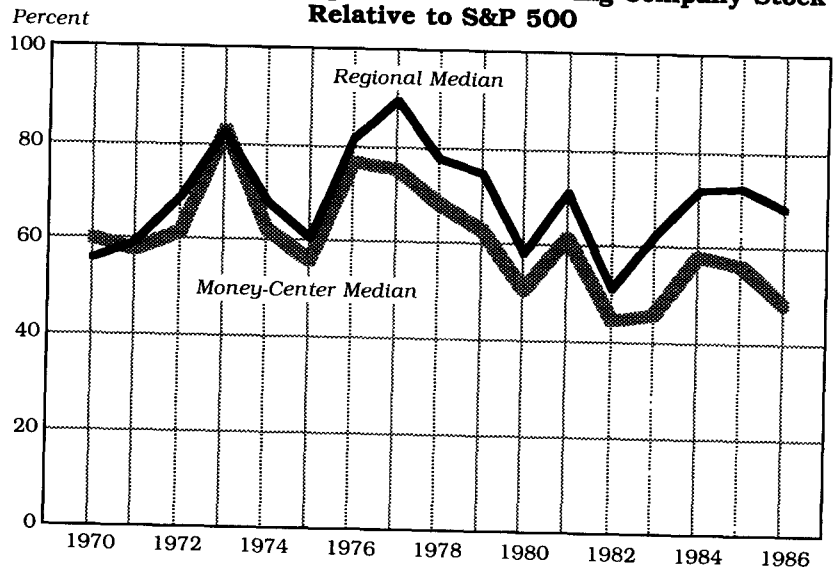
Low bank holding company stock prices demonstrate that the market believes the future growth and profitability prospects of the U.S. banking industry are limited relative to other investment opportunities, even among financial-services companies. The governmentally-imposed constraints on banking companies and the new competitive realities must be considered as important factors contributing to the diminished attractiveness of bank holding company stocks. Market valuations of bank holding company stocks provide the most objective evidence that, absent significant changes, the prospects for the banking industry are not good.

Conclusions

The complex regulatory framework constructed around the banking system was intended to protect its viability and to promote its stability. The economic benefits derived from this stability and confidence have been tremendous. But market developments have significantly altered banking firms' traditional business environment, and effectively diminished the industry's role in the economy. If banking companies are to maintain the earnings potential fundamental to their continued viability, they must have the opportunity to offer the products and services necessary to compete on even terms with their new competitors.

Chart C

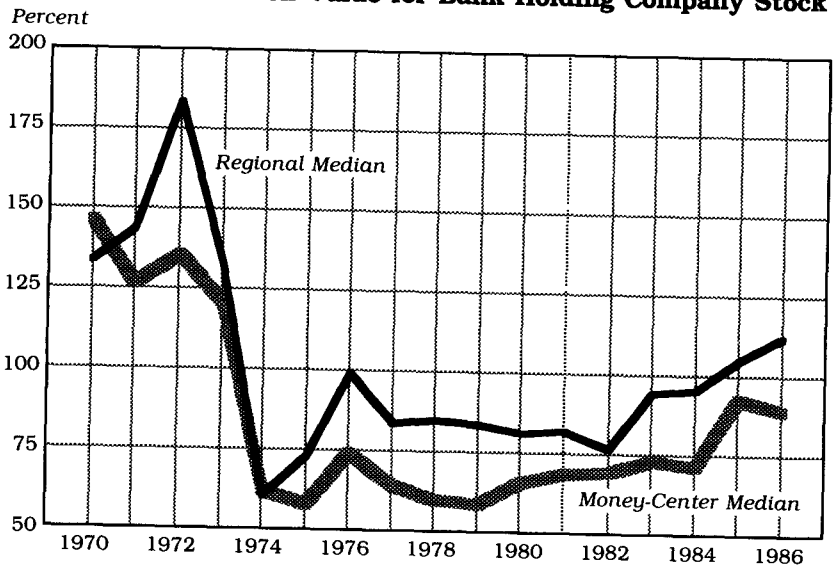
Price/Earnings Multiples for Bank Holding Company Stock Relative to S&P 500



Based on year-end data.
Source: Salomon Brothers.

Chart D

Market Price/Book Value for Bank Holding Company Stock



Based on year-end data.
Source: Salomon Brothers.

As financial-services providers are forced to adapt to meet the changing needs of a dynamic market, so too must the regulatory structure. Banking organizations have been effective in pushing their activities to permissible limits, and occasionally entering new territory. A gradual liberalization of some of the strictures on banks and bank holding companies has occurred. But this *ad hoc* process is neither efficient, consistent, nor timely, placing banking companies at a decided disadvantage vis-a-vis their less-regulated competitors.

Declining profitability threatens banking companies' capacity to serve growing customer needs and to meet increasing competition. It also poses direct risks for the FDIC. The combination of legislative and regulatory uncertainty and low profitability in a flourishing economy undermines the stability that public policy seeks to ensure. As the banking sector's declining market share and profitability persist, the urgency of addressing the regulatory side of the problem grows.

FOOTNOTES

[1]As ranked by total capital funds. Ranked by net income, they were numbers one, five and two, respectively. Bank holding companies owned two of the top ten finance companies, numbers seven and ten on the capitalization ranking list, but numbers eight and 22 by net income. (*American Banker*, June 10, 1987.)

[2]Optimism about bank prospects in this market should be tempered by the fact that, while they appear to be gaining market share at the expense of retailers, retailers have fought back by acquiring banks and turning them into credit-card facilities. Of course, retailers also are buying insurance companies, real-estate companies, stock brokerage firms and other financial-services companies. Banks, on the other hand, are severely constrained against purchasing retailers.

[3]The following list of selected "nonbank banks" includes the FDIC-insured institution, its assets as of June 30, 1987, and its parent company.

FDIC-insured "nonbank bank"	Assets ($million)	Parent company
Merrill Lynch Bank & Trust	$ 114.6	Merrill Lynch & Co., Inc.
Custodial Trust Company	305.6	Bear Stearns & Co.
Dreyfus Consumer Bank	61.3	Dreyfus Corp.
Harbor Trust Company	12.3	Drexel Burnham Lambert
Investors Fiduciary Trust	340.1	Kemper Corp.
Liberty Bank & Trust	24.3	Aetna
First Signature Bank & Trust	38.1	John Hancock
Prudential Bank & Trust	88.4	Prudential Insurance Co.
Boston Safe Deposit & Trust	10,298.2	Shearson/American Express
American Express Centurion Bank	613.7	American Express
Greenwood Trust Co.	2,286.5	Sears Roebuck & Co.
Hurley State Bank	17.2	Sears Roebuck & Co.
Clayton Bank & Trust	24.1	Mobil Corp.
City Loan Bank	597.7	Control Data Corp.
Hickory Point Bank & Trust	45.0	Archer Daniels Midland
Fireside Thrift Company	317.2	Teledyne, Inc.
GECC Financial Corp.	356.6	General Electric Corp.

In addition, some of these parent companies also control other nonbank financial-services companies. For example, Sears owns Dean Witter and Allstate; G.E. Credit Corp. owns Kidder Peabody; American Express owns Shearson-Lehman Bros.; and Prudential owns Bache.

[4]For a discussion of small-bank performance, see Lynn A. Nejezchleb, "Declining Profitability at Small Commercial Banks: A Temporary Development or Secular Trend?," Federal Deposit Insurance Corporation *Banking and Economic Review* (June 1986):9-21.

[5]As of December 31, 1986, banks with assets less than $100 million constituted 80 percent of all FDIC-insured commercial banks, but held only 13.7 percent of the banking sector's assets. Conversely, banks larger than $1 billion were only 2.4 percent of the total number, but held 66.5 percent of the assets.

[6]Adjusted pre-tax net operating income is income before taxes, securities gains/losses and extraordinary items, with the provision for loan and lease losses added back in. It is the amount of pre-tax income a bank would have earned on its regular banking business absent any loan-loss expense.

[7]With the commercial banking industry's $21.2 billion addition to reserves in the second quarter, the ratio of allowance for losses to outstanding loans increased to 2.66 percent as of June 30, 1987.

[8]For a discussion of asset-quality trends, see Ross V. Waldrop, "Asset Quality at Insured Commercial Banks in 1986," Federal Deposit Insurance Corporation *Banking and Economic Review* (July/August 1987):12-22.

[9]In the discussion that follows, it should be noted that earnings from foreign activities and the performance of nonbank subsidiaries have an impact on the earnings of bank holding companies.

[10]As of March 31, 1987, the market value of the equity shares of the Sumitomo Bank was $58.3 billion, making it the world's highest-valued banking company. J.P. Morgan, at $7.7 billion, was the top U.S. bank and 19th in the world. The 15th highest Japanese bank's value was greater than that of J.P. Morgan. It would have taken the combined market value of the top 19 U.S. banks to equal Sumitomo's. (*American Banker*, July 6, 1987.)

[11]Eight U.S. nonbank financial firms had market values greater than $4.7 billion, compared with two U.S. banking companies. (*American Banker*, July 6, 1987.)

Chapter 3

Historical Overview of Bank Powers

Introduction

A "separation of banking and commerce" was formally introduced into American banking with the passage of New Deal legislation in 1933. Specifically, the passage of the Glass-Steagall Act forced the partial separation of commercial and investment banking. This formal separation was extended by the 1956 Bank Holding Company Act and its 1970 Amendments to include restrictions on bank ownership and the activities of bank affiliates.

Today the financial community is engaged in debate over the relevance of this separation. This is due, in part, to the rapid changes occurring in finance and the subsequent blurring of the "line" as the financial industry undergoes change. For example, nonbank banks have brought both securities firms and nonfinancial firms into areas once reserved for banks, while banking organizations have sought to engage in other activities outside traditional banking functions (transactions and intermediation services). Because the question of "separation" has become fundamental to the debate over financial-services reform, an examination of the historical precedence for mixing banking and other forms of commerce is in order. In the discussion that follows, "banking" is defined as all activities carried out directly by the bank; "commerce" is broadly defined as "all other activities," including those of a financial nature.

Although history by itself cannot prescribe an optimal solution to the problems addressed by reform, it can provide a useful frame of reference. An historical perspective on American banking, especially on the issue of the separation of banking and commerce in American banking history, has been used to support various opinions on the direction that reform should take. These interpretations of history have led to divergent views on the proper regulation of banking, including the appropriate restrictions on bank ownership and nonbank activities.

Some participants in the current debate have used historical evidence to argue for the maintenance of a strict separation of banking and commerce, based upon the idea that "separation . . . has been a prevailing principle applied to commercial banks in America since colonial times."[1] Others have argued that a true

reading of the historical evidence reveals that banking and commerce have always been allowed to mix. Such divergent positions can coexist, in part, because they are based on different definitions of the "line of separation" between banking and commerce. This line of separation can be discussed in terms of the ways in which banking and commerce have been and are allowed to mix.

Lines of separation can be drawn on two levels: prohibiting the mixing of banking and commerce either directly or indirectly.[2] Prohibition of a direct mixing of banking and commerce would establish a line of separation between "banking" and "other" activities carried out within a bank or other firm. Prohibition of an indirect mixing would prevent common ownership of firms separately engaged in banking and other activities.

Evidence on the direct separation of banking and commerce is mixed. Such lines of separation have, on occasion, been drawn, prohibiting the mixing of banking and certain other activities within the bank itself. For example, prohibitions against engaging in manufacturing or speculative real-estate holdings were included in many of the early American bank charters. However, there has never been an absolute prohibition on banks engaging in "commercial" activities.

Throughout American banking history, both private and chartered banks have directly engaged in commerce. Two prominent examples are Wells Fargo & Co. and J.P. Morgan & Co. Wells Fargo incorporated an express stagecoach business with banking; the combination of commerce and banking was, at that time, permitted by California law. J.P. Morgan & Co., a private bank, accepted deposits, made commercial loans and underwrote securities. Until the 1933 Glass-Steagall Act was passed, it was the leading originator of new securities issues in the U.S.[3]

A direct mixing of banking and commerce also has frequently occurred when commercial, nonbanking firms have engaged in banking activities. One common example of this mix today is the direct provision of loans to consumers and corporations by nonbank firms. Unitary thrifts, many of which are owned by commercial firms, provide another example of this direct mix of banking and commerce. This is especially pertinent as these thrifts now have access to the payments system and can engage in limited commercial lending.

While certain restrictions on permissible bank activities have existed in some form throughout American banking history, prohibitions against an indirect union of banking and commerce have occurred only recently. Indirect affiliations between banks and commercial enterprises can occur in several ways. An indirect union or mix of banking and commerce is established inside a single corporate structure when (1) the bank is a subsidiary of a commer-

cial firm, (2) the commercial firm is a subsidiary of the bank or (3) the commercial firm and the bank share a common parent holding company. An indirect union of banking and commerce also occurs when, at the shareholder level, controlling interests in a bank and a commercial firm are held by a common set of owners. This mix can be enhanced by common management of the bank and the commercial firm. Examples of such indirect mixing of banking and commerce appear throughout American banking history and are common today.

Throughout American history, the law has permitted individuals to own controlling interests in both a bank and a nonbank, commercial firm. History presents many examples of banker-industrialists. In the 19th century, Thomas Mellon and Moses Taylor each owned controlling interests in banks and a variety of commercial enterprises. Taylor was president of, and held controlling interests in, National City Bank, a forerunner of Citibank, while he also held controlling interests in a gas utility, an iron company and a mercantile business. Mellon founded a private bank and simultaneously owned and ran a mercantile business. At the turn of the century, the Mellon family owned significant interests in, and exercised some degree of control over, the Mellon National Bank, Gulf Oil and Alcoa Aluminium. Current examples of individuals who own controlling interest in both a bank and nonbank enterprises include Joe L. Allbritton of Riggs National Bank and Sam Walton of Wal-Mart Department Stores. Allbritton also owns controlling interests in several television stations and Walton is the chief executive and principal shareholder of Northwest Arkansas Bancshares, a bank holding company.[4]

Throughout American history, the law also has permitted nonbank firms to own some form of a bank. Restrictions on this form of indirect union of banking and commerce are recent developments, stemming from the 1933 Banking Act. In Section 20 of this Act, member banks are prohibited from affiliating with institutions that are principally engaged in the underwriting and distribution of securities. With this exception, any nonbank firm could own any number of commercial banks. The Bank Holding Company Act of 1956 reduced that number to a single commercial bank. Until 1969 legislation, any nonthrift firm could own any number of thrifts. Prior to the recent passage of the Competitive Equality Banking Act of 1987, any nonbank firm could own a single thrift and any entity could own a nonbank bank.

In addition, *de facto* affiliations between banking, on the one hand, and commerce, on the other, can be found at the board of directors level. When the composition of the boards of directors of banks and their parent holding companies is examined, a wide-ranging "mix" of banking and commerce becomes apparent. That is,

in terms of the perspectives of bank directors, there exists a cross-fertilization of ideas across institutions and firms. For example, directors on the boards of major U.S. money-center banks often are affiliated with a broad range of corporations, including manufacturing and retailing firms, as well as firms associated with the energy, computer, pharmaceutical and automotive industries.

As these examples and a reading of the history indicate, separation has been, at best, a recent phenomenon that has not been universally applied. When historical evidence on the separation of banking and commerce is considered, it is important to recognize the distinction between direct and indirect forms of separation. While there is clear evidence for a direct separation of banking and commerce in the form of restrictions on permissible bank activities, such evidence should not be used to argue that it establishes a basis for restricting the activities of bank *owners* as well. Direct separation is not at the heart of the separation issue. What is at issue is the question of whether and how banking and commerce should affiliate. This means searching for answers to the questions of who may own a bank, and in what activities a bank's parent, affiliates or subsidiaries should be permitted to engage.

Overview of American Banking History

For present purposes the history of American banking can be divided into three distinct periods, each of which offers insights into the issue of separation. These periods are: chartered banking (1781-1837), free banking (1838-1933) and regulated banking (1933-present).

Chartered Banking (1781-1837)

The chartered banking era in American banking history began with the chartering of the Bank of North America in 1781 and ended with the Bank Panic of 1837. This era was characterized by the existence of chartered or incorporated banks as well as unincorporated or private banks.

Throughout this era, the charter was the standard method of incorporation. Charters were granted by the respective state legislatures and by Congress for federally-chartered banks. While the Constitution had clearly granted Congress the right to issue currency, it did not specify who could charter banks. This was a matter of particular importance, however, because chartered banks held the power to issue circulating notes, which were close substitutes for legal tender currency. Both the states and the federal government claimed and exercised this right. Dual chartering has remained a part of American banking history, with the notable exception of the

Jacksonian era (1837-1864) when there were no federally-chartered banks. A dual chartering system was formalized in 1864 by the passage of the National Bank Act, which established a system of national banks to exist alongside state-chartered banks.

The corporate charter granted limited monopoly privileges and created a definite association between the bank and government, thereby establishing a quasi-public role for the chartered bank. Banks were relied upon to finance government operations, in part through the purchase and sale of government obligations, and to furnish part of the circulating medium.[5] The importance of the quasi-public role performed by banks justified the granting of monopoly power and the need for regulation by the granting body. Therefore, the activities and powers of incorporated banks were limited to those expressly permitted by their charters.

The first incorporated bank was the Bank of North America, which received charters from the Continental Congress and several states. While the Bank of North America was originally intended to have a monopoly on the business of banking, this was short-lived, as states began to incorporate banks in 1784. By 1790, there were four incorporated banks operating in the United States: the Bank of North America, the Bank of New York, the Massachusetts Bank and the Bank of Maryland. The charters incorporating these early banks were written in general terms, granting them authority to issue notes, accept deposits, extend credit and provide banking services to the chartering government. They often also included prohibitions against trading in merchandise and owning more real estate than the bank required to transact its business.[6]

Throughout this era, the federal government granted charters to only two banks, the First and Second Banks of the United States. Each had a twenty-year charter. The First Bank of the United States, incorporated in 1791, was largely the product of one person's efforts, Alexander Hamilton. He envisioned and campaigned for a "national" bank for the newly formed United States, and used the Bank of England as his model. The First Bank's charter, like many of the early bank charters, reflected the influence of the English system, including the beliefs that the control of competition and a separation of banking from certain forms of commerce would promote the safety of deposits and the soundness of banks.

Like the Bank of England, the First Bank of the United States was intended to play a role similar to that of today's central banks. In addition to functioning as a commercial bank, it was to be the federal government's fiscal agent, which meant it would aid in the collection of taxes, administer the public finances and provide a source of loans to the Treasury.[7] The First Bank maintained several advantages over the state-chartered banks which contributed directly to both its success and its downfall. For example, the First

Bank held the deposits of the federal government and maintained branch offices in major cities nationwide. It issued notes as legal tender, and could influence the ability of state-chartered banks to compete through its policies on note convertibility. By accepting other banks' notes only if they were fully convertible into specie, the First Bank could limit the ability of state-chartered banks to issue notes and loans.

These advantages enabled the First Bank of the United States to become the dominant commercial bank in the United States. They also gave the bank's opponents grounds to argue against renewal of its charter. In 1811, Congress refused to renew the bank's charter. The War of 1812 followed, and with it, inflation and the state banks' inability to convert notes to specie.

By 1816, Congress again was willing to charter a national bank. Like its predecessor, the Second Bank of the United States grew to be the dominant commercial bank in the nation. Under the leadership of Nicholas Biddle, it also acted as a central bank. By 1836, however, the political climate had turned against the Second Bank, and its charter was not renewed. This marked the end of the chartered banking era, as the nation moved into the period of free banking. There would not be another national bank chartered until 1864.

In the twenty-five years between the establishment of the First and the Second Banks, the number of chartered banks rose from four to over 240. By 1818 the number had increased to 338.[8] This large increase reflected a change in both the interests of the nation and in the nature of banking itself. The relative dearth of banks in the early years reflected the political and economic factors of the times. For example, the agrarian movement represented strong political opposition to the establishment of any bank on the grounds that banks were "old world" in nature —designed to benefit only the established mercantile interests. Economically, the early development of external markets for American goods created the initial demand for American banks. Thus, the first chartered banks were established in the major commercial ports to advance foreign commerce and trade. It was not until the development of domestic markets and internal trade that commercial banks became more prevalent within the United States.

During this time, unincorporated or private banks developed alongside chartered banks as sources of credit. Located primarily in commercial and trading centers, they performed all the functions of commercial banks, including note issuance. However, private banks that specialized in issuing notes were particularly susceptible to economic downturns and suffered a high rate of failure. Most successful private banks did not issue notes and generally avoided the appearance of chartered or incorporated banks. They ran a

compact business with liabilities that were less widely held by the public and assets that turned over faster than those of an incorporated bank. The Banking House of Stephen Girard, founded in 1812 in Philadelphia, and Alexander Brown and Sons, founded in 1800 in Baltimore, are examples of successful private banks of this era.[9]

In an attempt to create a more stable medium of exchange, the states enacted laws to either prohibit or regulate unincorporated banks. Massachusetts, New Hampshire, New Jersey and Maryland were among the states which passed laws prohibiting private banks. Other states, including Rhode Island, Pennsylvania, Ohio and North Carolina, passed laws which prohibited unincorporated banks from issuing notes.[10] These restrictions on unincorporated banks, combined with the profitable nature of banking, increased the demand for state banking charters.

New banks were chartered to meet the demands for money from all sectors of the economy, not just from the wealthy merchant class. As the demand for banks grew, the value of bank charters increased dramatically. As chartering authorities, the states had an advantage over the banks: in exchange for charters, they extracted concessions.

Charters were written in a way that allowed the states to direct bank funds into education, transportation and business development, as well as to provide a low-cost source for long-term state borrowing. In many instances, banks were required to make long-term loans at low interest rates to help finance agricultural, manufacturing and commercial development. Oftentimes they were required to lend to the state at low, fixed interest rates. The state taxes paid by banks on their capital stock and dividends were used to finance education. States also often placed limits on the type of investments available to the bank, restricting investments to the stock of corporations of the chartering state only and to that state's bonds.

Some charters required banks to maintain an ownership position in other companies. For example, some states required banks to purchase stock in transportation companies. Connecticut, in 1825, required the Thames Bank to purchase stock in the Norwich Channel Company, and in 1832, it required the Quinibaug Bank to purchase stock in the Boston, Norwich, and the New London Railway Company.[11] The objectives of such requirements were, of course, the opposite of a separation of banking and commerce.

Often, charters directly combining banking with other businesses were issued. These, too, violated the "separation" principle. For example, insurance and banking were frequently combined. The first bank chartered in Kentucky was also an insurance company, as

was the Pennsylvania Company for Insurance on Lives and Granting Annuities, which later became First Pennsylvania Banking and Trust Company.[12]

In many states, internal improvement banks were chartered for the express purpose of promoting the development of specific industrial enterprises and public goods within the state. These banks created capital for a particular enterprise by issuing purchasing power through bank notes. In some states, banks were required to establish railroads, canals, roads, hotels and public water and light systems. For example, as a precondition for charter renewal in 1813, and again in 1822, Maryland required Baltimore banks to form a turnpike company, buy its stock, and manage it. Between 1832 and 1837, sixteen banking and railroad companies were chartered throughout the South. In Louisiana several banks were established to provide funds for specific private investments. The New Orleans Light and Banking Company installed gas lights, the Commercial Bank of New Orleans constructed a waterworks system in New Orleans, and Louisiana's Exchange and Improvement Banks were required to build hotels in the state.[13]

Another prominent example of the mixing of banking and commerce is the chartering of the Manhattan Company. In 1799, New York State granted a corporate charter to Aaron Burr for the establishment of a company to provide New York City with a safe water supply. Under this charter, Burr was able to establish a bank, The Bank of the Manhattan Company, to finance the water works. The bank developed rapidly to become the largest in the city and the state, and survives today as the Chase Manhattan Bank. The Manhattan Company quickly addressed the water supply problem as well, establishing a new supply within its first year of operation. It continued to sell water throughout most of the 19th century, and maintained the supply after water could no longer be sold.[14]

During this era, banks became the primary source for long- as well as short-term credit in the United States. As previously mentioned, many bank charters required banks to engage in long-term lending to business and government. In general, the extension of long-term credit took several forms. Long-term credit was extended directly in the form of long-term loans. For example, as early as 1792, chartered banks began extending long-term industrial loans to their customers in the form of renewable credits or accomodation paper.[15] Beginning in the 1820s, several states chartered land or real-estate banks as specific sources of long-term credit to agriculture. Their capital was raised from bond issues backed by mortgages on real estate owned by their shareholders. Similar to the early colonial land offices, land banks often combined the functions of offering short- and long-term credit and note issuance based primarily on real-estate mortgages as opposed to real-bills of discount.[16] As the first

investment bankers, commercial banks also extended long-term credit indirectly in the form of "loan contracting services," *i.e.*, subscribing to new issues of securities for the purpose of resale.

Throughout the chartered banking era, the nature of American banking adapted to the changing needs of the nation. The "business of banking" quickly evolved, broadening the role of banks beyond their initial role as suppliers of short-term, self-liquidating loans on real goods as prescribed by the real-bills doctrine. (See Appendix A for more detail on the real-bills doctrine.) Banks offered long- and short-term credit in a variety of forms, and often engaged in other forms of commerce as well. Similarly, the owners of banks mixed banking and commerce during this era. In short, neither the real-bills doctrine nor a strict separation of banking and commerce adequately describes this era in American banking.

Free Banking (1838-1933)

The beginning of the free banking era was marked by the passage of the New York Free Banking Act in 1838. Thought by some to be one of the most significant events in American banking history, the Act was absent of any imitation or influence of European banking traditions that may have been present in early chartered banking.[17] The ideas and language of the New York Free Banking Act subsequently were adopted by other state governments and the federal government.

Under free banking, the "privilege" of banking, once reserved for the few, became accessible to all individuals willing and able to meet minimum capital and regulatory standards set by the state. In return for charters, bankers posted collateral for the notes they issued to the public. State bonds were used as collateral, and they could be sold to reimburse noteholders in the event of a bank failure. Free banking represented a revolution in banking and quickly spread from New York to other states. By 1860, eighteen of thirty-three states had passed free banking legislation.

The free banking era was in part the product of the Bank Panic of 1837, and reflected changing views on how to ensure the safety and soundness of banking. Under early chartered banking, safety and liquidity were sought through the use of monopoly power. Monopoly profits, combined with restrictions limiting banks to self-liquidating assets, were thought to guarantee the safety of notes and therefore of the banks. As the number of banks rapidly grew in the early 19th century, monopoly gave way to increased competition. The guarantee of profit, and therefore safety, was weakened, contributing in part to the bank failures of 1837. Under free banking, competition was combined with state regulation of banks to better ensure safety. At the state level, the system had mixed success, with some states experiencing widespread bank failures.

Consistent with Jacksonian democracy, the change to free banking reflected the popular movement of the times, whereby the destruction of centralization and the promotion of individualism and laissez-faire were emphasized. Thus, monopoly banking was rejected in favor of free banking.

Free banking at the national level began with the National Bank Act of 1864, which was modeled on the successful New York Free Banking Act of 1838. This established a distinctively American system of banking. Congress designed the Act to achieve several federal objectives, including the establishment of a national currency, and the creation of a market for federal bonds to finance the Civil War. In particular, Section 8 of the 1864 National Bank Act enumerated the powers granted to national banks. Among these, banks may exercise "all such incidental powers as shall be necessary to carry on the business of banking . . ." Interpretation of the meaning of this clause and specifically the term "business of banking" continues to be a central issue in the ongoing transformation of the practical definition of and powers accorded to a national bank.

As they had throughout the chartered banking era, banks continued to extend short- and long-term credit, including the provision of investment banking services. The credit needs of business and government were provided through the direct extension of credit (loans) and indirectly through the purchase of debt obligations. Long-term loans or accommodation paper were a significant portion of the credit extended. This was noted by a British writer, commenting in 1837 on the difference between American and English banking:

> Their rule is our exception, our rule is their exception. They [the Americans] prefer accommodation paper, resting on personal security and fixed wealth, to real bills of exchange, resting on wealth in transition from merchants and manufacturers to consumers.[18]

By 1914, approximately two-thirds of commercial bank lending took the form of long-term funding.[19]

Commercial banks were the original investment bankers in America, providing "loan contracting" services before a market in the resale of securities developed. This was due in part to the involvement of commercial banks in long-term lending and the dependence of governments (state and federal) on these banks for the successful marketing of their debt obligations. The Second Bank of the United States, for example, actively engaged in the purchase and resale of new security issues. (Following the Second Bank's demise, its president, Nicholas Biddle, went on to become one of the first private investment bankers in America.) Commercial banks continued to enter the business of investment banking, and all New York City banks and most Philadelphia banks were so engaged by the beginning of the free banking era.

It was not until the depression of the early 1840s that unincorporated private banks began to enter investment banking. During the two decades preceding the Civil War, private bankers played a growing role in the industry, eventually dominating it in the latter part of the nineteenth century. Nevertheless, commercial banks continued to offer investment banking services in competition with the private firms. It was the federal government's immense financing needs during the Civil War that increased commercial banks' involvement in investment banking; their role continued to grow throughout the period.

The last three decades of the free banking era were characterized by a movement toward "department store" or comprehensive finance. Commercial banks competed with insurance and newly formed trust companies to provide customers with a range of financial services including deposits, credit, fiduciary, investment and insurance services. However, as providers of comprehensive finance, banks in general, and national banks in particular, were at a competitive disadvantage. The investment banking, trust and insurance powers of national banks were limited by the National Bank Act and rulings of the Office of the Comptroller of the Currency (OCC).

Through a 1902 ruling, which reflected the growing controversy over the corporate powers of national banks, the OCC severely limited the ability of national banks to engage directly in securities underwriting. As a result, national banks moved their investment banking business out of their bond departments and into newly organized security affiliates, which were chartered under the general business corporation laws of the states, and were owned and controlled by the stockholders of the national banks.[20]

Because security affiliates were not restricted by the limitations of the National Bank Act, they could engage in activities which were prohibited or which were determined by the courts to be beyond the banks' powers. Increased emphasis was placed on the investment banking activities of security affiliates toward the end of the free banking era (particularly the years 1916 through 1930). This reflected the decline in demand for short-term commercial loans and the rapid growth in the securities market, as well as banks' participation in the marketing of government obligations during World War I.[21]

In addition to security affiliates, realty companies, safe deposit companies, mortgage companies and insurance agencies were among the affiliates of national banks. The use of affiliates provided a successful way to avoid the limitations placed on commercial banks by the National Bank Act. These affiliates were controlled by the stockholders of the bank through various means. Common ownership of the controlling stock in both the bank and its affiliates was

one frequently used method. In the last half of the 1920s, however, the use of the holding company device became increasingly popular. The bank holding company provided the means for the continued mixing of banking and commerce, with the holding companies often owning controlling interests in commercial banks and other financial institutions as well as other business corporations.

An excellent example of the use of the holding company device during this era is the Transamerica Corporation. At the height of its influence, the Transamerica Corporation held 100 percent ownership of many different holding companies. In 1930, these included holding companies for: bank stocks, stocks of securities corporations, general investments of stock exchange securities, foreign holdings and investments, permanent commercial and industrial investments, stocks of joint stock land banks, stocks of insurance companies, and stocks of mortgage companies. The holding companies, in turn, held subsidiaries which included The Bank of Italy, The Bank of America N.A., The Bank of America of California, Occidental Life Insurance Company, Pacific National Fire Insurance Company, and Consolidated Foundries. Also included were other companies of both a financial and commercial nature.[22] The holding company structure clearly allowed Transamerica to engage in a wide variety of activities, effectively mixing banking and commerce.

The validity of national bank participation in investment banking, which was questioned by the 1902 Comptroller's ruling, was addressed by Congress in the 1927 McFadden Act. This Act reaffirmed the right of national banks to engage directly in underwriting securities. It also reaffirmed the right of national banks to affiliate with state-chartered corporations that engaged in investment banking and gave the Comptroller of the Currency the right to determine which securities could be underwritten directly by the bank and/or their security affiliates. As a result, the Comptroller ruled that national banks could directly underwrite all debt securities and their security affiliates could underwrite both debt and equity securities. By the end of the 1920s,

> . . . commercial banks and their security affiliates occupied a position in the field of long-term financing equal to that of private investment bankers, both from the standpoint of investment banking machinery and from the standpoint of the volume of securities underwritten and distributed by the two groups of institutions.[23]

The free banking era also saw the creation of the Federal Reserve System in 1913. Up to that time, the responsibility of maintaining reserves and liquidity was left to the individual banks. On occasion, banks collectively suspended the convertibility of deposits into currency or specie on demand, in order to halt the spread of failures during bank panics. Such a suspension occurred during the bank panic of 1893, and again in late 1907. Following the 1907 bank

panic, banks lobbied for the creation of a bankers' bank to serve as a lender of last resort. In 1908, the National Monetary Commission was created to study the matter. In response to the Commission's report, Congress passed the Federal Reserve Act. Among the goals of the Act was the provision of stability in the banking system. Through the use of its discount window, the Federal Reserve was expected to ensure that solvent, but temporarily illiquid, banks could obtain funds, and therefore survive a banking crisis.

Regulated Banking (1933-present)

Early Federal Reserve policy did not succeed in preventing massive bank failures. With the Great Depression came the end of a century of free banking and the beginning of what is referred to here as the period of regulated banking. By and large, commercial banks, particularly those with security affiliates, were held accountable for the economic events of the times: the stock market crash, the collapse of the banking system (with 15,000 bank failures during the 1920s and early 1930s) and the Great Depression itself. Abuses of the operations of commercial banks' security affiliates were cited as the primary cause of these events.

The reforms enacted by Congress were an attempt to ensure the safety and stability of the banking system. It was assumed that the overall stability of the system required a guarantee of safety for each and every bank, and steps were taken to ensure bank profitability. For the first time since the chartered banking era, laws were passed to restrict competition. To this end, bank product, price and geographic restrictions were established. These included limits on branching, "needs" tests as criteria for obtaining new charters, and prohibitions against the offering of transactions (demand deposit) accounts by any but commercial banks. Competition within the banking system also was restricted through the establishment of interest-rate ceilings and deposit insurance. The competition among banks for funds was limited, as each insured bank was now effectively as safe as any other insured bank.

Through New Deal legislation, Congress segmented the financial-services industry and, in effect, created a cartel among the surviving banks. The partial segmentation of commercial and investment banking was achieved through sections of The Banking Act of 1933, known as the Glass-Steagall Act. An in-depth analysis of this Act is the subject of the next chapter of this study. The 1933 Banking Act also created the Federal Deposit Insurance Corporation to ensure safety for individual depositors and stability for the banking system. In other reform legislation, the Securities and Exchange Commission was created to oversee the securities industry, and the Federal Reserve Board, as the nation's central bank, was granted additional powers. These included tools to control credit, *e.g.*, the power to vary

reserve requirements and to grant credit to member banks based on all of a bank's assets, not just on its "real bills."

The separation of banking and commerce initiated by passage of the Glass-Steagall Act was extended to restrictions on the activities of corporate owners of banks through the 1956 Bank Holding Company Act and its 1966 and 1970 Amendments. Although concern had been expressed as early as 1927 over the growth of "group banking" organizations, which later became known as bank holding companies, the 1933 Banking Act imposed minimal restrictions on their activities. After extensive hearings in 1930 covering branch, chain and group banking, Congress rejected attempts to abolish or severely curtail the activities of bank holding companies and, instead, introduced some control over the conditions under which bank stock could be owned and the privileges of ownership exercised. Specifically, holding companies were prohibited from voting their stock in member banks unless they agreed: to be examined by the Federal Reserve Board, to establish a reserve fund, and to cease engaging in underwriting and dealing in securities.

The Banking Act of 1933 left open a number of avenues through which bank holding companies could avoid regulation, continue to expand and to acquire additional nonbank affiliates. At the time, Congress was concerned with the extent to which it could legally exercise control over state-chartered corporations, especially in the face of evidence that bank holding companies played a positive role in the banking industry.[24] In fact, many bank holding companies were formed to provide diversification and management expertise to member banks, with the result that they were better able to avoid failure during the 1930s.[25]

Concerns over expansion by bank holding companies in the late 1940s led to the eventual passage of the Bank Holding Company Act of 1956. Essentially, that Act imposed limitations on the expansion of multibank holding companies by requiring Federal Reserve Board approval for new acquisitions, and by the "Douglas Amendment" which prohibited interstate bank acquisitions by holding companies. The 1956 Act also restricted the permissible activities of multibank holding companies to: banking, controlling banks, or owning shares of companies whose activities "are so closely related to banking as to be a proper incident thereto." Multibank holding companies were required to divest themselves of interest in companies that did not pass the Federal Reserve Board's interpretation of activities permitted under the "closely related to" exemption.

While the Bank Holding Company Act had the intended effect of separating banking and nonbanking activities and of bringing bank holding companies under federal regulation, the primary purpose underlying its passage was fear of monopolistic control in the banking industry. Federal regulators and independent bankers

lobbied Congress for over twenty years to pass more restrictive bank holding company legislation, but it wasn't until the Transamerica case was lost by the Federal Reserve Board that legislation was approved.

The complaint against Transamerica, then the largest U.S. bank holding company, was initiated in 1948. At that time, Transamerica controlled 46 banks, in addition to owning a large percentage of Bank of America. The Federal Reserve Board charged that Transamerica was in violation of the Clayton Antitrust Act by monopolizing commercial banking in the states of California, Oregon, Nevada, Washington and Arizona. In 1952, the Board ordered Transamerica to divest itself of all its bank stock, except for Bank of America, within two years. In setting aside the Board's decision in 1953, the Court of Appeals acknowledged that the Transamerica group controlled a substantial concentration of banking capital which might very well be against sound public policy. Under the Clayton Act, however, "the Board failed to demonstrate that Transamerica's acquisitions substantially lessened competition among the acquired banks."[26] Thus, the need to control expansion is often cited as the primary cause of bank holding company regulation.

During the numerous hearings on bank holding company legislation, supporters of stricter regulation pointed to the potential for abuse when banking and commercial enterprises are controlled by the same owners; but, in fact, little evidence of abuse threatening the safety and soundness of banks surfaced during the half century of unregulated bank holding company existence. The real concerns appear to have been that bank holding companies were perceived as a threat to the existence of small unit banks and were being used to circumvent federal and state restrictions on branching and interstate operations. The separation between banking and nonbanking enterprises was seen as a way to prevent undue concentrations of economic resources, with the added benefit of preventing possible conflict-of-interest abuses or harmful tie-ins. Had the true motivation for the Bank Holding Company Act of 1956 been the separation issue, it is doubtful that one-bank holding companies would have been excluded from the Act.

Amendments made to the Bank Holding Company Act in 1966 provide further evidence that the true purpose of the Act was to control expansion by, more so than the activities of, bank holding companies. First, exemptions for religious, charitable and educational institutions, as well as investment companies registered under the Investment Company Act, were removed. These exemptions had allowed a number of organizations to escape coverage under the original act, most notably Financial General Corporation and the Alfred I. duPont estate. Second, Section 6 of the original Act, intended to prevent unsafe and unsound dealings within the bank

holding company structure, was repealed. This provision had had the unintended effect of prohibiting most normal banking transactions between subsidiary banks! In its place, Section 23A of the Federal Reserve Act was applied to transactions within bank holding companies. Finally, the standards used by the Board in evaluating applications by bank holding companies were changed to incorporate the antitrust standards of the Sherman and Clayton Acts. The one-bank holding company exemption was retained despite strong pleas by the Federal Reserve Board. The prevailing feeling in Congress in 1965 was that conglomerate expansion problems were large scale in nature and most one-bank holding companies were believed to be small in size.[27]

Congressional attitudes changed drastically over the course of the next three years due to a dramatic upsurge in the formation of one-bank holding companies by many of the nation's largest banks. These were not viewed as traditional one-bank holding companies and, indeed, many were formed for the purpose of participating in activities not permissible to the bank itself. Fear of widespread abuse and unregulated growth led Congress to pass the 1970 Amendments to the Bank Holding Company Act. The major feature of this legislation was to bring one-bank holding companies under federal regulation, even though:

> In making this decision, the committee wishes to note agreement with all of the Government regulatory agencies who testified that there have been no major abuses effectuated through the one-bank holding company device. It is clearly understood that the legislation is to prevent possible future problems rather than to solve existing ones.[28]

A limited "grandfather" clause was inserted in the legislation to allow some existing one-bank holding companies to continue engaging in ongoing activities.

The 1970 Amendments also added a second "test" for the Board of Governors to use in evaluating applications by bank holding companies seeking to expand into nonbanking activities. In addition to being "closely related to" banking, a permissible activity must also be expected to produce positive benefits to the public which outweigh any possible negative effects. The Board also was authorized to act by "order or regulation" in determining which activities are permissible for bank holding companies. As a result of this authority and further legislation in the Garn-St Germain Depository Institutions Act of 1982, bank holding companies or their subsidiaries are permitted to engage in some limited forms of nonbanking activities which, nevertheless, remain "closely related to" banking.

The 1970 Amendments also modified the definition of "bank" to include those institutions that both accept demand deposits and extend commercial loans. Under this definition, a new avenue for avoiding the spirit of the Bank Holding Company Act was created.

By either extending commercial loans or accepting deposits, but not engaging in both activities, institutions currently referred to as "nonbank banks" can effectively carry out most of a bank's principal activities without coming under the restrictions and regulations of the Bank Holding Company Act, including the geographic limitations imposed by the Douglas Amendment.

Nonbank banks became increasingly popular in the early 1980s, with applications for about 400 charters submitted to the Comptroller of the Currency by late 1986. Nonbank banks have become increasingly controversial as well. The Competitive Equality Banking Act of 1987 changed the definition of a bank to an institution that has FDIC insurance or accepts deposits and engages in the business of making commercial loans. By extending the definition of a bank to all FDIC-insured institutions, Congress effectively eliminated the nonbank-bank loophole.

FOOTNOTES

[1]Melanie L. Fein and M. Michele Faber, "The Separation of Banking and Commerce in American Banking History," Appendix A to Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Commerce, Consumer and Monetary Affairs of the Committee on Government Operations of the United States House of Representatives, June 11, 1986, p. A-1.

[2]Thomas F. Huertas, "The Union of Banking and Commerce in American Banking History," Appendix B to Statement of Hans H. Angermueller, Vice Chairman Citicorp/Citibank before the Commerce, Consumer and Monetary Affairs Subcommittee of the Committee on Government Operations of the United States House of Representatives, December 17, 1986, p. B-4.

[3]Ibid., p. B-25.

[4]Ibid., pp. B-25, B-27-28.

[5]Bray Hammond, "Free Banks and Corporations," *Journal of Political Economy* XLIV:185. Throughout American history, the corporate entity has been viewed in changing ways. The corporation was initially identical with monopoly privilege, but, by the early 19th century, became synonymous with free enterprise and laissez-faire. However, by the early twentieth century, the corporation was again associated with monopoly. Hammond points out that the later association with monopoly was "the product of economic forces, whereas the old was a matter of law. "

[6]Hammond, *Banks and Politics*, pp. 65, 77. Hammond's book has been a primary source for this section.

[7]Ibid., p. 115.

[8]Ibid., p. 146.

[9]Ibid., p. 193.

[10]Joseph Van Fenstermaker, "Development of American Commercial Banking: 1782-1837" (Ph.D. dissertation, University of Illinois, 1963), pp. 37-38.

[11]Ibid., p. 29.

[12]Hammond, *Banks and Politics*, p. 143.

[13]Ibid., pp. 29-31.

[14]Ibid., pp. 153-54.

[15]Edward L. Symons, Jr., "The 'Business of Banking' in Historical Perspective," *The George Washington Law Review* 51 (August 1983):686.

[16]Fritz Redlich, *The Molding of American Banking: Men and Ideas* (New York: Hafner Publishing Co., Inc., 1951), p. 9, and Van Fenstermaker, pp. 40-42.

[17]Hammond, "Free Banks," p. 184.

[18]Redlich, p. 47.

[19]Golembe Associates, *Commercial Banking and the Glass-Steagall Act* (Washington, DC: American Bankers Association, 1982), p. 28.

[20]Ibid., p. 35

[21]W. Nelson Peach, *The Security Affiliates of National Banks* (Baltimore, MD: The Johns Hopkins Press, 1941; reprint ed., New York: Arno Press, 1975). This is an excellent source for information on the securities affiliates of commercial banks, and much of the following material is derived from Peach.

[22]James C. Bonbright and Gardiner C. Means, *The Holding Company: Its Public Significance and its Regulation* (New York: McGraw-Hill Book Co., Inc., 1932), pp. 333-335.

[23]Peach, p. 20.

[24]Roy T. Englert, "The Development of Bank Holding Company Legislation," *The Bankers Magazine* 153 (Autumn 1970):22.

[25]U.S., Congress, House, *Formation and Powers of National Banking Associations —a Legal Primer*, by Raymond Natter, Committee Print 98-4 (Washington, DC: Government Printing Office, 1983), p. 5-6.

[26]Ibid., p. 5-11.

[27]Sidney Martin Sussan, *An Evaluation of the Nonbanking Expansion of Bank Holding Companies Under the 1970 Amendments to the Bank Holding Company Act of 1956, as Amended* (Ann Arbor, MI: University Microfilms International, 1312338, 1978), p. 30.

[28]U.S., Congress, Senate, Committee on Banking and Currency, *Bank Holding Company Act Amendments of 1970*, Report No. 91-1084 (Washington, DC: Government Printing Office, 1970), p. 4.

Chapter 4

The Glass-Steagall Act

Introduction

The debate over the separation of banking and commerce has been waged largely, but not solely, in terms of the separation of banking and the securities business. This chapter deals with that important aspect of the debate.

The Banking Act of 1933 called for the creation of the Federal Deposit Insurance Corporation and the separation of commercial banking from certain investment banking activities. The portion of the bill that separated commercial and investment banking is commonly referred to as "the Glass-Steagall Act" (the "Act"). The relevant provisions are contained in Sections 20, 16, 21 and 32.

Commercial banks that are members of the Federal Reserve System are prohibited from having securities affiliates by Section 20, which states that no member bank shall be affiliated "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 16 of the Act places restrictions on the banks themselves, providing that the "business of dealing in securities and stock [by a national bank] 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 [national bank] shall not underwrite any issue of securities or stock." This prohibition contains several important exceptions, most notably for obligations of the United States and "general obligations of any State or of any political subdivision thereof." The same limitations are extended to state-chartered banks that are members of the Federal Reserve System.

Section 21 of the Act prohibits any "person, firm, corporation, association, business trust or other similar organization" from engaging in the securities business while receiving deposits "to any extent whatever." Although this restriction extends the effective reach of the securities prohibition to insured nonmember banks, it

does not prohibit subsidiaries or affiliates of insured nonmember banks from engaging in securities activities.[1]

Section 32 prohibits any officer, director or employee or partner of any organization engaged primarily in the underwriting of securities, or any individual so engaged, from serving simultaneously as an officer, director, or employee of any member bank, subject to such limited exceptions as may be permitted by the Federal Reserve Board.

These four provisions effectively preclude commercial banks and affiliates of Federal Reserve member commercial banks from underwriting or dealing in corporate securities within the United States. However, the Glass-Steagall Act permits commercial banks to engage in a wide variety of securities activities, either directly or through affiliates. These activities include, but are not restricted to: aiding in the private placement of corporate securities, holding corporate securities for their own accounts, acting as agents for customers in purchasing and selling securities, underwriting and dealing in general obligation municipal securities as well as certain types of municipal revenue bonds, engaging in trust activities, and underwriting and dealing in corporate securities overseas. Thus, it should be kept in mind that there has never been a complete "separation" of commercial and investment banking.

Reasons for Enactment

Three major reasons have been advanced to explain (or justify) the Glass-Steagall Act. First and foremost, it would help protect and maintain the financial stability of the commercial banking system, and would strengthen public confidence in commercial banks. Second, it would eliminate the potential for conflicts of interest that could arise from the performance of both commercial and investment banking operations by the same party or parties. Finally, the assumed potential for bank securities operations to exaggerate financial and business fluctuations and undermine the economic stability of the country by channeling bank deposits into "speculative" securities activities would be eliminated.

The specific provisions of the Act were the result of many contributing factors, including: economic conditions, the 1929 stock market crash, the collapse of the commercial banking system, the banking theory views held by Senator Carter Glass, and revelations concerning abuses by individuals in the banking industry.

Economic Conditions, the Stock Market Crash and the Collapse of the Banking System

The atmosphere that existed in the early 1930s required drastic actions. There is no easier time for Congress to pass legislation than

during a crisis and there has never been an economic crisis in the U.S. like the Great Depression. The U.S. net national product fell by more than one-half between 1929 and 1933.[2] More than one-fifth of the commercial banks in the United States, holding nearly one-tenth of the volume of deposits at the beginning of the contraction, suspended operations because of financial difficulties.[3] Altogether, the number of commercial banks declined by about one-third.

There have been several competing views as to the primary cause of the country's economic collapse. Keynesian economists generally attribute the inadequate demand for goods and services to a decline in investment expenditure. Monetarists are more likely to blame a decline in the money supply as the primary factor leading to inadequate demand. Friedman and Schwartz, for example, argue that monetary restraint by the Federal Reserve induced a recession in 1929, which, combined with the collapse of the banking system, led to a much larger drop in the money supply and a further deterioration in economic conditions.[4] Excessive stock speculation by the public is also thought to have been a contributing factor. Regardless of which of these views one favors, there is little evidence that would suggest that the mixing of commercial and investment banking was the source of the problem.

The country's banking problems began in the 1920s. There were a large number of small, poorly capitalized banks located in the Midwest that were dependent upon agricultural markets, which collapsed during the 1920s. The combination of widespread small-bank failures and the subsequent collapse of the larger Bank of United States due to fraud and insider abuse helped trigger a loss of depositor confidence in the banking system. The bank failures of the 1930s were largely due to runs that resulted from this loss of depositor confidence.

Students of the collapse of the banking system have not found that banks failed due to losses on poor-quality securities underwritten by bank affiliates.[5] Many banks did suffer losses on their securities portfolios but this was because they were illiquid and in the face of massive withdrawals were forced to sell their assets at deep discounts. Thus, it could be argued that bank security holdings contributed to a liquidity problem, but unless a bank is holding only cash almost any other asset will not be sufficiently liquid in the face of a run on deposits and no backup source of liquidity. Because the banking problems were due to a loss of public confidence in the banking system, the existence of federal deposit insurance and an effective lender of last resort would have helped control bank failures far more effectively than prohibiting commercial banks from underwriting and dealing in corporate securities.

In sum, it appears that more appropriate fiscal policy (*i.e.*, not raising taxes to balance the budget) and monetary policy (*i.e.*,

significantly increasing the money supply by providing liquidity support to troubled banks) could have greatly aided economic and banking conditions, and that subsequent reforms other than the Glass-Steagall separation of commercial and investment banking (*e.g.*, federal deposit insurance and a strengthened Federal Reserve) are more responsible for preventing a recurrence of these problems.

Senator Carter Glass

To further understand the reasons leading to the passage of the Glass-Steagall Act, it is worth examining the views of the legislation's principal architect, Senator Carter Glass of Virginia. Glass was formerly Secretary of the Treasury and an important force on the Senate Banking and Currency Committee. As a member of the House, he co-authored the 1913 Federal Reserve Act. He strongly believed that commercial banking should be entirely separate from investment banking (although this position was later reversed in 1935.) Glass was an ardent supporter of the real-bills doctrine. He believed the proper functions of commercial banks were the collection of deposits and the provision of short-term credit, while it was the role of investment banks to provide long-term credit through debt and equity issues. The leading academic proponent of the real-bills doctrine during the 1920s and '30s was H. Parker Willis, who served as Glass' principal economic advisor. However, the real-bills doctrine, although influential, was never the basis for U.S. banking policy. As far back as Colonial times, American banks have invested heavily in long-term assets. Glass viewed England's banking system as the ideal model for reform. However, he may have had a mistaken impression of how England's financial system actually operated since even there a strict separation of functions as described above was not adhered to.[6]

During the 1920s, Glass became increasingly concerned that too much money was being drawn into speculation in the stock market and too little was left for other, more productive purposes. He unsuccessfully advocated a separation of commercial and investment banking during this period. Even in the early 1930s, Glass was unable to gain legislative support for his bills and none were passed. By 1933, however, momentum had grown for some action. The Pecora hearings highlighted the abuses associated with securities activities; the banking panic led President Roosevelt to declare a banking holiday in March; and some bankers began to support a separation of commercial and investment banking.[7] When Glass' proposal was added to Rep. Henry B. Steagall's proposal for a federal deposit insurance system, passage of his bill became assured.

In retrospect, it is apparent that the leading proponent of a separation between commercial and investment banking based his arguments on a view of the proper role of banking that has always

been questioned and certainly was never adhered to in this country. One does not hear much of the real-bills doctrine today, in part because the doctrine is fundamentally incorrect. Additionally, our financial system has little resemblance to a world in which commercial banks provide only short-term credit while investment banks only satisfy businesses' medium- and long-term credit needs.

The major argument in favor of the real-bills doctrine was that it would force banks to remain almost totally liquid. In a world without a lender of last resort and federal deposit insurance, a highly liquid bank would have a better chance to remain solvent during economic downturns (which often led to a loss of depositor confidence and bank runs). But even short-term loans are illiquid in a financial collapse. Moreover, since we now have a more effective lender of last resort and federal deposit insurance, there is no need to require banks to be prepared for the worst.

Abuses Connected with the Operation of Security Affiliates by Commercial Banks[8]

Information concerning the principal abuses that arose during the 1920-30s in connection with the investment banking activities of commercial bank affiliates is largely limited to the extensive Senate investigation, which included the highly publicized Pecora hearings into stock exchange practices. A substantial portion of these hearings dealt with the activities of the securities affiliates (National City Company and Chase Securities Corporation) of the country's two largest commercial banks (National City Bank and Chase National Bank).[9]

The actual abuses that were revealed during the Senate investigation can be divided into three general categories. First, there were abuses that were common to the entire investment banking industry. Second, there were abuses attributable to the use of affiliates for the personal profit of bank officers and directors. The third class of abuses involved conflicts of interest resulting from the mixing of commercial and investment banking functions. In the following three subsections the primary types of abuses relevant to each of these categories are discussed, with comments directed toward examining the degree to which the Glass-Steagall Act constitutes an effective or desirable solution.

Abuses Common to the Investment Banking Business. Three principal types of abuses common to the investment banking business during the 1920-30s were:

1. Underwriting and distributing unsound and speculative securities.

2. Conveying untruthful or misleading information in the prospectuses accompanying new issues.

3. Manipulating the market for certain stocks and bonds while they were being issued.

Examples of the first two types of abuses presented during the Pecora hearings are found by examining National City Company's involvement in the financial operations of the Republic of Peru.[10] Throughout the 1920s, National City Company received reports that Peru was politically unstable, had a bad debt record, suffered from a depleted Treasury and was, in short, an extremely poor credit risk. Nevertheless, in 1927 and 1928, National City Company participated in the underwriting of three bond issues by the government of Peru. The prospectuses distributed in connection with these issues made no mention of Peru's political and economic difficulties. As a result, the public purchased all $90 million of the bonds, which went into default in 1931 and sold for less than 5 percent of their face value in 1933.[11] While this may be one of the more flagrant of the examples of these types of abuses, it was generally acknowledged that the extremely competitive banking environment of the 1920s led bankers to encourage borrowing, particularly by governments and political subdivisions in Europe and South America.

Oftentimes, questionable practices were employed by the affiliates of commercial and investment banks alike to induce the public to purchase security issues. In addition to falsifying or withholding pertinent information, securities affiliates were alleged to have, on occasion, propped up the price of securities while they were in the process of being sold.[12] It was disclosed to the Senate Banking and Currency Committee in 1932 that, throughout the 1920s, pool and market operators had used various publicity techniques to push stocks on unsuspecting investors. For example, newspapermen and radio announcers had been paid to publicly promote the sale of certain stocks.[13] The reputation of investment bankers also was sullied when it was revealed that established investment banking houses had abused the trust and interests of their investors.[14]

A large portion of the abuses of all types uncovered during Congressional hearings were common to the entire investment banking industry. Since these problems were not directly related to the relationship between banks and their affiliates, the Glass-Steagall Act was not the proper solution for them and could not be expected to eliminate them. The passage of the Federal Securities Act of 1933 and the Securities Exchange Act of 1934, which among other things hold individuals involved in the issuance of securities responsible for any misstatement of facts or failure to reveal pertinent information concerning the financial condition of issuing governments and corporations, were much more appropriate remedies for these types of abuses. A primary function of the Securities and Exchange Commission is to prevent any manipulation of the market while a security is being issued.

Self-dealing by Bank Officers and Directors. Affiliates of banks not only attempted to manipulate the stock and bond prices of other business and governmental entities, they also attempted to manipulate the stock prices of their parent banks. Under the procedure generally employed, the securities affiliate organized investment pools which traded in the stock of the bank. While the pools were financed primarily by the securities affiliate(s), they were generally open to selected individual participants, including bank officers and directors. Bank officials claimed that the purposes of such trading accounts were to steady the market in order to maintain public confidence in the bank and to encourage increased distribution of the bank's stock. However, it is likely that many of the participants expected to benefit from their inside information and gain large profits from their trading activity.[15] A second reason for trading in a bank's stock may have been that advancing the stock's price made it more attractive to the stockholders of other banks which were absorbed on an exchange-of-stock basis.

In addition to the profits obtained by trading in their own bank's stock, bank officers and directors often received compensation through affiliates that was far in excess of that paid to them by their banks. For example, instead of permitting the stock of affiliates to be owned by bank stockholders, the stock was often wholly owned by officers and directors of the bank. In some cases, management funds were created from which bank officials received, in addition to their regular salaries, a percentage of the annual earnings of the bank and its affiliates.

The types of abuses discussed above were the sparks that ignited the public's outrage against commercial banks and their investment banking affiliates. The failure of the Bank of United States, in December 1930, contributed to the public perception that bank securities activities were leading to bank failures. The collapse of the Bank of United States, with over $200 million in deposits, was the largest bank failure in history at that time. Not only did the bank's failure greatly damage public confidence, in part since many mistakenly assumed that its name connoted it had some special status, but the bank had affiliates that were used by bank officers for their own benefit. In retrospect, it appears that the affiliates of the Bank of United States were involved in the securities business only to the extent that they were used to trade in the bank's stock and engage in other forms of self-dealing.[16] Nevertheless, although the Bank of United States' failure was due primarily to fraud and insider abuse, the perception grew that the banking system as a whole was vulnerable due to improper relationships between banks and their affiliates.

Clearly, there would have been less drastic ways to prevent such self-dealing and insider abuse than prohibiting the entire commer-

cial banking industry from engaging in securities activities altogether. For example, trading accounts in the stock of parent banks by affiliates and the participation in such trading by bank officials could have been prevented by making it illegal for affiliates to deal in or own the stock of parent banks. Moreover, bank officials could have been prevented from participating as individuals in any business conducted by affiliates. The establishment of management funds would seem to be a problem mainly of concern to stockholders. With adequate disclosure of the salaries and bonuses distributed through such funds, stockholders could have determined whether they were excessive. Affiliates owned entirely by bank officers and directors instead of by bank stockholders also could have been prohibited. Solutions along these lines would have been more direct than the Glass-Steagall restrictions in addressing the self-dealing and insider-abuse problems discussed in this subsection.

Abuses from Mixing Commercial and Investment Banking. A number of abuses occurred due to the mixing of commercial and investment banking functions. Most of these relate to conflict-of-interest concerns, and while they have implications for bank safety and soundness, as previously mentioned, there is no evidence that a large number of bank failures were due to interactions between banks and their affiliates. The types of abuses revealed during Senate testimony include:

1. Using a bank's affiliate as a dumping ground for bad bank loans. An example highlighted during the Pecora hearings: National City Bank transferred to National City Company $25 million worth of loans to Cuban sugar producers after the price of sugar collapsed by about 90 percent and the borrowers were unable to repay the loans.[17]

2. Using a bank or its trust department as a receptacle for securities the affiliate could not sell. Examples where Chase National Bank bailed out its affiliates were revealed during the Senate investigation.

3. Lending to finance the purchase of securities underwritten by an affiliate. This could be another means whereby the affiliate's problems are transferred to the bank. That is, if the affiliate found it difficult to sell a particular issue, the bank might choose to offer loans to prospective purchasers under conditions disadvantageous to bank stockholders.

4. Excessive lending to affiliates to finance underwritings. This may lead to inadequate bank-asset diversification, the significance of which would depend upon the quality of the underwritings.

5. Overinvesting in long-term securities. This caused liquidity problems which contributed to a number of bank failures during the late 1920s.

6. Purchasing part of a poorly performing security after it had been issued, which would lower the quality of a bank's assets. The reason for such action would be that a bank was concerned with its image if a security its affiliate had underwritten or distributed began to lose value.

7. Lending to a corporation that might otherwise default on an issue underwritten by the bank's securities affiliate. Again, this could occur if a bank became concerned that its image would be severely damaged in the event a corporation defaulted on an issue the bank's affiliate had underwritten or distributed.

These and other potential conflicts of interest between banks and their affiliates, and possible remedies for them, are discussed more thoroughly in Chapter 5. Several observations can be made here, however. Most importantly, it should be noted that the potential for conflict-of-interest abuse is not confined to relationships between commercial and investment banking activities. Conflicts of interest exist among traditional commercial bank activities (*e.g.*, the relationship between a bank and its trust department), among different types of activities conducted by securities firms (*e.g.*, a firm's role as impartial investment advisor versus its role as a promoter of investment products), and among activities conducted by other types of financial as well as commercial enterprises. Automobile dealers with service departments are in a position to misinform and frighten customers about the condition of their (old) cars and the advisability of buying new ones. Real-estate brokers face the problem of conflict between the interests of sellers whom they represent and their own interests in making deals, and thereby commissions. Surgeons, dentists, military commanders and store clerks all face potential conflicts of interest. In all of these cases we have managed to make the conflict manageable without prohibiting combinations of activities. The methods include disclosure and punishment of false statements, among others.

The fact that a potential for abuse exists does not necessarily require that a firm be prohibited from conducting a certain activity. A more reasonable approach is to institute controls that would bring the level of abuse within acceptable boundaries, while at the same time limiting additional disruptions or costs to the marketplace and customers. Prohibiting an entire industry from engaging in certain activities should only be viewed as a last resort for situations in which the level of abuse is intolerably high despite the imposition of less drastic control mechanisms. Congress made no attempt in the 1930s to test the effect of regulation and supervision before mandating an outright prohibition.

In each of the situations outlined above, it would appear that less disruptive regulatory or legislative measures could have been enacted that would have subsequently controlled the problem. For

example, excessive lending to an affiliate or overinvesting in long-term securities could have been prohibited by placing limits, as a percentage of bank capital or assets, on transactions between banks and their affiliates. In fact, Section 23A of the Federal Reserve Act, which does just that, was put into place in 1933. Sections 23A and 23B of the Federal Reserve Act also have prohibitions against transactions that are detrimental to the bank.

Summary and Conclusions

In the 1930s, the general view in Congress was that mixing commercial and investment banking threatened the safety and soundness of the banking system, created serious conflict-of-interest situations and led to economic instability due do the channeling of bank deposits into "speculative" securities activities. To alleviate those concerns the Glass-Steagall Act was enacted. It appears that, to the extent these concerns were valid, they could have been handled through less disruptive means.

Scholars have studied the record with great care since 1933. There is little or no evidence that the investment banking activities of commercial bank affiliates were a major cause of bank failures. To the extent that securities investments were a factor in bank failures, it was because of liquidity problems rather than credit-quality concerns. It is hard to imagine banks not having liquidity problems in the face of massive bank runs and no backup liquidity support, regardless of the types of earning assets in their portfolios.

Most of the abuses that arose during the 1920s in connection with the operation of security affiliates by commercial banks appear to have reflected conflicts of interest pertaining to dealings with outside parties rather than transactions or other dealings with affiliates that threatened the safety and soundness of commercial banks. These problems could have been remedied without having to resort to a forced separation of commercial and investment banking.

Finally, whether or not the objective was valid, the provision of the 1934 Securities Exchange Act that authorized the Federal Reserve Board to regulate the extension of credit for the purchase of securities provided a means to effectively control the speculative use of bank assets in the securities markets.

In conclusion, until the 1930s, the securities affiliates of banks were not regulated, examined, or in any way restricted in the activities in which they could participate. Not surprisingly, abuses occurred. A certain degree of supervision and regulation and some restrictions on affiliate powers would have contributed significantly toward eliminating the types of abuses that occurred during this period.

FOOTNOTES

[1]*ICI* v. *FDIC*, 815 F.2d 1540 (D.C. Cir. 1987), *petition for cert. filed*, 56 U.S.L.W. 3010 (U.S., July 6, 1987) (No. 87-36). *See also Board of Governors* v. *ICI*, 450 U.S. 46, 58 n. 24 (1981).

[2]Milton Friedman and Anna Jacobson Schwartz, *The Great Contraction 1929-1933* (Princeton, NJ: Princeton University Press, 1963), p. 3.

[3]Ibid.

[4]Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton, NJ: Princeton University Press, 1963), pp. 357-59.

[5]Ibid., pp. 354-55; William F. Upshaw, "Bank Affiliates and Their Regulation" (Parts I, II, III), Federal Reserve Bank of Richmond *Monthly Review* (March, April, May 1973):17; and Mark J. Flannery, "An Economic Evaluation of Bank Securities Activities before 1933," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, Edited by Ingo Walter (New York: John Wiley & Sons, 1985).

[6]Interestingly, in England during 1931, the Macmillan Committee on Finance and Industry was appointed to investigate the sluggishness of British capital markets. The Committee praised the close cooperation between commercial banks and their corporate customers in the U.S. and commented on the vitality this brought to our securities markets. The report concluded that English banking law should be altered somewhat to conform to the American system. Edwin J. Perkins, "The Divorce of Commercial and Investment Banking: A History," *The Banking Law Journal* 88 (June 1971):526-27.

[7]Ferdinand C. Pecora was counsel for the Senate committee investigating the problems that arose in connection with the operation of security affiliates by national banks.

[8]Much of the material in this section, related to the abuses that occurred with the operation of security affiliates by commercial banks, is from W. Nelson Peach, *The Security Affiliates of National Banks* (Baltimore, MD: The Johns Hopkins Press, 1941).

[9]The hearings did little to ascertain the extent to which many of the abuses mentioned in this section were widespread, or conversely, the extent to which they were largely restricted to a few of the country's largest banks.

[10]Subsequent research posits that the National City Company conducted its affairs in a reputable manner and that it underwrote high-quality securities. See, Thomas F. Huertas and Joan L. Silverman, "Charles F. Mitchell: Scapegoat of the Crash?," *Business History Review* 60 (Spring 1986):81-103.

[11]Peach, p. 115.

[12]Ibid., pp. 117-18. It should be noted that some market stabilization in connection with underwriting is permitted even today.

[13]Vincent P. Carosso, *Investment Banking in America: A History*, (Cambridge, MA: Harvard University Press, 1970), pp. 324-25.

[14]Ibid., p. 325.

[15]In practice, however, these expectations were not always realized. After $900 million worth of trading in Chase National Bank stock, Chase's affiliates secured only $159,000 in profit. (Chase's president, Alfred Wiggin, was more fortunate, having gained a $10 million profit from his trading in Chase's stock.) National City Company was less successful in dealing in the stock of its parent bank, having sustained $10 million in losses. Ibid., pp. 124-26.

[16]Edward J. Kelly, III, "Legislative History of the Glass-Steagall Act," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, ed. Ingo Walter (New York: John Wiley & Sons, 1985), pp. 44-45.

[17]Peach, p. 133.

Chapter 5

Conflicts of Interest

Introduction

Potential conflicts of interest exist whenever one person or business is serving two or more interests and can favor one of those interests at the expense of the other(s).[1] Since most businesses offer a variety of products to a wide range of customers, the potential for abuse is widespread.

Despite the widespread potential for abuse, there is little to suggest that conflict-of-interest abuse in the U.S. economy is at an unacceptable level. Those who make such claims bear the burden of proof, but they have presented no such proof. Instead, there are only assertions that what is hypothesized must in fact, or does in fact, occur. Without evidence to the contrary, one must conclude that existing controls are adequate to prevent excessive conflict-of-interest abuse. Nowhere is this more true than in the banking industry. Since the safety of our banking system has important public-policy implications, bank activities have always been carefully scrutinized. The types of potential conflicts that can arise from bank participation in a variety of product lines are well-documented and have received much discussion. However, evidence has not been advanced that would suggest that the potential for abuse has resulted in actual problems that would warrant restricting the activities of banking organizations.

In this chapter the types of potential conflicts that exist in the banking industry are discussed, along with the safety measures in place to control the overall level of abuse. The major conflict-of-interest concerns cited with respect to commercial bank relations with nonbank affiliates are divided into six categories: (1) threats to bank safety and soundness that may arise out of transactions that are detrimental to the bank but beneficial to an affiliate; or conversely, (2) transactions that benefit the bank at the expense of an affiliate; (3) illegal tie-ins; (4) violations by a bank of its fiduciary responsibilities; (5) improper use of insider information; and (6) the potential for abuse due to the bank's dual role as marketer of services and impartial financial adviser. As a matter of convenience, some of the following discussion addresses concerns that go beyond those traditionally thought of as conflict-of-interest issues.

Bank Safety-and-Soundness Concerns

There are a variety of conflict-of-interest concerns that potentially could threaten the safety of banks. Each of these concerns relates to the possibility that transactions may occur in which an affiliate's financial condition is improved at the expense of the bank. Such transactions may occur directly between the bank and its affiliate or indirectly through a third party. The transactions could be in the form of loans, capital injections or asset purchases and, if conducted through third parties, could be effected through a parent holding company, through other bank affiliates, or through customers of the bank or its affiliates.

The incentive to abuse a bank is greatest when an affiliate is in danger of failing. This type of situation also could pose the greatest threat to the bank's safety since an affiliate in danger of failing may need substantial aid. When bank-sponsored real estate investment trusts (REITs) began to run into financial difficulty in the mid-1970s due to rising interest rates, the banks that sponsored those REITs came to their aid in many cases. There are concerns that bank holding companies would have an equally strong, if not stronger, incentive to protect bank affiliates facing financial difficulties.

The most significant legislative safeguards against this type of abuse are contained in Sections 23A and 23B of the Federal Reserve Act. Section 23A was added to the Federal Reserve Act in 1933 and amended in 1982. Section 23B was added in 1987. The relevant provisions limit "covered transactions" between a member bank and its affiliate to 10 percent of the capital stock and surplus of the bank. "Covered transactions" are broadly defined to include transactions that would qualify as investments, asset purchases and financial guarantees. There also are stringent collateral requirements on such transactions. Moreover, banks cannot purchase "low-quality" assets from an affiliate, and transactions between a bank and its affiliate must be "on terms and conditions that are consistent with safe and sound banking practices."

Sections 23A and 23B of the Federal Reserve Act also apply to transactions between nonmember banks and their affiliates. However, bank subsidiaries are not covered since they are not "affiliates" of the bank. However, the restrictions set forth in Section 23A have been followed by other bank supervisors in determining limits on transactions between banks and their nonbank subsidiaries. For example, the FDIC has imposed Section 23A-type restrictions on transactions between insured nonmember banks and their securities subsidiaries.[2]

The net effect of these safeguards is that today, unlike in the 1920s and early 1930s, a bank may not legally jeopardize its own soundness in order to "bail out" an affiliate. Bankers do not customarily violate the law, even when they are under stress. Individuals

who violate the restrictions in Sections 23A and 23B may be subject to civil penalties and possibly criminal charges.

Despite these safeguards, there will always be individuals who will violate laws or regulations and use their banks improperly to benefit their outside interests. This does not mean that policymakers should exert control over the market to the point where they eliminate the likelihood of such abuse ever occurring. In the unlikely event that this were even possible, it could only be accomplished at such a high cost to society as to make it totally unacceptable as a policy objective.

The objective of policymakers should be to work vigilantly to control abuse. Some abuses of bank resources will avoid detection, occasionally leading to bank failures. But occasional failures should not cause undue alarm. Banks have failed in the past due to fraud and insider abuse and they will continue to do so in the future. It is the safety and soundness of the system, not individual banks, that should be of primary concern.

The major means of controlling the level of abuse in banks rest with bank supervisors. What is critical is that the bank supervisory agencies be able to ensure that the bank remains financially sound. For example, banks regularly send dividend payments to their parent holding companies. There is nothing unusual about this. Nor is it unusual that sometimes the holding company may choose to direct a portion, if not all, of these funds to one or more of its nonbank subsidiaries. The only reason why such transactions should be of concern to outsiders is if the initial dividend payments were excessive given the bank's financial condition. The same holds true if the transaction is a loan rather than a dividend payment. If the bank's capital remains adequate and its earnings are strong, then the bank, and hence the financial system, is adequately protected against any dangers that could arise from this type of abuse.

Bank supervisors have traditionally carried out their responsibilities by enforcing capital standards, monitoring loan quality, assessing management quality, and a variety of other methods. By focusing on the bank itself, rather than attempting to oversee the entire holding company, the bank supervisory agencies should be able to continue to provide an adequate line of defense against any tendency by bank owners to weaken banks in order to aid their nonbank affiliates.

The challenges posed by an environment where banks can affiliate with a wide variety of nonbanking firms may require some new legislative or regulatory measures to supplement or replace existing safeguards. For example, an additional safeguard that may be desirable would be to limit the extent to which banks and their affiliates could have overlapping officers and directors. If the indi-

viduals responsible for the bank's safety are not identical to the group responsible for an affiliate's financial health, there is less incentive and less opportunity for abuse of the bank's resources.[3]

Using Affiliates to Benefit a Bank

A second type of conflict, which is the reverse of the situation previously discussed, occurs when the interests of a bank affiliate's shareholders, creditors or customers are compromised to benefit the bank. For example, during the 1930s it was alleged that banks used their securities affiliates to convert bad bank loans into bond issues. Customers of bank securities affiliates may not have been informed of the true quality of such issues and may well have been misled into purchasing low-quality bond issues.

Misrepresenting the quality of bond issues is far less likely to occur today given the disclosure requirements and antifraud provisions of federal securities laws. Individuals who fail to disclose relevant facts related to a securities underwriting may find themselves subject to civil and perhaps criminal charges.

Generally speaking, the potential for abuse of an affiliate to benefit the bank is of less concern than the reverse situation because there are fewer safety-and-soundness issues surrounding most nonbanking firms. In fact, one of the benefits of allowing banks to affiliate with other business firms or to own nonbank subsidiaries is that if the bank runs into financial difficulty the affiliate or subsidiary can be sold to raise capital for the bank. In effect, this provides a buffer for the FDIC and helps to maintain a stable financial system. It is not unusual for troubled banking organizations to sell affiliates or subsidiaries in order to raise additional capital for the bank and buy it time to work out of its problems. The outright sale of subsidiaries or affiliates to raise cash does not pose the same conflict-of-interest concerns that lending on disadvantageous terms or advancing excessive dividends does, since it need not adversely impact the interests of the nonbanking firm's shareholders, creditors or customers.

Tie-ins[4]

Tie-ins exist when a business entity attempts to condition the sale of a particular product or service upon the purchase of another of the entity's products or services. The potential for tie-ins is not restricted to the banking industry. Any firm that offers more than a single product could attempt to tie-in the sale of one product with that of another. Some might argue that the potential for abuse is greater if one of the services is the extension of credit. Even here,

however, the problems would not be restricted to the banking industry since many nondepository institutions can extend credit.

A distinction must be drawn between tie-ins that are beneficial to society and tie-ins that are harmful to society. Most tie-ins are not harmful to society. Clearly, if a consumer can freely choose to purchase two or more products at one location at a total cost no higher than what he or she would pay by purchasing the same products at several different places, there is a benefit to that consumer.

Most sales are tie-in sales. Grocery stores and department stores exist because consumers prefer to buy more than one product at a single location. The costs associated with searching, gathering information and independently purchasing every product or service a person may need or desire are too great for markets that bundle or tie-in products not to develop.[5]

There are two types of tie-ins that are detrimental to society and should be of concern to policymakers: (1) those due to information problems, and (2) those due to inadequate levels of competition. There also is the potential for abusive tie-ins due to self-dealing; however, such tie-ins fall into one of the categories above, since information problems or inadequate competition must be present for tie-ins due to self-dealing to be abusive.

Consumers may enter into undesirable tie-in arrangements when they are uninformed of the consequences of their actions. It may be that they are unaware of other alternatives. Generally, these types of problems can be rectified by providing more information. Adequate disclosure of costs, alternatives, and other pertinent facts can resolve many of these kinds of problems.

Abusive tie-ins can occur if there are inadequate levels of competition. In such situations consumers may purchase a second product or service they do not necessarily want in order to receive a product or service they do want because they have no viable alternatives. To the extent such tie-ins may occur, they represent an antitrust concern. Antitrust concerns are most appropriately dealt with through policies designed to foster greater competition, not by policies designed to prevent business entities from offering more than one product.

One example of an abusive tie-in due to self-dealing occurs when a seller tries to induce potential customers to purchase a service (presumably, though not necessarily, at a relatively high price) in which that seller has a personal interest by underpricing (at the expense of the seller's firm or its affiliate) a second service in which the seller's personal stake is less direct. The customer is not harmed by this particular type of tie-in, as he or she is only induced to pay a premium for one or more product or service because there is an offsetting subsidy on one or more of the other products or services

the customer wishes to purchase. This type of tie-in is harmful only to the bank or its affiliate, and even then only if one entity receives the premium while the other supplies the subsidy. If bank regulators became concerned that the potential costs to banks from such tie-ins could be excessive, they could consider prohibiting the use of the same employees, officers or directors by banks and their affiliates, or they could strengthen the penalties against individuals involved in such self-dealing.

In the absence of self-dealing at the expense of the benefactors of the proceeds of one of the tied-in services, the only way the tie-in threat can be effective is if the customer has inadequate information or no viable alternative. That is, customers will not pay a premium for a combination of products or services unless they have no alternative or they are unaware of the alternatives. In competitive markets, with adequate disclosure, customers would simply purchase the products or services elsewhere at more reasonable rates. If there is adequate disclosure and the markets for these products or services are competitive but lower prices are not available, there is no problem.

Tie-in arrangements are illegal under antitrust laws in all businesses when a "not insubstantial" amount of interstate commerce is involved and when there is enough economic power over the tied-in product to affect competition. This is designed to control abusive tie-ins due to inadequate levels of competition. Evidence has not been presented that abusive tie-ins are any more likely to occur in banking organizations than in other types of business entities. Nevertheless, there are laws that hold banking organizations to a higher standard than most other types of businesses. The 1970 Amendments to Section 106 of the Bank Holding Company Act provide that no bank shall "in any manner extend credit, lease or sell property of any kind, or furnish any service, or fix or vary the consideration of any of the foregoing" on the condition that the customer obtain additional services from a bank, its parent holding company, or one of its affiliates or subsidiaries. These laws against tie-in arrangements by banking organizations are much more stringent than the antitrust laws that apply to all types of businesses. Secton 106 of the Bank Holding Company Act provides a strong remedy for those harmed by banks that illegally tie-in their products and services.[6]

Violations of Fiduciary Responsibilities

Another concern relates to the possibility that a bank that operates a trust department may violate its fiduciary responsibility by compromising the interests of trust customers to benefit the bank or one of its affiliates. The most likely scenario would be the bank

selling securities to its trust accounts underwritten by it or one of its affiliates. However, it appears that while such abuse is a theoretical possibility, in practice it has been virtually nonexistent. A 1975 study by the Department of the Treasury noted that there was no evidence of even a single instance of abuse arising from 40 years of commercial bank underwriting of municipal bonds.[7] This strongly suggests that banks should not be prohibited from new activities on the basis that such activities create a conflict with the bank's fiduciary responsibilities. Potential conflicts of this type presently exist within the securities industry; if banks are granted broader securities powers, restrictions against self-dealing modeled after securities regulations could be implemented and penalties assessed if violations arise.

Improper Use of Insider Information

A conflict may arise when a business conducts different activities that grant it access to private information that can be profitably exploited. Commercial banks face such a conflict due to the combination of commercial lending and trust activities. However, there is no evidence that banks have violated their responsibilities to clients by exchanging confidential information between bank departments. Since banks have created an effective "Chinese wall" between their commercial lending and trust departments, it would seem plausible that they could do the same if they are permitted to engage in activities that grant them access to other types of confidential information.

This is not to say that an abusive use of insider information by banks could not occur. Clearly, the probability of abuse increases the greater the benefits and the lower the costs associated with violations. In situations where the potential benefits from abuse are significant, it is the responsibility of the industry, its regulators and legislators to see that the costs associated with such behavior are high enough to effectively control the level of abuse.

A good example may be found within the securities industry today. The benefits to investors associated with gaining access to confidential information on pending mergers and acquisitions are significant, while internal controls and the perceived costs associated with such behavior appear to have been inadequate. This combination created a strong incentive to exploit the use of confidential information related to pending mergers and acquisitions.

As this situation unfolds, it may be determined that additional safeguards against future abuse are necessary. It is possible that the civil and criminal penalties imposed against those convicted of improperly using insider information will be a significant deterrent against future abuse. It also is likely the securities industry will take

steps to strengthen its own "Chinese wall" between the merger and acquisition sections and the other sections within securities firms. Securities industry regulators and Congress also will assess the situation and determine whether additional safeguards are necessary. However, it is unlikely that the best solution will be to prohibit the combination of investment activities and merger and acquisition activities within the same organization. Such a prohibition would create inefficiencies that would result in higher costs to the public and would not necessarily be an effective control since insider information on potential mergers still could be profitably exploited if obtained by individuals outside the mergers and acquisitions firm.

Promotion vs. Disinterested Advice

During the 1930s, it was argued by some that bankers have a special role as dispensers of financial advice to the general public and that their integrity in carrying out this function is compromised if their banks or affiliates of their banks engage in investment activities.[8] The reasoning was that the banker cannot be an impartial or disinterested financial advisor if some investment opportunities bring profit to the bank while others do not.

While it could be argued that a potential for abuse exists whenever the two functions are combined, there are several factors to consider. First, this potential conflict between promoter and disinterested adviser already is widespread in banks, and always has been. Banks sell a large number of financial services which they must promote if they wish to stay in business. Despite the existence of this conflict, little evidence has been advanced to suggest banks have abused their position. Second, the same conflict exists in other financial-service sectors. The securities industry, for example, combines the functions of investment adviser and merchandiser of financial services, but securities laws and regulations, including disclosure requirements, antifraud provisions and other measures, ensure that such conflicts are not exploited. These measures appear to be adequate deterrents to abuse.

Conclusion

Potential conflicts of interest are not unique to the banking industry, but exist throughout the business world. In each conflict situation, whether within or outside the banking industry, appropriate safeguards should include adequate disclosure and prohibition of fraudulent activities.

In situations where there is no record of abuse, it is desirable not to hamper the marketplace by imposing elaborate regulations or

legislative restrictions. Where unacceptable levels of abuse exist, efforts should be made to control the abuse in the least disruptive way possible. An outright prohibition against combining within the same organization two particular functions that may create a potential conflict is the strongest restriction that can be imposed. It precludes realization of whatever operating efficiencies gave the marketplace reason to combine the functions within a single organization in the first place. This creates costs that are passed on to the general public. A prohibition against combining particular functions should be viewed as a last resort to be imposed only if all other less-costly and less-disruptive measures are incapable of controlling the problem.

FOOTNOTES

[1]This definition is akin to that provided by Franklin R. Edwards, "Banks and Securities Activities: Legal and Economic Perspectives on the Glass-Steagall Act," in *The Deregulation of Banking and the Securities Industry*, ed. L. Goldberg and L. J. White, (Lexington, MA: D. C. Heath, 1979).

[2]*See* 12 CFR 337.4.

[3]On the other hand, related experience suggests that safeguards of this type may be unnecessary. For example, banks regularly appoint outside directors who are affiliated with companies that are loan customers of the bank. An obvious conflict of interest is present in such an arrangement similar to that which would occur if an official of a bank affiliate were to sit on the bank's board. However, this long-established practice has not been a major source of safety-and-soundness problems in banking, nor has it produced other major problems commonly associated with conflicts of interest.

[4]For a more detailed discussion of the economics of tie-in arrangements, see Chase, Brown, Blaxall, Inc., "The Role of Bundling in the Provision of Financial Services," A Study for the Association of Bank Holding Companies, Washington, DC, February 1984.

[5]Ibid., pp. 4-9.

[6]Ibid., pp. 25-30.

[7]U. S. Department of Treasury, *Public Policy Aspects of Bank Securities Activities*, (November, 1975) p. 35.

[8]Edward J. Kelly, III, "Conflicts of Interest: A Legal View," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, ed. Ingo Walter, (New York: John Wiley & Sons, Inc., 1985), pp. 239-40.

Chapter 6

Bank Safety and Soundness

Introduction

Safety-and-soundness concerns rank first among the reasons advanced for restricting bank ownership or affiliations with nonbank firms. This chapter reviews the basis for these concerns and highlights the major issues involved in determining whether continued restrictions on bank ownership and affiliations are in the public's best interest.

The chapter begins with an overview of the reasons why banking requires government supervision and regulation. This is followed by a discussion of concerns raised as potential safety-and-soundness reasons for limiting affiliations between banks and certain nonbanking activities. These include: risks to the payments system, monetary-policy considerations, the riskiness of new activities, incentives created by mispriced deposit insurance, and the possible inability of regulators to insulate banks, and hence, the deposit insurance fund, from excessive risks in nonbanking activities.

The main conclusions of this chapter are that public-policy considerations require that banks be subject to government oversight and regulation, but that these public-policy considerations do not necessitate the current restrictions on bank ownership and affiliations. These restrictions can be relaxed in such a way as to benefit the general public and better promote the well-being and safety of our financial system.

On the "Specialness" of Banking

Economic theory and evidence suggest that, in the absence of special circumstances, unrestricted markets best promote general economic welfare. This implies that the burden of proof is generally on those who argue in favor of restrictions on competition, in this case, through continued restrictions on bank ownership and affiliations. However, there are possible "special circumstances" with respect to banking. These revolve around the idea that banking is "special"; that there are public-policy considerations that require

some degree of government oversight and regulation of banking. Thus, the first concept that needs to be examined is whether banks are special.

If it is determined that banks are special, it still does not necessarily mean that there should be restrictions on bank ownership. Even in the presence of special circumstances or "market failure" there should be evidence that the proposed remedy will produce a superior result to the unrestricted market and to other, less restrictive, policies. This also applies to already established laws and regulations. There is no reason to assume that what may have been acceptable in the past, is equally acceptable at a different time and under different circumstances.

There are three worthwhile public-policy objectives which suggest that banks, at least to some extent, should be treated differently from most other types of businesses. First, it is widely acknowledged that some portion of an individual's savings should be protected against loss, although there is some disagreement regarding the level of deposit protection and how those deposits should be protected. It also appears fairly noncontroversial that these protected deposits can be held in banks.

The government has chosen to protect a portion of an individual's savings through federal deposit insurance. This gives the government a financial stake in the banking industry. Thus, government, through the federal deposit insurer, has a role to play in ensuring that banks operate in a safe and sound manner.

Second, banks are "special" in the sense that, unlike most businesses, they are subject to runs (at least in the absence of deposit insurance). Runs may occur in banks because most of their liabilities are available on demand, while a large part of their asset portfolio consists of illiquid loans with uncertain market values. Past experience has made it abundantly clear that a worthwhile objective of public policy is to prevent bank runs, since they can be quite disruptive to an economy. Here again, federal deposit insurance is the primary vehicle through which the federal government has chosen to meet its public-policy objective.[1]

Third, the financial system is important to the functioning of the economy and it should be adequately protected. In part, protecting the financial system means adequately controlling risks to the large-dollar payments system, since a collapse of the payments system would threaten the entire financial system. Protecting the financial system also means the Federal Reserve needs a conduit to conduct monetary policy. However, protection of the financial system does not necessarily mean that individual banks should be protected since it is the safety of the financial system, not the

individual banks within that system, that is important. It also does not mean banks should be treated differently from other financial-services firms.

Thus, there are two important reasons for the existence of federal deposit insurance: the prevention of bank runs and the protection of individual deposit accounts. There also are two general reasons why there should be government oversight and regulation of banking. The first reason relates to the existence of federal deposit insurance and the need for the deposit insurer to protect its interests. The second reason is that banks are integral to the smooth functioning of our economic system. Given this, the relevant issue is: What, if any, activity and ownership constraints on banking organizations are necessary to protect the deposit insurer and safeguard the financial system?

Risks to the Payments System

A stable payments system is essential for a stable financial system and a stable economy. Banks always have played the predominant role in clearing payments through the system. Originally, this role was assumed because of their virtual monopoly on the ability to issue liabilities that are almost perfect substitutes for legal tender—*i.e.*, demand deposits. As technological innovations have enhanced the ability to electronically transfer large sums, and an increasing number of financial institutions issue liabilities that, for all practical purposes, are equivalent to demand deposits, banks and other depository institutions with access to the federal safety net have continued to dominate this function.

There are valid reasons to continue this arrangement for the purpose of minimizing risks to the payments system. First, institutions with access to the safety net have access to Federal Reserve credit and protection from the federal deposit insurance system. Secondly, and perhaps most importantly, these institutions are subject to federal supervision and regulation that, ideally, ensure that uniform safety and soundness criteria are applied to each participant in the payments system.

Nevertheless, some have argued that to adequately protect the financial system, access to the payments system should be limited to insititutions that have affiliate relationships whose activities conform to a narrow list of permissible activities. Others argue that, if the list of permissible activities is expanded, nonbanking firms should be prohibited from using the clearing services provided by affiliated banks. This section argues that there are more direct and less costly ways to protect the payments system.

Risk in the payments system exists because banks lend to one another over the course of each business day. Participants in the

payments system are permitted to incur daylight overdrafts. At the end of the business day, these overdrafts must be settled. There is the risk that at the end of the day a borrower may not be able to meet its obligations. This, in turn, raises a possibility that the lender will not be able to repay its obligations and a chain reaction of defaults may occur.

Most observers acknowledge that the probability of widespread default is slight. Nevertheless, the repercussions of such an event would be significant enough to warrant taking adequate steps to properly protect against a collapse of the payments system.

Currently, there are two major payments system networks, Fedwire and CHIPS (Clearing House Interbank Payment System). The Federal Reserve voluntarily guarantees all payments made over Fedwire. It controls the risk to which it is exposed by limiting daylight overdrafts to institutions with access to Fedwire. The Fed also reserves the right to restrict an institution from running any overdraft at all or requiring that any overdrafts be fully collateralized with interest-bearing government securities. It also has the right to convert an unsecured daylight overdraft into a fully collateralized loan from the discount window.[2]

CHIPS, which is used primarily for international payments, does not guarantee all payments. However, it has established credit limits for individual banks, limiting the maximum amount any one bank can owe at any given time. Thus, the two major payments systems have mechanisms through which they can control the risk exposure of the Federal Reserve (in the case of Fedwire) and the financial system (in the case of CHIPS).

The financial condition of participating institutions is the relevant consideration for purposes of setting overdraft limits or enforcing other forms of credit safeguards. To the extent that activities of affiliates or subsidiaries affect the financial condition of banks, they may be relevant in setting credit limits. In some instances it may be that, due to certain of its affiliations, a bank is perceived to pose greater risks than it would in the absence of such affiliations. In such instances, those controlling the payments system may wish to reduce that bank's overdraft limit or require that it post collateral against its exposure. However, it is not necessarily true that affiliation with nonbank firms increases risk; it may also strengthen a bank and make it more creditworthy. Moreover, appropriate safety and soundness supervision by the primary federal regulator ensures that each participant accurately reports its financial condition; there should be no need beyond this for the administrators of the payments system to audit or otherwise supervise participants.

The bottom line is that healthy, well-run financial institutions should have access to the payments system, while troubled institutions should have access only under conditions that control any

threat they may pose to the financial system. This distinction is not the same as providing or denying access to the payments system according to the types of activities engaged in by a banking organization. An across-the-board prohibition against participation in the payments system by banks that are affiliated with certain types of businesses, regardless of those banks' financial condition, is not the most efficient or most equitable way to maintain the safety of the payments system.

Monetary-Policy Considerations

Some have argued that banks require different regulatory treatment because of their unique role in the transmission of monetary policy. One facet of this argument is that banks should be prohibited from participating in certain product areas. While there is no disagreement that it is necessary for the Federal Reserve to have a conduit to conduct monetary policy, there is little reason why this requires separate treatment of banks, or more specifically, why banks and their subsidiaries and affiliates should be prohibited from participating in certain product markets.

The Federal Reserve uses open-market operations and, to a lesser extent, changes in reserve requirements and lending at the discount window to control the quantity of money and credit in the economy. The quantity of money and credit influences interest-rate levels which, in turn, impact the production of goods and services, employment levels and prices.

Open-market operations, which involve the purchase and sale of U.S. government securities by the Federal Reserve, are the primary means through which the Federal Reserve influences economic activity. Purchases by the Fed are used to inject money into the economy, while sales serve to reduce the money supply. Banks are the major conduit through which the Federal Reserve conducts its open-market operations. However, there is nothing about open-market operations which necessitates special regulatory treatment of banks. Permitting banks, their subsidiaries, or their affiliates to engage in a broader range of activities would not impair the ability of the Federal Reserve to buy and sell government securities through banks. Already, the Federal Reserve in its open-market operations deals directly with primary securities dealers that are not banks. The desired effect on the economy could be achieved regardless of where the Fed chooses to buy or sell securities.

Reserve requirements imposed on banks and thrifts are a second instrument of monetary policy. Noninterest-paying reserves must be held against transactions accounts and nonpersonal time accounts. By increasing or decreasing reserve requirements, the Federal Reserve can influence the supply of money. This policy instrument is

used infrequently; nevertheless, the Federal Reserve argues that it is an important monetary-policy instrument. Accepting that this is true, there is no reason why the Fed's ability to use reserve requirements as an instrument of monetary policy would be affected by changes in bank powers.

The third monetary-policy instrument is lending through the Fed's discount window. Increases or decreases in the extension of credit through the discount window increase or decrease the money supply. In practice, the discount window is used to provide short-term liquidity to institutions. This benefit is available only to institutions that are subject to reserve requirements. The only possible concern here is that new activities might increase the number of troubled banks and lead to increased borrowings from the discount window. However, in the past, whenever borrowings from the discount window have increased, the Fed has been able to offset the impact on the money supply by selling government securities. Thus, open-market operations are used to offset any unintended changes in the money supply that result from activity at the discount window.

To summarize, there is no clear reason why relaxing restrictions on bank, bank subsidiary, or bank affiliate powers should affect the Fed's ability to conduct monetary policy. Banks could remain an effective conduit for monetary policy and, if necessary, other types of financial institutions could also participate in this role.

Riskiness of New Activities

A major issue in debates over banking powers has been the likely effect expanded powers will have on the overall risk of banking companies. If risks can be reduced by means of opportunities to diversify more adequately, banking companies and constituent banks will be stronger and pose a lower risk to the deposit insurance fund. Moreover, if there are well-defined criteria that identify high-risk activities in the context of a particular industry, these activities could be barred to banking companies and, perhaps more significantly, to individual banks. To anticipate the conclusions of this section, expanded powers can serve to reduce risks if appropriate diversification rules are followed. However, there are no easy rules that would identify activities that pose an undue risk to all firms in an industry, unless all firms are almost identical.

If the FDIC is to protect the insurance fund, it must constrain bank participation in activities that could elevate the probability of bank failure excessively.[3] This effort requires that the FDIC be able to assess, monitor, and control the risks to which banks are exposed, suggesting at least three criteria for the acceptability of any proposed new activity.[4] Since current bank activities already carry

certain risks, the issue for the insurer is whether bank risk would be raised or lowered by a new activity and, if raised, whether bank participation could be structured or limited in such a way as to maintain an acceptable risk exposure for the fund. If these determinations can be made for a proposed activity, it should not be prohibited to insured banks on safety-and-soundness grounds.

The critical measure of bank risk from the insurer's viewpoint is the probability of insolvency.[5] Insolvency occurs when losses (negative net income) exhaust capital. In ratio terms, a bank is insolvent when the negative return on assets is sufficiently large to offset the (positive) ratio of capital to assets.[6] Thus, the three variables affecting the probability of insolvency are the level of the capital-asset ratio, the level of returns, and the variability of returns. The higher the capital-asset ratio and the level of returns (on average), the lower the probability of failure. The higher the variability of returns, the higher the probability of failure (other things equal). Accordingly, when gauging the likely impact of a new activity on bank risk, it is the net influence of the expected changes in these three factors that is relevant.

The variability of returns is the most widely used measure of risk, since most risk studies focus on the possible diversification benefits to be derived from new activities.[7] If a new activity exhibits a greater variability of returns in isolation than does banking, then, other things equal, it may be said to be more risky. If this new activity is combined with banking activities, however, it does not follow that the overall return stream will be more risky than that of banking as traditionally defined. The outcome in such a case depends upon the correlation of the new activity's earnings with those of banking. A negative correlation suggests that the new activity's returns are high when banking returns are low (and vice versa), so that a combination of the new activity with traditional banking activities would tend to smooth the returns of the banking firm. This could occur even if the variability of returns in the new activity were greater than the variability of returns in the banking firm before adding the activity.[8] In such a case, the bank could lower the variability of its returns by adding the new activity so long as the size of the investment were not too large relative to the original banking firm. If the investment were too large, the greater absolute variability of returns in the new activity would overpower the risk-reducing benefits of the negative correlation of returns, and the bank would be more risky after the addition of the new activity.[9]

In fact, risk may be reduced by diversifying via a new activity whenever the correlation of returns is less than perfect, even if positive.[10] If the new activity makes it possible for the banking firm to achieve a higher level of operating efficiency, greater diversification benefits are more likely to be captured.[11] Increases in operating

efficiency raise the returns from any given set of investments and, if large enough, can offset the impact of earnings variability on the firm's probability of insolvency. A positive correlation of returns between banking and new activities would not imply a greater risk of insolvency if the average level of returns (or capital) were raised sufficiently. In this case, the greater variability implied by the positive correlation of returns would be rendered irrelevant by the higher average return around which such variation would take place.

This discussion indicates that many second-order variables make up the three basic determinants of the insolvency-risk measures that are relevant for assessing new activities. Among these variables are the correlation of returns, the size of the investment in new activities relative to the size of the original portfolio (as well as the relative sizes of its components), and the opportunities for increases in operating efficiency presented by new activities. There may be significant differences in these and other relevant variables among banking firms, since banks differ in asset composition, organization, managerial skill, and areas of specialization.[12] As a result, it will not always be possible to generalize about the implications of new activities for bank risk exposure. To the extent that risk is firm-specific, new activities may increase risk at one bank while reducing it at another.[13] This characteristic largely eliminates any basis for distinguishing between commercial and financial activities in an effort to restrict banks to "low-risk" investments. Diversification remains the greatest protection against excessive risk.

Additionally, since safety-and-soundness concerns pertain primarily to systemic banking problems as opposed to problems at individual banks, the effect of activity expansion on the correlation of bank returns is relevant. Even if new powers would result in a greater variability of returns at individual banks, the banking system would be "safer" if the correlation of returns from bank to bank were reduced. A major element of systemic banking risk is the possibility that bank returns will move together at the same time. To the extent that a wider menu of activities may result in more diverse earnings characteristics among banks, it may contribute to stability even if individual bank earnings are more variable.

A concern that falls outside traditional risk analysis involves the inexperience that initially plagues any new venture. It is possible that some new activities require specific modes of operation in order to be both profitable and adequately safe, and this may be initially unknown to both the banking firm and the supervisor. In many businesses, the secrets of managing the risk-return trade-off most effectively come only with experience. This legitimate concern ap-

pears to be an argument for proceeding slowly in the area of new powers, but it alone cannot justify excluding any new activities from consideration.

The role of the states in determining appropriate bank activities must be considered. State banking laws allow state-chartered banks to directly participate in a wide variety of activities, many of which are prohibited to nationally-chartered banks. As Appendix B shows, the states are clearly leading the movement toward broader powers in the banking industry. Many of the additional powers recently granted by the states indicate their willingness to respond to changing market conditions and to help assure that banks can remain viable competitors in today's financial markets.

To summarize, it appears likely that most new activities would have a variable impact on risk across banks. For these activities, deposit-insurance considerations may warrant some controls in the form of investment limits and similar measures, along with structural insulation of the bank from risks in some cases. The limits could be modified in accordance with experience since, in many cases, insulation alone is likely to remove any threat initially posed to the average bank by the new activity. Ideally, the conditions for participation in a new activity could be made dependent upon the individual characteristics of a bank, provided that the costs of such case-by-case consideration do not prove prohibitive. For some activities, notably those for which risk is easily assessed and monitored, the potential for excessive risk-taking to go unobserved may be acceptably low regardless of the individual characteristics of the bank. These activities may require little or no regulatory limits beyond those already in place. As a rule, however, it likely will be difficult to generalize about the relative riskiness of different activities for banks. In particular, it is apparent that commercial and financial activities will not be distinguishable on the basis of any inherent differences in risk.

Incentives for Excessive Risk-taking

Federal deposit insurance has been a part of the U. S. financial system since 1933. By most accounts it has been a tremendous success. This does not mean the system is without faults. One often-cited problem is the mispricing of deposit insurance. Currently, all banks are charged for their deposit insurance protection at the same annual rate, one-twelfth of one percent of total domestic deposits.[14] Since deposit insurance does not base premiums on risk exposure, there is a need to monitor and limit the risk-taking activities of insured banks. In the absence of such oversight, the incentives created by mispricing may result in excessive losses to the insurance fund. This occurs because insured institutions can

raise funds at risk-free rates regardless of the riskiness of their investments. This creates an incentive to invest in high-risk activities.

The incentive to take excessive risks can be observed from the experience of the Federal Savings and Loan Insurance Corporation (FSLIC). Insolvent and near-insolvent S&Ls had little to lose by rolling the dice and participating in high-risk activities. The losses that resulted from these high-risk investments have greatly increased the costs facing the FSLIC.

Theoretically, properly priced deposit insurance (accompanied by measures to control the effects of moral hazard) would solve the problem of excessive risk-taking by insured institutions. However, there are strong reasons to believe that the insurance-pricing problem cannot be overcome entirely.[15] This does not mean that improvements cannot be made in the current system of flat-rate assessments; it only suggests that it is likely that, given the difficulties involved in measuring risk, determining the proper price for risk will remain an inexact science. Thus, as long as federal deposit insurance exists there will be a need for some government oversight and regulation of insured institutions.

The key safety-and-soundness issue relates to the level of oversight and supervision that is necessary to adequately control excessive risk-taking by federally-insured institutions. Government involvement must be sufficient to protect the federal deposit insurer and ensure the stability of the financial system. Yet, it must not be so great as to stifle the industry and make it impossible for banks to remain competitive. Herein lies the dilemma. Too little government involvement can threaten the viability of the banking system, but so can too much government involvement.

With respect to corporate affiliates of banks, the preferred course would be to allow banking organizations to engage in a wider range of activities without subjecting banks to risks that could threaten the solvency of the deposit insurer or the stability of the financial system, and without creating unfair advantages or excessive costs for any one group of competitors. There is little doubt that as long as banks can be adequately insulated against excessive risks there are benefits to the general public from permitting more open and more equitable competition. There also are clear benefits from maintaining a healthy deposit insurance system and a stable financial system if the activity and ownership constraints on banking organizations are relaxed so as to make banks more viable business entities. Thus, a primary factor in analyzing the case for new banking activities is an evaluation of the ability of bank supervisors to create and maintain adequate protection of the banking system.

One of the major factors in determining the extent to which banking organizations can be protected against undue risk relates

to the "location" of any new activities. There are basically three options with respect to location: new activities can be placed in a department of the bank, in a subsidiary of the bank, or in a subsidiary of the bank's holding company.[16]

One benefit of allowing new activities to be conducted in a department of the bank is that any profits from the new activities would directly benefit the bank. This, in turn, would help maintain a viable and safe banking system. The major safety-and-soundness concern, however, with placing new activities in-house is that, to the extent new activities are riskier than current bank activities, they might increase risk within the bank and weaken the banking system.

The concern that new powers may increase risk in the banking system has led to suggestions that at least some new powers be placed outside the bank, in a subsidiary of the bank, or in an affiliate within a holding company framework. To the extent bank supervisors can insulate the bank from its subsidiaries or affiliates, they can insulate the bank from the risks posed by new activities.

Determining the extent to which a bank can be insulated from the risks posed by new activities is perhaps as important as any issue in deciding what activities banking organizations ought to be allowed to engage in. This issue is discussed in the following section.

Insulating the Bank from Excessive Risk

The issue of whether banks can be effectively insulated from the risks posed by their affiliates is a critical one. Can a "wall" be established between a bank and its affiliates to adequately protect the banking system from risks due to new activities? From the outset, it should be made clear that the objective is not to devise a framework that can prevent any bank from ever failing due to the "nonbanking" activities of its affiliates or subsidiaries. Rather, the objective is to devise a framework that can effectively protect the deposit insurer and the financial system from excessive risks due to new activities. There are three aspects of this issue that affect the ability of bank supervisors and legislators to effectively protect and insulate the banking system from excessive risk.

First, is it possible to create an effective legal separation between a bank and the entity through which new activities are conducted? Second, can controls be established, or are there controls already in place, that can effectively protect the banking system from risks due to banks and their holding companies having an economic incentive to treat affiliates and subsidiaries as part of an integrated economic entity? Finally, can public confidence be maintained if a bank's affiliates or subsidiaries experience financial difficulties?

Legal Separation

The law clearly indicates that every corporation is a separate legal entity, even those that exist within the same organizational structure.[17] Provided the courts can find that a bank and its affiliate or subsidiary are not held out to the public or operated as integrated entities, the bank is not likely to be held liable for nonbank debts. If the affiliate or subsidiary is about to fail, the bank is not obligated to come to its aid. This does not mean the bank won't attempt to come to the aid of a troubled subsidiary or affiliate. It just means the bank does not have to.

The courts can pierce the "corporate veil" and determine that a bank is liable for the debts of its subsidiary or affiliate if they decide that the separation is more facade than reality. However, there are straightforward steps a bank can take (or bank supervisors can require) to ensure that the bank and its affiliate or subsidiary are separate in fact, as well as in appearance. These steps include having separate management and separate recordkeeping for the two corporations. It also would seem appropriate that the boards of directors not be identical for the two entities. With some basic safeguards such as these, legal separation can be reasonably assured. Thus, from a legal viewpoint, corporate separateness can help insulate the bank from any financial risks inherent in nonbanking activities.

Economic Separation

From the point of view of bank holding company shareholders, it is shareholder value at the holding company level that should be maximized rather than profits of any individual subsidiary. It follows that there are economic incentives to use the bank's fundraising capability (which is subsidized by federal guarantees) to support whatever activities will contribute the most to consolidated profits. This may mean that bank funds will be diverted to help affiliates if such an action is expected to increase consolidated profits. It also may mean that the holding company has an incentive to shift activities from the more regulated bank to its less regulated affiliate.[18] The fact that such incentives exist at the holding company level has led some to conclude that effective insulation between banks and their subsidiaries or affiliates is not possible. However, the important question is whether adequate controls can be instituted to ensure that the bank is not used to subsidize the holding company's nonbanking activities.

If bank supervisors can ensure that a bank is not used to subsidize other holding company activities, then it doesn't matter if its holding company chooses to shift activities from the bank to less-regulated, nonbanking affiliates. If management chooses to avoid the costs associated with bank regulation and supervision, it

will simultaneously be choosing to give up the benefits connected with having activities conducted in a bank. This includes the ability to finance its activities with federally-insured funds.

The critical public-policy concern is that the government not implicitly guarantee the claims against the nonbanking affiliates or subsidiaries of the bank. If the government chooses to protect the creditors of the holding company and its nonbanking subsidiaries, then it will be obligated to extend the scope of government regulation and supervision throughout the holding company. If the government chooses not to extend its "safety net" beyond the bank, and controls can be put in place to protect the bank, then government regulation and supervision for safety-and-soundness purposes need not extend beyond the bank.

Experience suggests that existing controls have been adequate in preventing abuse of banks by their affiliates. In recent years there have been few instances where banks have failed due to the financial problems of their affiliates being transferred to, or absorbed by, the bank itself. One widely cited case occurred in the mid-1970s when Hamilton National Bank of Chattanooga failed after it was forced by its parent holding company to buy large amounts of low-quality mortgages from a troubled mortgage banking affiliate of the holding company. This transaction was a violation of federal banking law, but was not detected in a timely manner. Such instances are few and far between and, while this case resulted in the failure of the bank, it posed no threat to the banking system. Moreover, regulatory and legislative safeguards subsequently have been strengthened. The Garn-St Germain Act of 1982 strengthened Section 23A of the Federal Reserve Act by extending it to transactions between real estate investment trusts (REITs) and other related entities that previously were excluded. The Competitive Equality Banking Act of 1987 strengthened these controls further by adding Section 23B to the Federal Reserve Act which incorporates additional safeguards on transactions between banks and their nonbank affiliates.

A more common, and perhaps a more difficult, situation for bank supervisors to handle is when the same individuals rather than companies own banks and other businesses that engage in transactions with one another. There are restrictions on what types of companies may own or become affiliated with banks, but there are no similar restrictions on individuals. Individual bank owners are often involved in a variety of nonfinancial business activities.

The nonbanking activities of bank owners are harder for bank supervisors to keep track of since bank owners are not required to report their nonbanking activities if they are done outside the bank or outside a holding company framework. There are, of course, restrictions on the amounts and conditions of credit extended to insiders and penalties associated with violations of these restric-

tions, but instances occur where these limits are violated. In some cases, a pattern of abuse may not be detected until it is too late to save the bank. Two points should be made. First, while some bank failures have occurred due to abuse of the bank to benefit an owner's other business activities, there has been no threat to the system from such abuse. Second, to the extent that legislative changes permit more nonbanking activities to be conducted in the bank or its subsidiaries or in affiliates of the bank within a holding company, there will be increased use of corporate affiliates for nonbanking activities, and hence more scope for reporting requirements to enable bank supervisors to protect the bank.

To summarize, past experience suggests that, even in the absence of the Glass-Steagall and Bank Holding Company Act restrictions on permissible activities, existing statutes and regulations are adequate to offset threats to the banking system due to the economic incentive bank holding company owners have to treat each unit within the holding company as part of an integrated entity. If it is believed that expanded powers for banking organizations would increase the threat, then the safeguards can be strengthened.

Market Perception

Even if banks can be separated both legally and economically from the risks posed by new powers, there is the third potential threat: that the market will so closely identify banks with troubled affiliates that the affiliate's problems will extend to the bank due to a lack of public confidence in the organization as a whole. The first step necessary to analyze this issue is to determine what factors may cause such a public perception. The second step is to ascertain what, if anything, can be done to alter such perceptions.

There would appear to be three main reasons why the marketplace would closely identify banks with their affiliates or subsidiaries. First, such an identification would be reasonable if the entities are not legally separated. Second, even in the presence of legal separation there may be the view that regulation and supervision do not offset the incentive bank holding company management has to operate the combined entity as though it were a single entity, especially in times of trouble. This implies the public would believe that problems in one part of the organization are likely to be transmitted to the other parts of the organization. Finally, the actions of bank supervisors are important. If bank supervisors treat the overall organization as a single entity, the market will perceive it as a single entity. If supervisors treat units within a larger entity as separate units, the market will have to recognize that fact.

The first reason why the public may lose confidence in a healthy bank with a troubled subsidiary or affiliate—that there may not be a legal separation between the two entities—is the easiest to resolve.

As pointed out above, there are straightforward ways (most of which are already in place) to legally separate a bank from the risks posed by its affiliates and subsidiaries.

The other two points deserve more careful attention. The proposal put forth here is that the banking system can be insulated from the risks posed by new activities. However, this does not necessarily mean that each bank will always be fully protected against risk from affiliates or subsidiaries. Occasionally, individual banks may fail due to the activities of their affiliated companies. This suggests the market cannot entirely ignore these interrelationships. Individual depositors and investors are, after all, concerned with individual banks. However, it does not follow that because the market may perceive some interrelationships between banks and their nonbanking affiliates, there is a threat to the banking system.[19]

The actions and expected actions of bank supervisors are important factors in determining how the market will react to adverse news about a nonbanking affiliate or subsidiary of a bank. If market participants perceive insulation as being effective, and that their deposit or loan to the bank is safe, they have no reason to panic and withdraw their funds. If they view insulation as being ineffective and they believe the FDIC may not give them immediate and full access to their money in the event the bank fails, then they have a reason to withdraw their funds.

There is some disagreement about how the market and bank supervisors view units within a bank holding company. Some Federal Reserve economists believe the evidence indicates that the market and bank supervisors view the bank holding company as a single corporate entity rather than as a conglomeration of separate corporate entities.[20]

One argument presented in this regard is that reporting practices of bank holding companies make it difficult, if not impossible, for market participants to analyze the separate corporate entities within a holding company.[21] However, reporting requirements can be changed. In fact, if bank supervisors treated the individual entities within a holding company as separate units, the market would likely force a change in reporting by holding companies and their individual units.

REITs. One of the most noteworthy events pointed to by proponents of the view that banking organizations will come to the aid of troubled nonbanking affiliates in times of stress involved bank- and bank holding company-sponsored real estate investment trusts (REITs) in the mid-1970s. When the real-estate market declined in the early to mid-1970s, so too did the financial condition of many REITs. In a number of cases, bank sponsors provided financial support to their REITs to avoid any adverse publicity that may have

resulted from the REITs' failure. As a result, the financial problems of some REITs were absorbed by their sponsor banks.

While it is clear that banking organizations had an incentive to aid the REITs they sponsored, it should be pointed out that regulators could have tried to discourage such aid but they did not. In fact, the Federal Reserve supported efforts by banks to save their REITs.[22] If the Federal Reserve had taken a strong stand against the practice of diverting bank resources to troubled REITs, the diversions may not have occurred. Thus, while the REIT situation may be indicative of the incentive holding companies have to protect individual subsidiaries, it should not be used to advance the argument that regulators cannot prevent banks from coming to the aid of troubled nonbanking affiliates or subsidiaries.

It should also be pointed out that not a single bank failed as a result of aid given to REITs. There may be some incentive for banks to aid associated or affiliated firms, but there is no evidence from the REIT experience that the incentive is so great that a bank is willing to go down with the ship.

Banco Denesia. In 1985, First Chicago Corporation ultimately absorbed losses of $131 million on an original $15 million investment in Banco Denesia, a Brazilian subsidiary. This case is often cited as an example of how banks will bail out their subsidiaries and affiliates at any cost. Perhaps more relevant, however, and certainly less often pointed out, is the fact that a $131 million loss is not life-threatening for a multibillion dollar institution. It seems more plausible that First Chicago would have let Banco Denesia fail if its bailout costs would have threatened the solvency of First Chicago. Many of the examples cited as cases where banking organizations have gone to great lengths to preserve their reputation, which is undoubtedly of great value, are cases where preserving that reputation came at a relatively low cost to the parent institution.

Drysdale Securities. There have been other instances where bank supervisors have encouraged banks to aid troubled companies even when there has been no direct affiliation. For example, the Federal Reserve has cited the agreement by Chase Manhattan Bank and Manufacturers Hanover Trust to make interest payments for Drysdale Securities as evidence that bank holding company management will use bank resources to aid troubled nonbanking affiliates. However, Chase Manhattan originally refused to make the payments on the grounds that it had acted only as an agent, not as a principal, but bank officials changed their minds after the Federal Reserve exerted pressure on Chase to make the payments.[23]

Continental Illinois. The 1984 financial assistance program for Continental Illinois National Bank and Trust Company provided further support to the view that bank supervisors treat banks and their holding companies as integrated units. While the management

and stockholders of Continental paid a stiff price for the bank's near failure, creditors of both the bank and its holding company received complete protection against loss. In this case, the safety net of federal deposit insurance was extended beyond the bank to the bank holding company.

The FDIC was aware of the fact that protecting creditors of the holding company set a bad example. However, these creditors would have been protected to a large extent regardless of the FDIC's actions. There were enough good assets in the holding company outside the bank to ensure that creditors would have recouped a large portion of their investment. There also was a relatively small preferred stock issue of the holding company that was protected under the assistance transaction, but it was not considered significant enough to risk having these shareholders disapprove what was viewed as a highly cost-effective solution for the FDIC. In the end, the FDIC opted not to try to make bank holding company creditors take what could only have been a small hit and risk jeopardizing an otherwise optimal solution to Continental's difficulties. Since that time, the FDIC has more consistently drawn a line between the bank and its holding company in handling bank failures. This has been apparent in subsequent bank failures and in the open-bank assistance transactions arranged by the FDIC. Only the larger of these transactions have involved holding companies, and in those transactions creditors of the holding company have suffered losses.

First National Bank of Oklahoma City. The handling of the Continental transaction was interpreted to signal a willingness on the part of the FDIC to protect holding company creditors. The failure of First National Bank of Oklahoma City, in July 1986, indicated that this is not the case. First National, with assets of $1.6 billion, was the major asset of First Oklahoma Bancorporation, a unitary bank holding company with a significant debt burden. Although options with respect to open-bank assistance were explored, the best financial alternative to the FDIC was to allow the insolvent bank to be closed and then to arrange the sale of the closed bank to a healthy institution (a purchase-and-assumption transaction). The acquiring institution, First Interstate Bancorp of California, purchased many of the failed bank's assets and assumed its liabilities. As a result, the depositors and creditors of the bank were fully protected against loss, but the holding company and its creditors received no protection. Afterwards, the holding company went bankrupt, and its creditors suffered significant losses.

Bank of Oklahoma. The following month, in August 1986, the FDIC financed a $130 million open-bank assistance program for Bank of Oklahoma. The Oklahoma City-based bank had over $500 million in total assets and was one of 11 banking subsidiaries of

BancOklahoma Corporation, a bank holding company with over $2.5 billion in total assets. The failing bank was merged into the holding company's largest bank, the $1.6 billion Bank of Oklahoma, Tulsa, N.A., and the FDIC received $90 million in nonvoting convertible preferred stock which, under certain circumstances, can be converted into 99.99 percent of the resulting bank's common stock. The FDIC also received warrants to buy 55 percent of the holding company's common stock at a nominal price. The effect of these provisions was that owners made a significant contribution to ensure the assisted institution's future viability.

The treatment of debtholders at the bank level and the holding company level deserves attention. Depositors and other creditors of the assisted bank received full protection under the assistance program. However, the bank creditors of the holding company were forced to accept significant concessions on the interest rates and terms of their loans, including conversion of approximately one-third of their existing debt to primary capital. The significance of this differential treatment between bank and bank holding company creditors is that while the FDIC viewed the federal deposit insurance safety net as extending to the bank, it did not view the net as extending to the holding company. Bank creditors were protected. The signal to holding company creditors, however, was that they should not treat their loans as risk-free investments. This principle has been extended to subsequent open-bank assistance transactions.

BancTEXAS. In February 1987, the FDIC and the Office of the Comptroller of the Currency granted preliminary approval to a $150 million financial assistance package for subsidiary banks of BancTEXAS, Inc., a $1.3 billion bank holding company with 11 bank subsidiaries. Final approval was granted July 17. Private investors injected $50 million in new capital. Unlike many previous failing-bank assistance transactions, the FDIC did not assume any of the banks' problem assets.

Creditors of the banks were protected against loss. However, creditors of the holding company were forced to make concessions on the terms of their loans. Senior creditors of the holding company agreed to accept as settlement for approximately $25 million of BancTEXAS obligations the payment of approximately $8.5 million in cash, common stock of the restructured company with a book value of $2 million, charged-off and subquality assets with a book value of $1 million, and warrants to purchase up to five percent of the restructured company. There also was some subordinated debt that BancTEXAS had sold in bearer form in the Euromarkets. A large majority of the holders of this debt agreed to concessions on the terms of their obligations. Thus, although the safety net of federal deposit

insurance was extended to cover uninsured liabilities within the bank, it was not extended to cover creditors of the holding company.

First City Bancorporation. In September 1987, the FDIC granted preliminary approval to a $970 million financial assistance package for subsidiary banks of First City Bancorporation, a $12 billion organization, headquartered in Houston, Texas, with 62 banking subsidiaries. In addition to the FDIC's $970 million in assistance, private investors are to inject $500 million in new capital. Nonperforming and troubled assets totalling $1.79 billion will be transferred to a separate entity created to service these assets. The FDIC will be guaranteed a minimum repayment of $100 million from collections on these assets.

The open-bank assistance transaction protects all depositors and creditors of the subsidiary banks against loss. It does not protect shareholders and unsecured creditors of the holding company. Preferred shareholders and the holders of long-term, unsecured debt, totalling about $243 million, will be forced to accept significant concessions if the deal is to be consummated. The interests of common shareholders were virtually eliminated. Under $50 million of short-term debt held by the bank creditors of the holding company was effectively secured by the stock of unexposed and profitable subsidiaries worth far in excess of the debt's face value, and thus no concessions can, or should, be exacted from this group.

The handling of these more recent failing-bank situations indicates that the FDIC does not intend to extend the safety net of federal deposit insurance to the bank holding company. If bank supervisors remain consistent in this regard, the market will have to treat banks and their holding companies as separate entities. There already is evidence of the market's perception that individual banks and the parent holding company should be viewed as distinct entities.

Credit analysts generally perceive debt issued by the bank to be less risky than debt issued by the holding company. Credit ratings on debt issued by holding companies and their lead banks illustrate the point. In general, rating agencies rate debt of banks higher than debt issued by their holding companies.[24] Whether this practice persists will depend in large part on whether regulators continue to make a distinction between individual banks and bank holding companies.

To summarize, market perception is largely influenced by the actions of bank supervisors. However, bank supervisors have been inconsistent over the years in their treatment of banks and their holding companies. More recently, there has been a greater effort to distinguish between units within a holding company. Bank supervisors must treat banks within a holding company as independent units. Over time, consistent adherence to this policy will strengthen

the market's confidence that market participants will not be blindsided by actions that will permit a nonbanking affiliate's problems to be extended to the bank.[25] There still will be instances where unfounded fears may lead to a "run" on the bank, but if those fears are unfounded, there is no reason why the Federal Reserve, as lender of last resort, cannot provide the liquidity support necessary to protect the bank until it becomes apparent to the public that the bank is not in danger.

Summary and Conclusions

Since unrestricted markets best promote economic welfare, the burden of proof generally is on those who argue in favor of restrictions on competition. However, due to deposit insurance and the role banks play in the financial system, there are public-policy considerations that require government oversight and supervision of banking for safety-and-soundness purposes. The focus of this chapter is to determine if there should be restrictions on the activities of banking organizations due to public-policy concerns related to the need to protect the safety and soundness of the banking system.

While it is acknowledged that maintaining the stability of the payments system is integral to maintaining stability in the financial system, it has been shown that there are more efficient and more equitable ways to safeguard the large-dollar payments system than by maintaining restrictions on the activities of banking organizations. It also is concluded that the Federal Reserve would not be hindered in its efforts to conduct monetary policy if banking organizations were permitted to engage in a broader range of activities.

This is followed by a discussion of how to measure the risks inherent in new activities and how to determine whether new activities would increase or decrease the overall level of risk-taking in the banking organization. While some possible new activities pose few risks and would benefit the bank from a safety-and-soundness viewpoint, other activities may increase the overall level of risk for some banks if conducted within those banks. Thus, some activities may only be desirable if there are adequate safeguards to ensure that the bank is protected against excessive risks. Since risk varies from activity to activity and from organization to organization, it is not possible to make sweeping generalizations; such as, for example, that "commercial" activities are riskier than financial activities.

Another safety-and-soundness concern is that, due to mispriced deposit insurance, banks have an incentive to engage in excessive risk-taking. This incentive would be extended to new activities if those activities could be funded with insured deposits. However,

risk-taking within banks is reduced due to government supervision and regulation. Risk-taking is also moderated by the fact that bank shareholders and management *do* face the prospect of total loss in the event of failure. Thus, incentives created by underpricing deposit insurance can be offset by controls on bank behavior and the threat of losses to shareholders and management. If activities are conducted in entities outside the reach of bank supervisors, then it is important there be safeguards to ensure that those activities are not funded with insured deposits.

The next issue examined is whether the bank can be insulated effectively from the risks posed by new activities. Can banks be protected adequately if new activities are placed in subsidiaries or affiliates of the bank? The view presented here is that effective insulation is possible. Subsidiaries and affiliates can be protected against legal risks if certain procedures are followed to ensure that the operations are conducted in truly separate corporate entities. While there are economic incentives to treat different units as part of an integrated entity, these can be controlled through legislation and regulation, with appropriate penalties for abuses. Finally, the market also will view different units within an organization as distinct corporate entities if they are, in fact, treated that way. As bank supervisors make distinctions between banks and their holding companies and affiliates, the market in all probability will do the same. Thus, problems in an affiliate or subsidiary need not put a bank at risk.

In conclusion, new powers can be granted to banking organizations, with appropriate safeguards to ensure that the banking system remains safe and sound. Some activities may be permissible within the bank if they pose no great risks. Others should be in separate subsidiaries or affiliates, with safeguards structured to ensure that the bank remains viable regardless of the condition of the bank's affiliates and subsidiaries.

FOOTNOTES

[1]While it is clear that there are important reasons for the existence of federal deposit insurance which make banking "special," it is not as clear that there are any other functions performed by banks that make them special relative to other financial-services firms. Gerald Corrigan has stated that three characteristics make banks special. First, they offer transactions accounts. Second, they are a backup source of liquidity for all other institutions. Third, banks are the transmission belt for monetary policy. However, there is no particular reason why banks need to be the sole providers of any of these services. Other types of financial-services firms already offer transactions accounts. These firms also have the ability to provide liquidity to other institutions if necessary. However, it is questionable whether this is even an appropriate role for banks or any other private-sector firms. It is the Federal Reserve's responsibility to be a lender of last resort or source of liquidity. Finally, as discussed in more detail later, monetary policy can be conducted through other vehicles as well as through banks. See, E. Gerald Corrigan, "Are Banks Special?" in Federal Reserve Bank of Minneapolis *Annual Report*, 1982 and Richard C. Aspinwall, "On the 'Specialness' of Banking," *Issues In Bank Regulation* 7 (Autumn, 1983).

[2]For an historical overview of the reasons leading to the Federal Reserve's involvement in the payments system, see James N. Duprey and Clarence W. Nelson, "A Visible Hand: The Fed's Involvement in the Check Payments System," Federal Reserve Bank of Minneapolis *Quarterly Review* (Spring 1986):18-29.

[3]Mark J. Flannery, "Deposit Insurance Creates a Need for Bank Regulation," Federal Reserve Bank of Philadelphia *Business Review* (January/February 1982):17-27, and Robert A. Eisenbeis, "Risk as a Criterion for Expanding Banking Activities," in *Deregulating Financial Services*, ed. George G. Kaufman and Roger C. Kormendi, (Cambridge, MA: Ballinger Publishing Co., 1986), pp. 169-89. Preventing excessive losses to the fund is not the same as preventing systemic instability. This section deals with the FDIC's role as insurer, whose interests go beyond that of a protector of the system. It is conceivable that a given bank failure or succession of failures could cause intolerable losses for the insurer without generating a systemic collapse, as recently witnessed in the thrift industry.

[4]The insurance premium already reflects a certain probability of failure. Ideally, the insurer would raise the premium as needed to reflect any increases in the bank's risk exposure. Lacking this ability, the FDIC must constrain bank risk-taking to levels consistent with the premium.

[5]Strictly speaking, the relevant measure of bank risk from the point of view of the insurer is expected insolvency costs, which involves the expected cost of bankruptcy to the fund as well as the probability of bankruptcy. See, Robert A. Avery, Gerald A. Hanweck and Myron L. Kwast, "An Analysis of Risk-Based Deposit Insurance for Commercial Banks," in Federal Reserve Bank of Chicago *Proceedings of a Conference on Bank Structure and Competition*, (Chicago: n.p., 1986), pp. 217-250.

[6]Specifically, a bank is insolvent when (R/A is less than or equal to -K/A), where R = net income, K = capital, and A = assets. See, Timothy H. Hannan, "Safety, Soundness and The Bank Holding Company: A Critical Review of the Literature," Federal Reserve Board, 1984, (Mimeographed.)

[7]Hannan, "Safety," discusses this further and notes that while valuable information may be gleaned from any of the three variables considered in isolation, it is not appropriate to draw conclusions about insolvency prospects *per se* using fewer than all three variables.

[8]Robert A. Eisenbeis, "Risk and the Expansion of Banking Activities," in *Perspectives on Safe and Sound Banking: Past, Present, and Future*, ed. George J. Benston *et. al.* (Cambridge, MA: MIT Press, 1986), pp. 127-72; Robert E. Litan, "Measuring and Controlling the Risks of Financial Product Deregulation," Brookings Institution, 1985, (Mimeographed.); John H. Boyd, Gerald A. Hanweck, and Pipat Pithyachartyakul, "Bank Holding Company Diversification," in Federal Reserve Bank of Chicago *Proceedings of a Conference on Bank Structure and Competition*, (Chicago: n.p., 1980), pp. 105-21; and David R. Meinster and Rodney D. Johnson, "Bank Holding Company Diversification and the Risk of Capital Impairment," *Bell Economic Journal* 10 (Autumn 1979): 683-94.

[9]Eisenbeis, "Risk and the Expansion of Banking Activities," and Michael L. Mussa, "Competition, Efficiency, and Fairness in the Financial Services Industry," in *Deregulating Financial Services*, ed. George G. Kaufman and Roger C. Kormendi, (Cambridge, MA: Ballinger Publishing Co., 1986), pp. 121-44, discuss this possibility in more detail.

[10]Diversification will fail to reduce the variability of returns only if the investment in the new activity is too large, as noted, or if the correlation between the returns exceeds the ratio of their standard deviations (measures of variability). See, Peter Lloyd-Davies and David B. Humphrey, "New Banking Powers: A Portfolio Analysis of Bank Investment in Real Estate," Federal Reserve Board, 1986. (Mimeographed.)

[11]Eisenbeis, "Risk and the Expansion of Banking Activities. "

[12]There is empirical evidence to this effect. See, Eisenbeis, "Risk and the Expansion of Banking Activities," Roger D. Strover, "A Reexamination of Bank Holding Company Acquisitions," *Journal of Bank Research* 13 (Summer 1982): 101-08; Rebel A. Cole, "Risk Implications of the Nonbank Bank," University of North Carolina School of Business Administration, 1985, (Mimeographed.); Meinster and Johnson, "Capital Impairment," and Peter C. Eisenmann, "Diversification and the Congeneric Bank Holding Company," *Journal of Bank Research* 7 (Spring 1976): 68-77.

[13]Eisenbeis, "Risk and the Expansion of Banking Activities," elaborates on this point.

[14]Assessments are collected semiannually. After deducting operating expenses and insurance losses from gross assessment income, 60 percent of the remainder is rebated to insured banks in the form of a credit applied to the following year's assessment. This rebate may drop if the fund drops below 1.1% of total insured deposits. For more detail, see Maureen Muldoon, "Financial Operations of the FDIC," Federal Deposit Insurance Corporation *Banking and Economic Review* (March/April, 1987):3-9.

[15]There is an extensive literature on the problems associated with precise risk measurement. Many observers feel a system that incorporates market-based pricing of risk is the most promising means for improving risk measurements. Still, experience in markets where the private sector provides insurance suggests that most types of risk cannot be measured with total precision. For example, property and casualty insurers are known to go through cycles where risk is underpriced and then later, as financial problems arise for insurers, risk is overpriced.

[16]Another possibility is for one or more banks to establish a bank service corporation, which would allow small banks to pool their resources to jointly participate in an activity.

[17]Samuel Chase and Donn L. Waage, "Corporate Separateness As a Tool of Bank Regulation," Prepared for the Economic Advisory Committee of the American Bankers Association, Washington, DC, 1983.

[18]Robert A. Eisenbeis, "Bank Holding Companies and Public Policy," in *Financial Services: The Changing Institutions and Government Policy*, ed. George J. Benston, (Englewood Cliffs, NJ: Prentice-Hall, Inc., 1983).

[19]The case of Beverly Hills National Bank (BHNB) is often cited as evidence that debtholders fail to distinguish between problems in the bank and problems elsewhere in the holding company. In 1973, the parent company of BHNB had loans to a real-estate developer that were funded with commercial paper. When the developer failed to repay the loans, the parent holding company could not honor its commercial-paper obligations. One day after the holding company announced that it was pursuing a program of liquidating assets in order to meet these obligations, it sold a 95 percent equity interest in BHNB. It has been argued that runs on the bank forced the holding company to sell BHNB, but this account has been contested. (See, Thomas F. Huertas, "The Protection of Deposits from Risks Assumed by Non-Bank Affiliates," Appendix C to Statement by Hans Angermueller, Vice Chairman, Citicorp/Citibank, before the Subcommittee on Commerce, Consumer and Monetary Affairs of the Committee on Government Operations of the U.S. House of Representatives, June 11, 1986, pp. C-28-30). It should be noted that the managers of the holding company may have committed securities fraud by failing to point out to commercial-paper purchasers that they were buying the paper of the holding company and not the bank. Thus, the BHNB case offers little evidence of debtholders failing to distinguish between the bank and the holding company under normal (legal) circumstances. It is also noteworthy that BHNB did not fail and never posed a threat to the stability of the banking system. This now dated event proved to be little more than an isolated incident with no systemic repercussions.

[20]Anthony Cornyn, Gerald Hanweck, Stephen Rhoades and John Rose, "An Analysis of the Concept of Corporate Separateness in BHC Regulation From an Economic Perspective," Appendix C to Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Commerce, Consumer and Monetary Affairs of the Committee on Government Operations of the U.S. House of Representatives, June 11, 1986.

[21]Ibid, p. C-6.

[22]Ibid, p. C-7.

[23]Thomas F. Huertas, "The Protection of Deposits from Risks Assumed by Non-Bank Affiliates," Appendix C to Statement by Hans Angermueller, Vice Chairman, Citicorp/Citibank, before the Subcommittee on Commerce, Consumer and Monetary Affairs of the Committee on Government Operations of the U.S. House of Representatives, June 11, 1986, p. C-21.

[24]Ibid, pp. B-29-31.

[25]For more discussion on this issue, see Chapter 8.

Chapter 7

Equity, Efficiency and Concentration of Resources

Equity Considerations

One argument used by opponents of bank involvement in nonbanking activities is that banks possess unfair competitive advantages. This raises a public-policy concern that if, on balance, one group of competitors has an unfair competitive advantage, they may be able to drive other producers out of the market. This is inequitable and may lead to an inefficient allocation of resources. (The next section addresses the efficiency aspects of competitive advantages.) The competitive advantages in question include certain tax benefits (the 1986 tax reform package eliminated most of these advantages); access to the discount window, the federal funds market and the payments system; and most importantly, access to federally-insured funds.

Federal deposit insurance creates a significant competitive advantage because depositors who are covered by federal insurance have no incentive to demand interest rates that accurately reflect the bank's level of risk-taking. They are willing to accept virtually risk-free rates, even though their bank's investments are not risk free, since their insured deposits are protected against loss. If deposit insurance were priced to accurately reflect the difference between rates actually paid on insured deposits and rates that would have to be paid absent federal deposit insurance, there would be no competitive advantage or disadvantage to banks from deposit insurance. However, this is not the case. There is evidence that deposit insurance is underpriced, which suggests that, in the absence of other mitigating factors, banks have a competitive advantage.[1]

While banks possess certain competitive advantages, they are also subject to a wide variety of restrictions, controls and oversight from which other types of businesses are largely exempt. These government controls include capital, reserve, and lending requirements; geographic and product restrictions; and a host of other regulations and constraints. All of these impose costs on banks.

There is no definitive answer as to whether the competitive advantages of being a bank outweigh the disadvantages. If banks have a competitive advantage, it does not necessarily mean they

should be able to turn that advantage into higher profits. A net subsidy will simply draw more resources into an activity and excess profits will be competed away.[2]

There is a strong incentive on the part of bank supervisors to ensure that the cost-imposing controls on federally-insured banks adequately offset the incentive for excessive risk-taking.[3] This suggests that the unique costs imposed on banks may offset their advantages, resulting in no inequity. In the absence of clearcut evidence one way or the other, competitive equity can be obtained by allowing the same options to all. If a banking organization can engage in nonbanking activities, then nonbanking organizations ought to be allowed to engage in banking activities, and their banks should have the same benefits (*e.g.*, access to federal deposit insurance, the discount window, etc.) and the same costs (*e.g.*, government regulation and supervision) as do other banks.

If the same options are available to all, each potential participant can determine if those options are worthwhile, and there need be no concern that one group has advantages unavailable to all.

Efficiency Considerations

Another concern raised with respect to expanded bank powers is the possibility that, as banks enter new markets, more resources will be misallocated by the distortional effects of mispriced deposit insurance (or, more generally, mispriced safety-net coverage in all of its forms). It was pointed out in the last section that deposit insurance coverage may be underpriced. Banks may also have other fund-raising advantages associated with the federal safety net that surrounds them.[4] If banking organizations can raise extra funds for new activities at prices that do not fully reflect the extra economic risks posed by these activities then, other things equal, such organizations can profit at lower rates of return than their nonbank rivals in these new activities.[5] Moreover, even without the entry of bank-affiliated firms as competitors in their industry, nonbank firms would have incentives to acquire banks in order to capture the fund-raising subsidy. Thus, a banking firm's access to underpriced funds can create incentives for nonbank competitors to purchase or establish a bank (or seek government subsidies through a different channel), even if it has not created excess profits (net subsidies) for banking firms in their traditional activities. This is not necessarily unfair if nonbank competitors are given equal opportunities to open banks, but it is inefficient in that it causes resources to be reallocated on the basis of an artificial fund-raising distortion instead of consumers' wants and needs.

To avoid confusion, it should be noted that this concern is not the same as the concern over competitive equity. The two issues are

related but separate. Concerns over competitive equity relate to whether insured bank owners have unfair advantages over potential competitors. To the extent that deposit insurance and other factors may confer such advantages, equity can be achieved provided that all competitors are given an equal opportunity to own banks. This also would serve the goal of economic efficiency to the extent that protected markets would be opened to greater competition. However, concerns about economic efficiency would remain. Any gains due to increased competition would be offset to some degree by the reallocation of nonbank resources to cope with, or to share in, the funding advantages of banking firms. Resources would be moved out of activities preferred by consumers and into activities warranted solely by federal guarantees on bank funding. Efficiency is not served under such a scenario since resources would be transferred into bank formation or subsidy-seeking activities without consumers expressing a desire for any such reallocation.

It is uncertain how large the cost to society might be from this type of inefficiency. However, the profit motive provides a natural limit to any misallocation, since banks would have to forego profits by subsidizing an affiliate if higher returns were obtainable by lending elsewhere. Moreover, there are controls that will limit the extent to which a bank could subsidize nonbanking activities by financing them with federally-insured funds. If nonbanking activities are conducted outside of banks, in subsidiaries or affiliates, Section 23A- and 23B-type restrictions would be able to provide effective controls on a bank's ability to finance nonbanking activities with federally-insured funds. Such controls greatly reduce the potential for inefficient allocations of resources. Also, policymakers can reduce the incentives that generate this type of inefficiency by working to eliminate distortions that arise from deposit-insurance pricing, as well as from failure-resolution policies, bank-closure rules, regulatory accounting procedures, and other aspects of bank supervision.[6]

In conclusion, it is unlikely there would be any significant misallocations of resources due to an expansion of bank powers if bank supervisors take steps to ensure that bank funds are not used to finance the activities of nonbanking subsidiaries or affiliates. Moreover, the costs associated with any residual misallocations of resources must be weighed against the benefits produced by the pro-competitive effects of expanded bank powers.

There should be a commitment to minimize any possible distortional effects created by mispriced deposit insurance. This effort is underway and will continue, but it is unlikely to result in an ideal system for pricing deposit insurance anytime soon. Bank supervisors must, therefore, recognize that, as legislative restrictions on banks are reduced, there is a greater need to examine alternative

methods to monitor bank risk-taking. The FDIC and the other bank supervisory agencies are committed to ensuring a strong supervisory force. The FDIC also is committed to continuing to explore ways to increase market discipline on banks. Some possible avenues have been explored in the past.[7] As practical difficulties have arisen, these procedures have been reevaluated. Nevertheless, there is a continual commitment on the FDIC's part to analyze and refine methods to eventually impose greater market discipline on banks.

Concentration of Resources

Several concerns have been raised with respect to expanded bank powers that relate to the potential for increased concentration of banking resources. First, there is the concern that fewer and larger banks will result in less competition and a concentration of economic power. Second, there is the fear that there will be a greater concentration of political power if banks grow larger and fewer in number. Third, there is the concern that concentration of banking resources could exacerbate safety-and-soundness concerns.[8]

Economic Power

Most observers believe that as geographic barriers in banking are lowered the number of banks in the U.S. will decline. As banks seek geographic diversification, they will continue to merge across state lines and there will be larger, fewer, and more diversified banks over time. The same reasoning holds true if bank product barriers are lowered. As banks seek product diversification, they will merge with other financial-services firms or commercial firms, and there will be larger, fewer, and more diversified banking organizations over time.

However, a decline in the number of banks in the United States does not mean there will be fewer banks in any given market. Similarly, allowing banks greater freedom to engage in nonbanking activities may, and in some cases certainly would, reduce concentration in nonbanking markets. The financial evolution currently underway is providing its own means to ensure continued strong competition. Technological advances in information processing and communications are drastically reducing the costs associated with entry into new markets. Already, this has meant that securities firms, insurance companies and other financial and commercial firms have found it cost effective to enter into traditional banking markets. Thrift institutions now have powers virtually equivalent to banks and offer significant competition in many markets.

Banks are no longer faced with the same geographic constraints and the same high brick-and-mortar costs associated with entry into new markets. Low-cost electronic funds transfer stations can be established in locations that present profit opportunities.

Today's banking environment is highly competitive and is likely to remain that way. The reduced entry barriers into banking have created a situation where inadequate competition (and, hence, excessive profits) in any given market will attract new competitors until higher-than-normal profits are competed away.

The lack of significant entry barriers also means that both potential and actual competition provide safeguards against the existence and abuse of monopoly power. Product and geographic deregulation should increase both actual and potential competition in banking and ensure that even if the total number of banks decreases, competition will remain strong.

Political Power

Historically, in the U.S. there has been a fear of concentration of political power. The federal government was designed so as to ensure that power was divided among different branches to provide a system of checks and balances. Similarly, it has been an unwritten objective to limit the power of individual business organizations. One reason for this concern is that excessive concentrations of resources may lead to concentrations of political power. There is the fear that if business organizations grow too large and too few, they may have a disproportionately large influence over the political process.

This fear of "bigness," for whatever reason, has been particularly directed toward banks and their affiliations with nonbanking organizations. This fear was especially prevalent in the years immediately following World War II, perhaps because the popular feeling at that time was that close ties between banking and industry in the Axis powers facilitated the events that led to the war. Most likely because of the dominance of the banking industry and the high visibility of Transamerica/Bank of America during this period, other financial-services competitors have generally escaped public concern.

Regardless of the merits of this concern and the central role assigned to banks, the spectre of undue resource concentrations arising if banking and commerce were allowed to mix is raised in most discussions of deregulation of the banking system. This argument has little merit based on existing evidence. Undue concentrations can arise by means of cross-industry affiliations between industrial firms, nonbank financial firms or between industrial and nonbank financial firms. This has not occurred, even though there have been rather significant cross-industry acquisitions during recent years.

Why have undue concentrations not arisen? Several possible reasons can be identified. First, the economics of formal affiliations between large firms on an inter-industry basis may not have been

favorable. Second, firms may be sensitive to the government's response if affiliations that would raise concerns of undue concentration are proposed; this phenomenon clearly has been evident in the intra-industry merger area, where firms have shown extreme sensitivity to the attitude of the Department of Justice regarding antitrust matters. Finally, contemporary perceptions may view affiliations between larger firms—both in absolute and relative terms—as less of a threat in terms of the undue concentration issue. This perhaps is reflective of the increased competition from foreign firms that has adversely affected many domestic industries.

There is little or no reason to believe that banks would behave differently than any other firms regarding acquisitions, although there is a likelihood that their actions could be perceived differently by society. While there is not sufficient *a priori* evidence to conclude that significant abuses will occur if banks are allowed to affiliate with other firms, these very real concerns cannot be ignored. However, there are more efficient ways of dealing with undue concentration problems than by prohibiting affiliations. A prohibition of affiliations between the largest firms across industries is a less disruptive means of dealing with the issue. Congress should give these concerns and the appropriate remedies serious consideration.

Safety and Soundness

It is feared that if banks become fewer and larger in size, it will be more difficult to protect the deposit insurance fund and maintain a stable financial system. Because the benefits of risk diversification apply to a deposit insurer as well as to other businesses, there is a legitimate concern that if the deposit insurance agency ultimately insures only a few very large banks, the failure of any one of those banks could create costs that could threaten the solvency of the insurer. However, we are nowhere near such a point, and we have enough control over events to ensure that we never reach such a point. If the market appeared to be moving in that direction, limits could be placed on bank size to ensure that the deposit insurer is able to adequately diversify its risks.

Beyond this concern, it is not clear why a decrease in the number of banks should increase safety-and-soundness concerns. While larger banks may imply higher costs in the event of failure, fewer banks suggest the possibility of fewer failures. There is little reason to presume the first effect would outweigh the second. In fact, the reverse is more likely to be true. The main reason banks may grow larger is to take advantage of opportunities to gain geographic and product diversification. Diversification reduces risks and can lead to safer, healthier banks. Moreover, fewer banks mean fewer opportu-

nities for banks to slip through the cracks and avoid government supervision that can detect unhealthy activities or behavior.

FOOTNOTES

[1]See, J. Huston McCulloch, "Interest-Rate Sensitive Deposit Insurance Premia: Adaptive Conditional Heteroskedastic Estimates," Ohio State University, 1983, (Mimeographed.); David H. Pyle, "Pricing Deposit Insurance: The Effects of Mismeasurement," Federal Reserve Bank of San Francisco and University of California, Berkeley, 1983, (Mimeographed.); James A. Brickley, and Christopher James, "Deposit Guarantees and S&L Stock Returns: An Option Pricing Approach," University of Utah and University of Oregon, 1984, (Mimeographed.); Edward J. Kane, "S&Ls and Interest-Rate Reregulation: The FSLIC as an In-Place Bailout Program," *Housing Finance Review* 1 (July 1982): 219-43; and Edward J. Kane, *The Gathering Crisis in Federal Deposit Insurance*, (Cambridge, MA: MIT Press, 1985). Alan J. Marcus and Israel Shaked, "The Valuation of FDIC Deposit Insurance: Empirical Estimates Using the Option Pricing Framework," Boston University School of Management, 1982, (Mimeographed.); and George G. Pennacchi, "An Empirical Analysis of Bank Risk," in Federal Reserve Bank of Chicago *Proceedings of a Conference on Bank Structure and Competition*, (Chicago: n.p., 1985), pp. 251-67, find conflicting evidence. See, Kane, "The Gathering Crisis," on this point and Arthur Murton, "A Survey of the Issues and Literature Concerning Risk-Related Deposit Insurance," Federal Deposit Insurance Corporation *Banking and Economic Review* (September/October 1986): 11-20, for a review of relevant empirical work.

[2]Even though banks are not earning above-normal rates of return, a subsidy still has value. A net subsidy raises the value of bank charters (stock prices), which increases the wealth of charter-holders. Changes in the subsidy change the value of charters.

[3]The "incentive for excessive risk-taking" derives from the ability of insured banks to raise funds at risk-free rates regardless of the riskiness of their investments. In the absence of costs and controls imposed by the insurer, this underpricing of risk would lead insured institutions to invest in high-risk activities that unduly threaten the insurance fund. See Chapter 6 for a more complete explanation.

[4]Experience shows there to be some positive probability that the safety net will be extended to uninsured creditors of banking organizations in the event of failure. This "conjectural guarantee" may provide an additional reduction in funding costs for banking organizations beyond the fund-raising advantage associated with explicit deposit insurance. See, Mark J. Flannery, "Contagious Bank Runs, Financial Structure and Corporate Separateness Within a Bank Holding Company," in Federal Reserve Bank of Chicago *Proceedings of a Conference on Bank Structure and Competition*, (Chicago: n.p., 1986), pp. 213-30.

[5] Also, the willingness to accept lower risk-adjusted returns in new activities rises with the effectiveness of bank regulation in preventing risk-taking via traditional activities. See, Fischer Black; Merton H. Miller; and Richard A. Posner, "An Approach to the Regulation of Bank Holding Companies," *Journal of Business* 51 (July 1978):379-412. Since risk exposure is held below privately optimal levels in traditional activities, owners of banking firms would willingly absorb more risk than is economically justified by the expected returns in new activities so long as the returns exceeded those of traditional bank activities. Nonbank competitors do not have the luxury of settling for returns that do not fully compensate them for the risks involved since their cost of funds reflects these risks. Bank regulation in traditional activities gives banking firms added incentives to seek higher returns in new activities, and artificially low funding costs, if not somehow offset, would allow banking firms to profit from lower risk-adjusted rates of return than other competitors. See, Michael L. Mussa, "Competition, Efficiency, and Fairness in the Financial Services Industry," in *Deregulating Financial Services*, ed. George G. Kaufman and Roger C. Kormendi, (Cambridge, MA: Ballinger Publishing Co., 1986), pp. 121-44.

[6]Research in these areas is producing potentially useful results. For example, Pyle, "Pricing Deposit Insurance," and David H. Pyle, "Deregulation and Deposit Insurance Reform," Federal Reserve Bank of San Francisco *Economic Review*, no. 2 (Spring

1984): 5-15; Herbert Baer, "Private Prices, Public Insurance: The Pricing of Federal Deposit Insurance," Federal Reserve Bank of Chicago *Economic Perspectives* (September/October 1985): 45-57; Allan H. Meltzer, "Financial Failures and Financial Policies," in *Deregulating Financial Services*, ed. by George G. Kaufman and Roger C. Kormendi, (Cambridge, MA: Ballinger Publishing Co., 1986), pp. 79-96; Frederick T. Furlong, and Michael C. Keeley, "The Search for Financial Stability," in Federal Reserve Bank of San Francisco *The Search For Financial Stability: The Past Fifty Years*, (San Francisco: n.p., 1985), pp. 213-33; McCulloch, "Interest-Rate;" J. Huston McCulloch, "Misintermediation and Macroeconomic Fluctuations," *Journal of Monetary Economics* 8 (1981):103-15; Flannery, "Contagious Bank Runs;" Mark J. Flannery, "Discussion," in Federal Reserve Bank of San Francisco *The Search For Financial Stability: The Past Fifty Years*, (San Francisco: n.p., 1985), pp. 147-51; Tim S. Campbell, and David Glenn, "Deposit Insurance in a Deregulated Environment," *Journal of Finance* 39 (July 1984):785-87; and Christopher James, "Some Evidence on the Uniqueness of Bank Loans," University of Oregon, 1987, (Mimeographed.).

[7]See, Federal Deposit Insurance Corporation, *Deposit Insurance in a Changing Environment*, (Washington, DC: Federal Deposit Insurance Corporation, 1983).

[8]For further discussion of these issues, see Franklin R. Edwards, "Concentration in Banking: Problem or Solution?" in *Deregulating Financial Services: Public Policy in Flux*, ed. George G. Kaufman and Roger C. Kormendi, (Cambridge, MA: Ballinger Publishing Company, 1986).

Chapter 8

Rules Needed to Insulate Banks from Risks in Nonbank Affiliates

As discussed in the preceding chapters, most observers agree that there are legitimate reasons why the banking system (if not every individual bank within the system) needs to be protected. The present system accomplishes this goal in a variety of ways. First, each bank operates under rules governing its operations, can engage only in a limited array of activities and is subject to supervisory oversight. If a bank is judged to be operating in an "unsafe or unsound" manner, the banking agencies have various remedies that can be used to obtain corrective action. Second, transactions between a bank and insiders (including affiliated organizations) are subject to limitations. Finally, the activities of corporate affiliates of banks are subject to limitations, and the affiliates are subject to direct regulation and supervision by the banking agencies.[1]

Also as discussed in previous chapters, benefits would accrue to both banks and their customers if restrictions on activities and supervisory constraints could be reduced or eliminated without jeopardizing the stability of the system or imposing unacceptable losses on the deposit insurer. The purpose of this chapter is to discuss the rules that we believe would be sufficient to insulate banks if activity restrictions are removed from affiliated nonbank organizations and if the banking agencies no longer have the direct regulatory and supervisory authority of the Bank Holding Company Act over these entities.

Before proceeding with the discussion, it is important to recognize that the success of any law or regulation depends on the willingness of a vast majority of people to play by the rules of the game. In the present context, the effectiveness of laws or regulations governing banking behavior rests on the premise that most bankers are honest and willing to adhere to reasonable rules. It goes without saying that if the opposite were true (*i.e.*, if most bankers were dishonest), laws and regulations would provide scant protection against widespread abuse. Experience during the Prohibition Era makes it clear that a law that is not supported by a large majority of those subject to it is unenforceable in a free country. Obviously, this has not been the case in banking. Nevertheless, there will be individuals in the industry who will engage in prohibited activities

even though such action may result in penalties. Provided that abuses do not threaten the stability of the system or result in unacceptable losses to the deposit insurer—due to an excessive number of dishonest people in the industry or lax supervision—some level of abuses can be tolerated without jeopardizing the safety and soundness of the system. Thus, we are not proposing that a foolproof wall be built around banks; in fact, if such a wall could be constructed, the costs in terms of foregone efficiency might far outweigh any benefits.

With this in mind, the discussion first will focus on the issues related to risks that are associated with conflicts of interest (see Chapter 5). Second, questions relating to the appropriate treatment of investments in subsidiaries of the bank will be discussed. The last section will consider the Federal Reserve's policy regarding the obligation of corporate owners to act as a "source of strength" to subsidiary banks.

Conflicts of Interest

In Chapter 5, the major concerns regarding conflicts of interest arising from affiliations of banks with nonbank organizations were reviewed in some detail. For present purposes, it is convenient to segregate the risks related to these conflicts into two categories: (1) those that arise because of intercompany transactions, and (2) those related to nontransactional activities. Each will be discussed in turn.

Risks associated with conflicts of interest arise when an insured bank incurs or makes loans, guarantees, or other obligations or transfers for the benefit of affiliated persons or organizations, and such transactions threaten the bank's solvency or soundness. Note that this is a two-part definition: the transaction(s) must be for the benefit of a related party, and must be, individually or in the aggregate, potentially detrimental to the viability of the bank. For example, dividends paid to the parent organization would be acceptable provided that they bear a reasonable relationship to existing capital and earnings potential, whereas a "significant" loan to a troubled affiliate that could not pass normal underwriting standards would be unacceptable.

Present rules are very conservative with respect to intercompany transactions. Section 23A of the Federal Reserve Act generally limits loans to, and guarantees or purchases of obligations of, nonbank affiliates by the bank, to 10 percent of bank capital for any one affiliate, and 20 percent for all affiliates in the aggregate. Moreover, most extensions of credit or guarantees involving a nonbank affiliate must be fully collateralized; the sale of subquality assets to the bank is prohibited; and transactions with affiliates must be on terms and

conditions "consistent with safe and sound banking practices."[2] Additionally, the National Bank Act and most state banking laws impose other restrictions. For example, the National Bank Act limits extensions of credit to any single borrower or group of related interests to 15 percent of capital, and places restrictions on dividends and other transfers.

The Competitive Equality Banking Act of 1987, among other things, serves to tighten restrictions on transactions between banks and nonbank affiliates. The new Section 23B of the Federal Reserve Act specifically requires that transactions with affiliates be on terms and conditions substantially the same as those with nonaffiliated companies, and generally prohibits bank trust departments from purchasing securities of an affiliate. Moreover, the Act places severe restrictions on the acquisition of securities by the bank during the time any affiliate is acting as an underwriter or member of a selling syndicate of such securities. Finally, Section 23B prohibits any bank or nonbank affiliate from taking any action (including advertising) that would suggest that the bank is responsible for any obligation of the affiliate.

The restrictions imposed by these rules are sufficient, assuming proper administration, to contain risks arising from intercompany transactions. However, some improvements need to be made before liberalization progresses very far.

The first step would be to create the proverbial "level playing field" by applying the same rules to all institutions having direct access to the federal safety net. That is, all such institutions would be subject to the same set of rules governing interaffiliate transactions and other transfers. The restrictions incorporated in Sections 23A and 23B by statute already are applicable to all FDIC-insured banks (see Section 18(j) of the FDI Act). However, restrictions relating to dividend payments and general loan limits are contained in various state and federal laws, and are not uniform for all banks. If consistency is important, and we think it is, a new Section 23C that articulates these restrictions can be added to the Federal Reserve Act.

The second proposed statutory change would extend limitations applicable to affiliates to direct bank subsidiaries. The term "affiliate" in Sections 23A and 23B does not include bank-owned subsidiaries (except when the subsidiary is a bank itself). Transactions between banks and direct subsidiaries are not subject to restrictions except under the general safety-and-soundness provisions of the FDI Act.[3] It is preferable to have a set of specific rules to supplement a general prohibition on "unsafe and unsound" practices. In the absence of specific rules, the FDIC must substantiate the allegation of unsafe or unsound banking practices. This can

require, under a particular set of circumstances, a major commitment of FDIC resources, and may provide only a limited guide to banks in other cases.

The third change relates to so-called "daylight overdrafts"—*i.e.*, extensions of credit (usually related to funds transfers or security transactions) that occur during the business day but are closed-out during settlements shortly after the close of business. While daylight overdrafts can pose risks similar to any other extension of credit, the major perceived exposure is to the payments system. The fear is that a nonbank affiliate will be unable to honor a significant balance due to an affiliated bank and this will either place the Federal Reserve at risk (if the overdraft occurs on Fedwire) or precipitate multiple defaults within the system (if CHIPs is the clearing agent). Although both Fedwire and CHIPs place limits on participants based on financial capacity, there undoubtedly are risks, even under the current system.

Those who perceive a high level of risk with respect to affiliations of banks with nonbanking firms base their assessment on the same types of conflicts of interest associated with other interaffiliate transactions. The only difference is that daylight overdrafts are settled within a business day, assuming no problems arise, whereas other extensions of credit normally extend for a longer period of time. Provided that appropriate rules are in place and supervision is adequate, the maturity of an extension of credit should not affect the degree of risk related to extensions of credit to affiliates—*i.e.*, daylight overdrafts are no different from a risk perspective than any other extension of credit to an affiliate.

Daylight overdrafts have not been subjected to the restrictions of Section 23A. However, the Competitive Equality Banking Act of 1987 does place a full collateralization requirement on *all* overdrafts between a grandfathered nonbank affiliate of a "nonbank bank" and the affiliated bank. This was accomplished through an amendment to the Bank Holding Company Act. Restrictions should be placed on all banks, especially if limitations on permissible activities of nonbank affiliates are removed. Section 23A should be amended so that it is clear that daylight overdrafts are subject to the same restrictions as other extensions of credit.

These are the changes necessary to control transactions risks if the agencies do not have direct regulatory or supervisory authority over bank affiliates. However, it should be emphasized that regulatory flexibility will have to be maintained, and that it may be necessary to seek further legislative changes as experience is gained during the process. One certainty is that a significant amount of talent will be directed to searching for loopholes in laws and

regulations. This being the case, there is a potential for finding unintended ways to evade the rules that cannot be foreseen at this time.

There are other areas of concern regarding transactions risks, but these can best be handled under current regulatory and supervisory powers. The first concern relates to potential abuses involved in business dealings between a bank and customers of nonbank affiliates. There is no question that the potential for abuse exists in these types of transactions. However, there is little evidence to suggest that existing relationships of this type have in fact resulted in excessive abuses. *De facto* affiliate relationships between bank and nonbank firms exist, and have existed since the earliest days of banking. For example, it is not uncommon for a retail firm (*e.g.*, an auto dealership) to have common ownership with a community bank. Often, the sales generated by the nonbanking firm are financed through the "affiliated" bank. If these transactions are consummated on an arm's-length basis and underwritten using acceptable credit standards, few, if any, safety-and-soundness concerns arise. Moreover, this same potential conflict exists in present holding company relationships; for example, there may be a strong incentive for a subsidiary bank to make a subquality loan to a vital supplier of services to a nonbank affiliate that is in financial difficulty. Here again, there is little evidence that excessive abuses have occurred.

Based on our experience, this type of risk is best handled through regular examination and supervisory activities. To place specific restrictive transactions limitations on every sort of possible dealing with customers of affiliated organizations would be complicated and not cost-effective. Flexibility in supervision is desirable in this type of situation.

An interesting safety-and-soundness issue has been raised by promotional activities offered primarily by automobile manufacturers. Auto makers recently have attempted to promote sales by offering below-market financing (often at zero percent rates), in exchange for fewer concessions on the sale price of the product. Within the context of affiliations between banks and nonbanking firms, would this practice raise a safety-and-soundness concern? In the absence of any transfers from the affiliate to the bank to compensate for foregone income, the answer has to be "yes." On the other hand, if the affiliate compensates the bank for credit concessions, under the affiliate transactions rules outlined above, these concerns would disappear. Again, this type of situation is best handled through supervisory activities rather than a change to existing law.

Other concerns have been expressed over the numerous potential conflicts that might arise if bank affiliates (or banks themselves) are

allowed to engage in securities underwriting and related activities. As was discussed at some length in Chapters 4 and 5, these potential conflicts are best handled under securities laws and SEC regulations. Moreover, recently enacted Section 23B prohibitions would provide additional safeguards in this area.

The second area to consider under the general heading of conflicts of interest is related to issues not directly associated with transactions between, or for the benefit of, affiliated organizations. As pointed out in Chapter 5, these potential conflicts include abuse of insider information, violations of fiduciary responsibility, and promotion under the guise of disinterested advice. These potential conflicts are currently faced by banks and by most other multiproduct firms, with little evidence that these potential conflicts lead to significant harm. This suggests that no statutory changes are needed.

A more important consideration is the need for the maintenance of corporate organizational structures that, to the greatest extent possible, ensure legal separation between insured banks and nonbank affiliates and subsidiaries. Under the "safety-and-soundness" provisions of the FDI Act, the banking agencies can impose requirements on matters under the bank's control, such as the composition of the board of directors and management, maintenance of separate records and advertising on behalf of the bank. Moreover, the new Section 23B gives the agencies the authority to control advertising and other promotional efforts by nonbank affiliated organizations. Since one element of maintaining effective "corporate separateness" is the way in which the relationship of affiliated companies is presented to the public, the ability of the bank supervisory agencies to ensure that this occurs is necessary.

Another means of promoting legal separation is to legislatively remove legal responsibility from banks for obligations incurred by nonbank affiliates, except in cases where there is a contractual arrangement between an affiliate and the bank. While this has some appeal, such legislation could have implications for a variety of areas, including the rights of customers of the affiliate. It does not seem appropriate to contemplate enacting this type of legislation until the ramifications are thoroughly understood.

Finally, the banking agencies will need to maintain a mechanism to monitor compliance with the transactions rules suggested above. There are two parts to this effort. First, the agencies need to have the ability to audit both sides of transactions between insured banks and nonbank affiliates; the banking agencies currently have authority to perform such audits. Second, the agencies need the authority to require banks and affiliates to report such transactions and, in the case of nonbank affiliates, to make available financial statements that the supervisors deem necessary.[4] It also may be advis-

able to require banks to give prior notice of proposed new affiliate relationships. This is not to imply that direct supervision of nonbank activities by the banking agencies is necessary, desirable, or will be exercised. Rather, these requirements are necessary to monitor compliance with rules applicable to transactions between the bank and its affiliates and to assess risks posed by nonbank affiliates. In a very real sense, this is not dissimilar to the way exposure to credit risk posed by bank-loan customers currently is assessed; in evaluating the risk associated with a credit, an examiner, among other things, will focus on current financial statements of the borrower.

Treatment of Bank Subsidiaries

From a risk insulation standpoint, there is some debate as to whether the degree of legal separation attainable depends on the position of the bank in the organization chart vis-a-vis nonbank affiliates. Specifically, some legal experts believe that a direct subsidiary relationship is more likely to be "pierced" than an indirect affiliate relationship. While there is no definitive answer to this legal question, the FDIC has taken the position, in regulations governing the activities of securities subsidiaries, that adequate insulation can be achieved.

The above discussion notwithstanding, from the standpoint of benefits that accrue to the insured entity, or to the deposit insurer in the case of a bank failure, there are advantages to a direct subsidiary relationship with the bank. In general, the earnings and dividends of a firm accrue to its immediate owners and, in the case of an insolvency of the parent, the value of the subsidiary is available to satisfy claims against the owner. If the firm is a subsidiary of the parent holding company (or of a nonbank subsidiary of the holding company), none of these values is available to insured bank subsidiaries, or to the FDIC if the bank should fail. On the other hand, if the firm is a direct subsidiary of a bank, these values are available to the bank and, if failure should occur, available to the FDIC to reduce ultimate costs.

Of course, there is a downside to the bank subsidiary relationship. Specifically, the bank may feel a greater obligation to bail out a troubled direct subsidiary than it would a less-closely related affiliate. Moreover, the market may perceive a close relationship and react negatively if the bank permits the company to fail and write off its investment. However, as discussed in Chapter 6, these potential problems can be minimized if the rules governing transactions with subsidiaries are appropriately enforced, and the bank and subsidiary hold themselves out to the public as separate entities.

An important policy question is how to treat equity investments in subsidiaries in calculating capital adequacy. The most conserva-

tive approach would be to deduct equity investments in calculating a bank's capital for regulatory purposes; this is generally consistent with the treatment of equity investments under the National Bank Act and with the objective of protecting the bank from losses incurred in affiliated organizations. An alternative approach would be to treat the equity investment as any other banking asset, permitting it to be carried at net equity value, reduced by the amount of any perceived loss in value.

It is important to note that the treatment of equity investments in subsidiaries for capital-adequacy computation purposes will affect the return on the investment. As an example, assume that a banking organization decides to capitalize a new subsidiary at $100, and that the initial capital will be funded by a subsidiary bank. If the new firm is made a subsidiary of the bank and the rules require that equity investments be subtracted from capital, the holding company will be forced to make enough funds available to the bank to offset any capital deficiency created by the $100 investment. On the other hand, if the new firm were organized as a holding company subsidiary and funded by the parent with publicly-issued securities, the capital position of the bank would remain unchanged. Obviously, the more conservative approach of deducting investments in subsidiaries would provide a financial incentive that would favor the holding company subsidiary approach.

There is no single correct solution. The most balanced posture probably would be to make the treatment of equity investment in subsidiaries dependent on the type of activity performed in the subsidiary. Thus, investments in subsidiaries that perform normal banking activities would be exempt from automatic deduction from capital, whereas investments in all other subsidiaries would be offset against bank capital. If the capital is not offset, the subsidiary would be subject to normal supervisory control.

Source of Strength

The Federal Reserve has long adhered to the notion that a bank holding company has the duty and obligation to act as a source of financial and managerial strength to subsidiary banks, and must conduct its affairs accordingly. This policy, which did not appear as a formal regulation until 1983, when it was made part of Federal Reserve Regulation Y, has been articulated in public pronouncements and in the processing of applications related to acquisitions by bank holding companies. The major exception has been in the case of the formation of small bank holding companies (*i.e.*, those with assets of $150 million or less), where the Fed has permitted leverage at the holding company level that is not consistent with the "source-of-strength" doctrine. This exception has been honored

because of the Fed's perception that public policy would be best served by facilitating the sale of small, closely held banks that, absent the tax advantages of leveraged financing that employs the holding company structure, would be difficult to finance.

During periods when the economy was favorable and few banks were in severe financial difficulty, there was no reason to seriously question the implications of this doctrine. Moreover, there was no opportunity to test whether the Fed had the authority to force a holding company to use its resources to offset losses in a bank subsidiary when such transfers would have a significant adverse impact on the value of the holding company. The first real test came in early 1987, when the Federal Reserve Board ordered Hawkeye Bancorporation, a multibank holding company operating 32 subsidiary banks in Iowa, to inject $1.2 million in capital into a failing bank subsidiary. Hawkeye, which was under financial strains both at the parent level and at some subsidiary banks, refused to comply with the order. The Fed then charged Hawkeye with unsafe and unsound practices, which Hawkeye countered with the argument that formal agreements of the parent company with its creditors would not permit such a massive investment in the bank. Although the Federal Reserve Board subsequently withdrew the complaint against Hawkeye, it has issued a draft policy statement reaffirming that holding companies should act as a source of strength, particularly in situations where the subsidiary bank is in danger of failing.

The ability to shift assets from the holding company to bank subsidiaries would enhance the viability of selected banks, and most likely would reduce costs to the FDIC. However, the "source-of-strength" doctrine does raise several questions. If this type of authority were asserted and proved to be enforceable, it would make investment in bank equities relatively unattractive: if the downside potential of an investment exceeds the initial commitment, investors will demand a higher expected return to compensate for the additional risk. It should be remembered that many bank stocks prior to the mid-1930s were subject to additional assessments if the bank experienced financial difficulties. This requirement was removed because of its negative effect on the ability of banks to raise new capital.

An equally significant question relates to the differential treatment of corporate owners under the Bank Holding Company Act. In general, the "source of strength" doctrine pertains to corporate owners of banks, but not individuals. Thus, corporate owners of banks are held to a different standard than individual owners.

From a practical standpoint, whether a holding company will allow a subsidiary to fail depends on the costs to the parent organization. In general, management does not want a subsidiary to fail and the market often reacts negatively to any such move. In each

case, the parent corporation will make its own cost-benefit analysis and act accordingly. If effective supervision of the bank is in place, and given the desire of management not to see the demise of a part of the organization, the power to force further investment does not appear to be particularly desirable.

Control by the agencies in terms of the ability and willingness of owners to commit resources to an insured bank consists—and perhaps should continue to consist—of two elements. First, an evaluation of the integrity and likely capacity of the proponents of an application for a new charter (or deposit insurance) or change of control; this same evaluation process is repeated for any subsequent request that requires regulatory approval. Second, monitoring of the financial position of each insured bank and the power to set capital standards and to promptly close banks at, or even shortly before, the point of insolvency.

The bank supervisory agencies operate under these guidelines today, and could continue to do so even in the absence of the Bank Holding Company Act. The extent to which the agencies do not meet these goals is due to resource constraints and measurement problems, and not to a lack of powers.

Summary and Conclusions

This chapter lays out a set of rules that would adequately protect the stability of the banking system and the deposit insurance fund if restrictions on affiliates of insured banks and the regulatory and supervisory powers by banking agencies on these organizations were removed. It is pointed out that transactions between banks and nonbank affiliates currently are subject to very tight restrictions, and that few changes to existing law would be necessary to protect the system even if a very conservative approach were taken.

It is suggested that all banks with access to the federal safety net should be subject to the same rules. Thus, uniform restrictions on dividends and lending limits should be extended to all insured banks. It is recommended that these same restrictions cover transactions and other dealings with direct nonbanking subsidiaries of insured banks, which are currently exempted from Section 23A-23B-type activities. Additionally, any necessary restrictions on daylight overdrafts should be made part of Section 23A.

While direct regulatory or supervisory authority over nonbanking affiliates is not necessary, there are limited areas where the bank supervisory agencies need to retain or be given authority. These include the power to audit both sides of transactions between banks and nonbank affiliates, and ensure that advertising and other promotional material distributed by nonbank affiliates is consistent with the maintenance of "corporate separateness" between the bank and nonbank affiliates.

The additional rules proposed here, along with existing ones, most likely would provide a very effective "wall" between an insured bank and any affiliated organizations. If they turn out to needlessly diminish the attractiveness of affiliations between banks and nonbanking firms, or to allow unanticipated abuses to occur, they will need to be adjusted. The process of liberalizing the powers available to any industry that has been regulated for decades must be approached with a combination of caution and flexibility.

Two related issues also are discussed in this chapter. First, the issue of how to treat investment by banks in subsidiary organizations for purposes of determining the capital adequacy of banks probably is best resolved by differentiating between types of activities performed by the subsidiaries. It is suggested that investments in subsidiary firms that perform functions that could be performed in the bank not be deducted from capital, whereas equity investments in other subsidiaries should be deducted from capital. If capital is not offset, the subsidiary would be subject to normal supervisory control.

The second issue relates to the so-called "source-of-strength" doctrine, *i.e.*, the ability of the regulatory agencies to force corporate owners to support subsidiary banks. From a practical standpoint, the best approach would be to use the normal applications processing and supervisory activities to protect the deposit insurer from loss; this is the approach currently used in the case of banks owned by individuals.

FOOTNOTES

[1]The main vehicle for controlling and limiting the activities of affiliated organizations is the Bank Holding Company Act. However, there are affiliations that escape the purview of the Act. These include direct subsidiaries of banks (although the Federal Reserve recently has asserted that subsidiaries of banks that are members of a bank holding company are subject to the BHCA); bank directorates controlled by executives of nonbanking firms; ownership by an individual or limited group of individuals of banking and nonbanking firms; and, and until passage of the Competitive Equality Banking Act of 1987, the so-called nonbank bank. Perhaps the most complete separation is afforded by the Glass-Steagall Act, which prohibits a wide variety of affiliations between commercial banks and investment banking firms (see Chapter 4).

[2]Section 23A exempts transactions between affiliated banks from virtually all limitations except those relating to the sale of subquality assets. While this can be rationalized on the basis that banks are subject to supervisory and regulatory standards more stringent than nonbank affiliates, it does raise concerns from the viewpoint of the deposit insurer. Specifically, this permits banks within a multibank holding company structure to be operated as if the system were a single entity. Thus, a failure of one bank within the holding company structure often has implications for the solvency of affiliated banks.

[3]In regulations relating to securities subsidiaries of state, nonmember banks, the FDIC extended the restrictions of Section 23A to this type of arrangement. *See* 12 CFR 337.4.

[4]The agencies also will need—and perhaps already need—to reevaluate the level of aggregation required for the Call and Income Reports periodically submitted by all insured banks. Currently, such submissions are prepared on a fully consolidated

basis. If direct subsidiaries of banks are allowed to engage in a wide variety of activities (which currently exists under numerous state laws), it probably is advisable to collect and analyze information separately for banks and, as appropriate, for the subsidiary operations.

Chapter 9

A Proposal for Restructuring The Banking System

The foregoing analysis addresses issues raised by the restructuring of the banking system. Several conclusions emerge from this work. First, there is a need for restructuring. The maintenance of a healthy and viable banking industry demands that the industry generate sufficient returns to attract new capital to support normal growth and expansion into new areas. This requires the ability to compete on an equitable basis with other business enterprises. Second, there appears to be no historical precedent to suggest that there is a long-standing tradition of separation of banking and commerce in the United States. Beyond historical precedent, our review of the evidence does not support the wisdom of separation and thus we find no compelling reasons for continuing it.

Perhaps most importantly, the analysis does not support the view that product limitations and regulatory or supervisory authority over nonbanking affiliates of banks are necessary to protect the stability of the system or to limit the exposure of the deposit insurer or the payments system. There is evidence that insulation from risks from any type of affiliate can be maintained with relatively few changes to current rules governing the operations of banks and, most importantly, the professional supervisory staff of the FDIC concurs with this view.

From a public-policy perspective, the implications are clear. If a regulation is not necessary, economic efficiency will be enhanced if the regulation is eliminated. Neither the Glass-Steagall separation of commercial and investment banking nor the Bank Holding Company Act appear to be necessary to the safety and soundness of the banking system. The question is how best to test this proposition and how to implement change in an orderly fashion. The remainder of this chapter discusses these issues.

A Program for Expanding the Powers Available to the Banking Industry

The primary objective is to have a safe and sound system of banks that is not unduly hampered by regulation and supervision. While no one can define with certainty the extent of necessary supervision,

the analysis indicates that certain types of restrictions can be removed without great risk to the system. We propose that banks could own, or be owned by, firms that engage in any legal business activity, including nonfinancial activities. However, transactions between an insured bank and nonbanking affiliates would be subject to supervision and regulation, and the bank supervisory agencies would have authority to audit these transactions and require certain disclosures on the part of affiliates. The banking agencies would have *no other* regulatory or supervisory power with respect to affiliated organizations. If good public policy indicates that some nonbanking organizations require specific regulation, the responsibility should be assigned to the agency directly charged with this task (*i.e.*, regulation would be along *functional lines*).

It is unrealistic to believe that rules to completely accommodate this structure can be put into place overnight without incurring unnecessary risks. The banking industry and regulators will need time to adjust to the new rules. It will take time for the agencies to develop appropriate supervisory strategies, staff levels and skills necessary to operate effectively in a world where nonbanking affiliates are not subject to direct supervision and regulation. Moreover, it is unreasonable to expect the agencies to foresee all problems that could arise. Gradual phasing-out of present rules will permit unintended exceptions to be identified and addressed in an orderly manner. Moreover, changing the rules applicable to an industry that is as vital to the functioning of the economy as banking warrants caution. Thus, the most reasonable approach would be to proceed in steps, with a comfort period between each step.

The first step would be to enact the necessary legislation discussed in Chapter 8. Specifically, restrictions governing dividend payments and general loan limits need to be added to the Federal Reserve Act; the provisions of Sections 23A and 23B need to be extended to cover direct subsidiaries of banks; and, the agencies need to be given authority to require reports as needed from nonbank affiliates.

The second step would be to eliminate the Glass-Steagall restrictions on securities activities of banking organizations. Eliminating the Glass-Steagall restrictions all at once would be more equitable than a gradual phaseout of those restrictions, since it would allow securities firms to cross the line into banking at the same time that banking organizations are given the right to conduct a full-range of securities activities.

It is important to recognize that the order in which new activities become available to banking companies will have an effect on the way the system evolves. Everything else equal, activities that are permitted earlier in the phaseout period will be more attractive than those that become available later in the process. Thus, the availabil-

ity schedule for new activities must balance this consideration with other relevant factors, including the ability of the banking agencies to monitor the risks of the new activities.

The third step is to put in place an orderly phaseout of certain provisions of the Bank Holding Company Act. The timing and sequence of dismantling the BHCA involves maintaining a delicate balance between the need to remove unnecessary restrictions while keeping risks at an acceptable level. While there may be no single correct schedule, we believe the following will maintain this balance.

There should be little concern regarding removing provisions relating to regulatory and supervisory authority over nonbank affiliates and the parent company. The activities currently performed by banking organizations subject to the BHCA are limited to those "closely related to banking." The agencies have considerable experience supervising banks not currently subject to the BHCA with nonbank subsidiaries. With an appropriate phase-in schedule for new activities, there is little need for direct control during the transition period.

The provision of the Bank Holding Company Act relating to permissible activities is another area where a gradual liberalization is appropriate. It makes sense to permit affiliations with financial firms to take place on a faster schedule than affiliations with nonfinancial companies. Other than this broad guideline and the caution expressed earlier relating to the order in which new activities become available, the exact timetable probably is not important. However, it is important that decontrol is accomplished in an orderly and timely fashion and that the schedule is legislatively determined at the beginning of the process. In our view, it is important that certainty be part of the process. If this is not present, the chances of accomplishing the ultimate goal are diminished.

In summary, it seems reasonable to repeal certain sections of the Bank Holding Company Act. Product liberalization can be accomplished by an orderly legislative schedule broadening permissible activities, with a specific sunset date when all limitations on affiliations would terminate.

The last remaining question relates to the activities permitted to be conducted within banks. As pointed out in Chapter 6, this is not a simple question, and cannot be answered by a simple enumeration of permitted activities. If proper diversification can be achieved by a bank, it would be difficult to argue that any particular activity is "too risky." However, from a practical standpoint, any individual bank probably will not be able to achieve appropriate diversification due to the difficulties in measuring the factors important to diversification. Thus, in deciding what activities can be conducted within banks, risk is an important consideration.

A more important consideration relates to the activities that have access to the federal safety net. Activities that are performed within a bank have access to the payments system, Federal Reserve credit and funding by means of federally-insured deposits. Moreover, to the extent that the FDIC is successful in passing failed-bank assets to successor organizations, operating units within banks will be immune to closure. This obviouly has rather profound public policy and competitive implications, and represents a strong argument to restrict activities permitted within banks.

Historically, innovations in banking often have come about because of changes in state laws. This has had a positive effect on the industry and expanded the services available to consumers. Thus, a narrow list of permissible activities mandated at the federal level probably is not appropriate. Congress may wish to provide a broad outline of the types of activities that may be conducted within banks. However, even in the absence of such guidelines, Congress must decide who shall make the individual decisions regarding appropriate bank activities.

The individual bank supervisory agencies still will have to rely on rules that limit exposure from nontraditional banking activities, and prohibit activities that, in some sense, seem inappropriate for banks to perform directly. It should be noted that this is not a new problem created by eliminating the Bank Holding Company Act. State laws currently govern the permissible activities of state-chartered banks; there is considerable variation among these laws. Some states could permit banks to engage in activities that, in the judgment of the banking agencies, pose an undue risk. These situations would be handled on a case-by-case basis and, in some instances, would require a regulatory response.

Summary and Conclusions

Without the ability to retain and attract new business, the regulated banking industry will not be safe and sound. It is necessary, from the perspective of both industry viability and competitive equity, that the regulatory structure be changed to assure soundness.

To improve viability, two basic alternatives are available: maintain strict regulatory constraints, but allow banking companies to offer a wider variety of products; or remove the constraints and allow banking organizations to compete in markets that, in the individual judgment of management, make good business sense. The removal of constraints is appropriate if we can insulate the banking entities from the risks associated with nonbank affiliates, without spinning a regulatory web around the entire organization.

The major conclusion of this study is that insulation can be achieved, with only minor changes to existing rules pertaining to

the operations of banks. Thus, systemic risks to the banking industry and potential losses to the deposit insurer will *not* be increased if activity restrictions and regulatory authority over nonbank affiliates are abolished.

The public-policy implication of this conclusion is that certain provisions of the Bank Holding Company Act and the Glass-Steagall restrictions on affiliations between commercial and investment banking firms should be abolished. However, because of the importance of the banking industry to the economy and the high financial stakes that are involved, it is suggested that decontrol proceed in an orderly fashion.

It is suggested that the provision of the Bank Holding Company Act pertaining to regulation and supervision of bank holding companies could be eliminated without undue risk to the system. Product liberalization then could be accomplished by an orderly legislative schedule first eliminating the restrictions imposed by Glass-Steagall and then scheduling a gradual phaseout of certain provisions of the Bank Holding Company Act, with a specific sunset date when all limitations on affiliations would terminate.

This restructuring would be accompanied by a strengthening of the supervisory and regulatory restrictions on banks. The prudent supervision of banks would become more important, along with the need to monitor and limit risks posed by new activities conducted in the bank.

In summary, a supervisory safety and soundness wall can be built around banks that will allow their owners, subsidiaries, and affiliates freedom to operate in the marketplace without undue regulatory interference.

Appendix A

The Real-Bills Doctrine

The real-bills doctrine is an element of monetary theory that can be traced to Adam Smith's 1776 book, *The Wealth of Nations*. Although it has been disputed on theoretical grounds since its conception, the doctrine has continued to find new life over the years, both as an aspect of monetary theory and as a prescription for sound banking practice. As stated by Mark Blaug, the real-bills doctrine has

> . . . survived repeated criticism in the 19th century to be enshrined in the Federal Reserve Act of 1913, thus scoring high on the list of longest-lived economic fallacies of all times.[1]

As an element of monetary theory, the real-bills doctrine suggests that the expansion of money should be in proportion to any extension of trade that might occur in an economy. Its purpose was to provide elasticity to the money supply. This elasticity or flexibility would result if bankers limited their lending to the extension of short-term, self-liquidating commercial loans (bills of exchange and business paper). Lending and, in turn, the aggregate money supply would contract and expand with the needs of business, thereby keeping the level of prices stable.

As a form of monetary policy, the real-bills doctrine sought to indirectly manage the quantity of money in the economy by regulating, through the type of credit extended, credit quality. However, the doctrine has been consistently discredited by economists. It was demonstrated as early as 1802 that neither the quantity of money nor the volume of credit could be controlled by restricting discounts or loans to real bills.[2] As a guide to monetary policy, the real-bills doctrine has been deemed "utterly subversive of any rational attack on the problem."[3] Even so, this concept has survived into this century in the form of Federal Reserve credit-quality controls.

When applied to the practice of banking, the doctrine suggested that if banks would limit their assets to short-term, self-liquidating commercial loans or "real bills," liquidity (*i.e.*, the ability to convert notes into specie on demand) within the banking system would be assured. The problem with this "guide to sound banking" is that the self-liquidating notes need not be as, or more, liquid than other bank assets.

The real-bills doctrine initially took on the appearance of "orthodox doctrine" because the first American banks were founded by the merchant class for their own use. Merchants needed short-term extensions of credit to finance the production and distribution of their goods, and they alone, of all existing economic groups, had the means to supply this credit.

> This condition itself put them on the threshhold of banking and made them the firms to engage in it. . . . [H]ence banking germinated and rooted itself in the one place that at the time it could—in commerce.[4]

The first chartered banks were, therefore, mercantile institutions whose earning assets arose from the sale and purchase of real goods. Thus, the real-bills doctrine was a matter of expedience for the first American bankers. That it was not "orthodoxy" is evidenced by the other forms of lending that banks engaged in. Thus, even in the first era of American banking history the real-bills doctrine was not strictly adhered to.

In this century, the real-bills doctrine has played a role in the formation of public policy. As discussed in Chapter 4, the real-bills doctrine was used to justify the formal separation of commercial and investment banking in the Glass-Steagall Act of 1933. It was relied upon again to justify the restrictions and regulations placed on bank ownership and the nonbank activities of bank holding companies by the Bank Holding Company Act of 1956 and its 1970 Amendments.

More recently, the real-bills doctrine has reappeared as "evidence" for the historical precedence of a separation of banking and commerce. Specifically, it has been asserted that a separation of banking and commerce is a necessary corollary of the real-bills doctrine.[5] However, because the real-bills doctrine is silent regarding the ownership of banks, it appears that this is yet another misapplication of the doctrine. Thus, the real-bills doctrine has been and remains a controversial economic theory that has been misapplied as a guide to sound banking practice and policy.

FOOTNOTES

[1]Mark Blaug, *Economic Theory in Retrospect*, 3rd ed. (Cambridge, England: Cambridge University Press, 1978), p. 56.

[2]Rebuttal of the real-bills doctrine appeared in Henry Thorton's *Nature of the Paper Credit* (1802). It is discussed in Blaug, *Economic Theory*, pp. 211-12, and Lloyd W. Mints, *A History of Banking Theory in Great Britain and the United States* (Chicago: University of Chicago Press, 1945), pp. 52-55.

[3]Lloyd W. Mints, *A History of Banking Theory*, p. 35. See also, Blaug, *Economic Theory*, pp. 211-12.

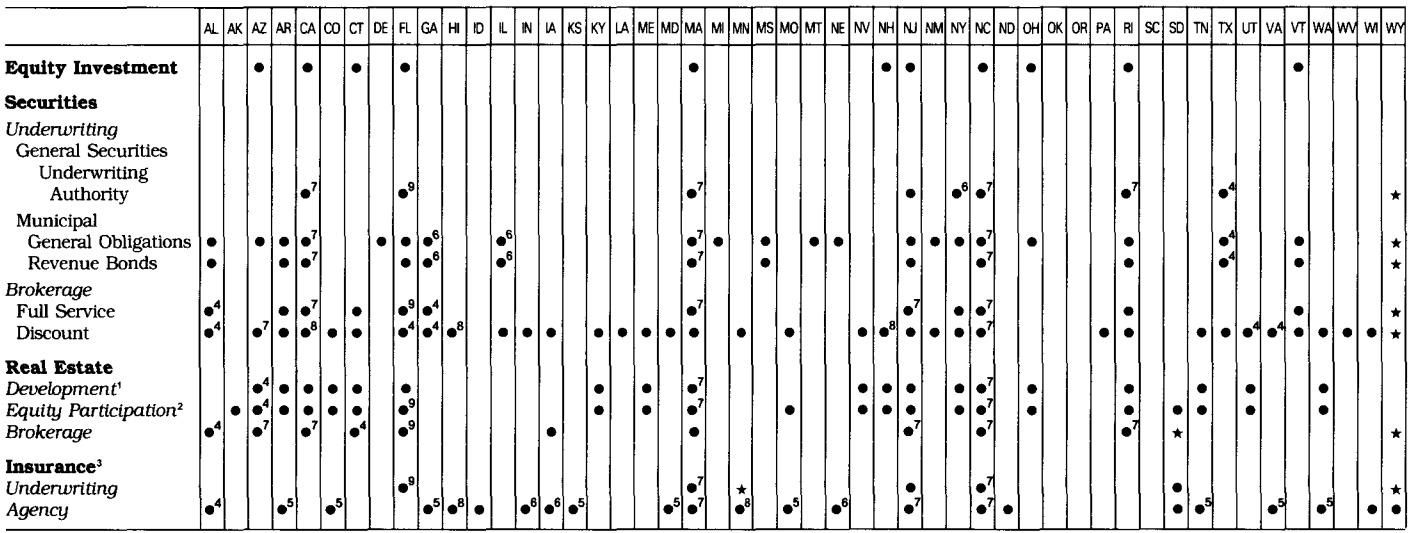
[4]Bray Hammond, *Banks and Politics in America from the Revolution to the Civil War*. (Princeton, NJ: Princeton University Press, 1957), p. 75.

[5]Melanie L. Fein and M. Michele Faber, "The Separation of Banking and Commerce in American Banking History," Appendix A to Statement by Paul A. Volcker, Chairman,

Board of Governors of the Federal Reserve System, before the Subcommittee on Commerce, Consumer and Monetary Affairs of the Committee on Government Operations of the United States House of Representatives, June 11, 1986, p. A-1.

Appendix B

STATE BANKING AUTHORITY BEYOND TRADITIONAL LEVELS
(as of April 8, 1987)



● Permitted activity

★ Uncertain whether activity could be offered, as state laws are silent

[1] Involves an active role in the development of real properties other than foreclosed properties

[2] Equity participations involve a passive investment role

[3] Insurance underwriting and brokerage authority beyond credit life insurance.

[4] Permitted but only by subsidiary.

[5] Permitted only in towns with populations of less than 5000.

[6] Permitted but with other limits.

[7] Possible through equity investment authority for control purposes.

[8] Permitted though state laws are silent.

[9] Permitted through bank subsidiaries though state laws are silent.

SOURCE Victor L Saulsbury, "State Banking Powers. Where Are We Now?" Federal Deposit Insurance Corporation *Regulatory Review* (April/March 1987):5-6.

Appendix C

Issues Relating to Federal Deposit Insurance

Protection of the deposit insurance system is a critical factor to be considered in restructuring the rules under which banks operate. Chapter 6, "Bank Safety and Soundness," dealt with this issue and concluded that as banking organizations are permitted broader powers it becomes increasingly important that banks be insulated from risks posed by nonbanking activities and that the federal safety net not be extended beyond the bank itself. There are other issues relating to deposit insurance that, even in the absence of banking reform, need to be addressed. This appendix identifies these issues, but does not provide an analysis of alternatives or present suggestions or answers—an undertaking worthy of a separate study.

With this in mind, the discussion will focus on three issues: complications that arise in handling failing banks that are part of a multibank holding company; pricing deposit insurance to reflect individual bank risk; and, the implications of deposit insurance for market discipline.

Multibank Holding Companies

As indicated in Chapter 6, it is the FDIC's policy to handle failing banks in a manner that does not benefit the owners or creditors of the parent or affiliated organizations. Some relationships with affiliates of bank holding companies, however, complicate FDIC policy decisions. In the case of bank-to-nonbank affiliate relationships, Section 23A limits the bank's exposure to nonbank affiliate risk. However, for bank-to-bank affiliate relationships, most Section 23A restrictions do not apply. Thus, it is not uncommon to find smaller subsidiary banks funding the operations of the lead bank by means of large CDs or unsecured federal funds advances—especially if the lead bank is experiencing financial difficulties and unable to secure market financing at reasonable rates.

Under these types of arrangements, the financial condition of affiliated banks may also be worsened since their lending rate may be below market for the risk they are assuming. Moreover, because these interbank connections are not limited, it is difficult for the FDIC to deal with an individual failing bank in isolation; it must take into consideration the effect on affiliated banks in deciding how

to resolve the situation. For example, in the case of First City Bancorp, prior to the agreement in principle to an open-bank assistance transaction, subsidiary banks were providing about $2 billion in funding for the failing, $5 billion lead bank of the holding company. Any failing- or failed-bank transaction with the lead bank that did not protect the affiliates of the lead bank may have led to the failure of many otherwise solvent banks. This type of problem generally does not arise with bank-to-nonbank arrangements, as the ultimate fate of nonbank affiliates need not be factored into decisions of how to treat the failed or failing bank.

As discussed in this study, insulation of banks from risks posed by nonbank affiliates is important to prevent extension of the deposit insurance "safety net" to nonbank entities. From the perspective of potential losses to the FDIC, transactions between affiliated banks that are not subject to strict restrictions can be as damaging as those between banks and nonbank affiliates. This type of situation raises serious questions about the exemption from Section 23A regarding transactions between affiliated banks.

Additionally, questions have been raised regarding the level of expected loss for failed banks in states with restrictive branching laws. Historically, the FDIC has experienced more difficulty in arranging purchase and assumption transactions (P&As) in states that have branching restrictions and limit the activities of multibank holding companies. In such cases, costs are increased, since a purchase-and-assumption transaction normally is less expensive to the FDIC than a deposit payoff. This phenomenon, coupled with the problems involved with multibank holding companies discussed above, has prompted some to suggest that banks operating in limited branching states be charged higher deposit insurance premiums than banks operating under less restrictive state laws. The FDIC believes that this concept has considerable merit.

There are legitimate reasons other than avoidance of restrictive state branching laws why a banking organization would choose to operate as a multibank holding company even if other alternatives are available. Nevertheless, the FDIC must maintain the ability to deal with problem-bank situations in isolation, without undue concern for other affiliated banks. Restrictions placed on transactions between affiliated banks probably need to be strengthened, particularly since multibank holding companies most likely will proliferate as interstate banking opportunities expand. The question is: what restrictions will adequately protect the deposit insurer with minimum interference to the operations of banking companies?

Pricing of Deposit Insurance

From an actuarial standpoint, a good case can be made that deposit insurance, overall, has been at least adequately priced during most of the history of the FDIC. Until recently, realized losses have been modest relative to assessment income. Even with the rebate system, which was instituted in 1950, and increases in insurance coverage, the deposit insurance fund has remained relatively constant in proportion both to total and insured deposits.

The flat-rate system of assessments has not appropriately distributed the burden of deposit insurance premiums among insured banks. Since a flat-rate premium is assessed against the deposit base (essentially deposits held in domestic offices with adjustments designed to eliminate double counting due to "float") and not risk, banks that have a low-risk profile subsidize those that choose to engage in riskier activities. This creates inappropriate incentives for bank expansion even in the face of serious risk to the bank, and is not an equitable way to assess deposit insurance premiums.

All parties concerned agree that the ideal premium structure would relate each bank's deposit insurance assessment to the risk it poses to the insurance fund—*i.e.*, a risk-based deposit insurance premium structure. However, measuring the expected loss implied by current bank operations is difficult. Moreover, some risk measures (*e.g.*, the ratio of commercial and industrial loans to total assets) may have an allocative effect that is undesirable from a public-policy perspective.

The FDIC has made various proposals designed to account for individual bank risk.[1] The most recent FDIC proposal is based on the idea that risks can be identified based on the operating characteristics that differentiate problem from nonproblem situations.[2] While the models that have been developed have been very successful in differentiating between the two classes of banks, the overall proposal has the effect of penalizing institutions that already have been identified as problem banks. While not a measure of *ex ante* risk, the proposal has the advantage of introducing equity into the deposit insurance system and most likely will present an additional deterrent to engaging in activities that present a high risk to the bank.

Although it may not be possible to develop a risk-related premium structure that perfectly measures *ex ante* risk, the FDIC is committed to working toward a practical and equitable system. The proposal released for comment in 1986 represents a first step toward introducing an element of equity into the pricing structure. The FDIC will continue to undertake research in this area and encourages other interested parties to pursue this topic. While strictly

theoretical constructs are a necessary first step, what is needed is a practical solution that can be implemented within the banking environment that exists today.

There have been a variety of other proposals dealing with risk-based deposit insurance premiums. These have ranged from using an options-pricing methodology to use of subjective evaluations derived during bank examinations.[3] While this appendix does not review these proposals, it should be noted that each deserves consideration.

Another general approach is exemplified by the risk-based capital proposals released for public comment by the three U.S. federal banking agencies and the Bank of England.[4] This approach ties the level of capital a bank must hold to the types of risk on and off the bank's balance sheet. The three primary objectives of the risk-based capital proposal are to 1) assess a capital requirement against certain off-balance-sheet exposures; 2) temper disincentives inherent in the existing guidelines to hold low risk, relatively liquid assets, and 3) move U.S. capital adequacy policies into closer alignment with policies currently in use or under development in other major industrial countries. This last objective is of particular importance in view of increasing global banking competition and the desirability of achieving greater convergence in the measurement and assessment of capital adequacy of multinational banking organizations. The major problem with such an approach is that unless carefully crafted, the weighting scheme employed could have a disruptive effect on credit allocation.

The role of investment strategies that reduce risk has received relatively little attention in discussions of deposit insurance pricing schemes. As pointed out in Chapter 6, the key to risk management is appropriate diversification. A bank should exercise reasonable underwriting standards and remain appropriately diversified, both between and among major asset categories, if it is to control its risks. Unfortunately, measuring diversification in a meaningful way is very complex. It is not clear how future returns will behave, and what correlations will exist between returns on various categories of assets. Linkages between geographic regions, industrial sectors and firms are not always obvious until a downturn occurs in one area. Nevertheless, this area deserves a great deal of additional thought and research.

Market Discipline

Technically, deposit insurance protects each depositor in an insured bank up to $100,000. However, the FDIC has chosen to handle most bank failures, at least since the early 1960s, in a way that protects all depositors and other general creditors from loss. Specifically, the preferred method of failure resolution has been to

dispose of the bank by means of a P&A transaction, whereby all claims of senior creditors are transferred to an assuming institution. This type of arrangement normally has been less expensive than a statutory payoff because the assuming bank will purchase some of the failed bank's assets (avoiding FDIC liquidation costs), and will pay a purchase premium to the FDIC approximating the remaining franchise value of the defunct bank. Although financially more advantageous to the FDIC, the use of P&A transactions has removed the need for most depositors and other creditors to assess the condition of banks. This has been especially true for large banks, where the market has perceived that a statutory payoff is unlikely.

Recently, the FDIC has attempted to arrange a P&A transaction whenever possible, and has demonstrated a willingness to provide financial assistance in mergers or acquisitions of large and small troubled banks when cost effective.[5] There are valid reasons for these policies. First, a major criticism of the deposit insurance system is that there has been unequal treatment of large and small banks—large banks probably would never be handled by means of a statutory payoff, whereas small banks often were handled in this manner. While not completely eliminating the differences between methods of handling large- and small-bank failures, the degree of unequal treatment has been reduced. Second, assets left in the banking system most often have a higher value than assets to be liquidated. Thus, the FDIC is attempting to pass to the acquiring institution more or, in some cases, all of the assets of the failed bank—regardless of how the failure is handled. The major drawback of this policy is that it further reduces the incentive for depositors and other general creditors to be concerned about the quality of bank assets.

The FDIC's study of the deposit insurance system (the "DICE Study"), which was completed in 1983, concluded that increased market discipline is necessary to adequately control risks as regulation of banks (*e.g.*, deposit interest-rate controls) is relaxed.[6] Absent increased market discipline, supervisory activity would have to be significantly increased.

The study suggested that the best way to increase market discipline is to place uninsured depositors at risk for at least a portion of uninsured amounts. The recommended vehicle to achieve this was the so-called "modified payoff." Under this approach, when a bank was closed the FDIC would advance to uninsured creditors an amount based on the anticipated present value of recoveries on the failed bank's assets. Thus, uninsured creditors would be placed at risk, but community disruption would be reduced since uninsured funds, up to the amount of eventual recoveries, would be available immediately. Problems soon arose with this approach.

The near-failure of Continental Illinois National Bank and Trust Company made it clear that the risks to the system are far greater when dealing with a large bank than with small institutions. It became evident that there are reasons that the FDIC or, more generally, the U.S. government, cannot permit a large bank failure to be handled in a way that would result in losses to depositors. It was felt that the chance of a deposit run on other large banks if uninsured funding sources lose confidence probably is too great to effect a modified payoff or similar transaction in this type of situation. Moreover, it is unlikely that any major industrialized country would permit creditors to experience a loss because of a major bank failure.[7] Finally, Continental served to remind everyone that banks are "special" in several ways, including funding sources. Banks are one of the few types of institutions that are highly leveraged and rely on short-term instruments redeemable at par as the primary source of funding. Thus, market discipline can be exercised suddenly and without warning and, as occurred in the early 1930s, could spread to an unacceptable proportion of the industry. This is one of the primary reasons why there is a deposit insurance system in the United States. For these reasons, the FDIC does not believe that increased depositor discipline is practical in the current structure of the U.S. banking system.[8]

Another concept discussed in the *DICE Study* is an increased role for subordinated debtholders and owners in providing market discipline.[9] Under the proposal, a portion of a bank's regulatory-required capital could be satisfied by subordinated debt. There are several advantages to this approach. First, the appropriate overall equity capitalization of each bank would, within limits, be market-determined by the relative costs of debt and equity. Second, market perceptions of the condition of a bank would be communicated quite clearly by the terms and conditions upon which new subordinated debt could be sold and by the price at which existing instruments trade on the market. Finally, since the maturity of subordinated debt has to be longer than the maturity of typical deposit liabilities to count as capital, the instability problems associated with reliance on depositor discipline are avoided.

This proposal is not without problems. Perhaps the most significant is that minimum regulatory capital standards probably would be increased. This would further reduce the ability of banks to attract new capital. Additionally, it is unclear what markets would develop for the subordinated debt of small banks. While upstream correspondent banks and present owners are the most likely source, these markets are imperfect and cannot be relied upon to send appropriate signals to banks.

There are other ways to create a class of uninsured creditors that would be exposed to loss in a failure situation. One suggestion is to

enact a national depositor preference statute, whereby depositors would be given a preferred position relative to other general creditors of the bank. Several states recently have enacted depositor-preference statutes that apply in failures of state-chartered banks. While there is an incentive for nondepositor creditors to seek depositor status, this proposal has the potential to increase creditor discipline and to make it easier for the FDIC to resolve failing-bank situations in an orderly and consistent manner.[10]

The desirability of creditor discipline is still open to question. Whatever the answer, it is important to note that the present system is not devoid of market discipline. Clearly, publicly-traded companies have to contend with the discipline imposed by stockholders, security analysts and, in the case of holding companies, creditors of the parent organization. Moreover, the threat of loss of employment or a reduced income and loss of personal reputation cannot be disregarded as sources of discipline on management. Additionally, there is a degree of uncertainty as to whether a large bank will be paid off; thus, individual banks still have to be concerned with the perceptions and actions of exposed depositors.

Summary and Conclusions

This appendix discusses three broad issues. First, the issue of the appropriate restrictions on transactions between affiliated banks is raised. Currently, the rules allow affiliated banks to be operated as a *de facto* branch banking system. While this may make sense from an operational standpoint, it can complicate the handling of failed-bank situations in a way that forces the FDIC to consider the effects on affiliated banks.

Second, the present flat-rate deposit insurance system subsidizes banks with a high-risk profile at the expense of more conservatively run institutions. Moreover, there is a presumption that this system provides an incentive to increase risks at individual banks. Many of the proposals suggested to date either penalize banks that already are identified as problems or would measure risk by the degree of participation in broad categories of activities. The extent of appropriate diversification probably is the best means to reduce risk. However, there are serious conceptual and measurement problems to be solved before diversification risk can be used to price deposit insurance.

Finally, issues related to the effect of deposit insurance on the disciplinary role of the market are considered. The evidence indicates that efforts to bolster discipline by placing depositors at increased risk is not a viable alternative under the present structure of the U.S. banking system. However, there are other means to

increase incentives for market participants to be more concerned with bank operations. If and how this should be accomplished is still open to question.

FOOTNOTES

[1]See, Federal Deposit Insurance Corporation, *Deposit Insurance in a Changing Environment*, (Washington, DC: Federal Deposit Insurance Corporation, 1983), Chap. II.

[2] See, Eric Hirschhorn, "Developing a Proposal for Risk-Related Deposit Insurance," Federal Deposit Insurance Corporation *Banking and Economic Review* (September/October 1986):3-10.

[3]For a review of the relevant literature, see Arthur J. Murton, "A Survey of the Issues and the Literature Concerning Risk-Related Deposit Insurance," Federal Deposit Insurance Corporation *Banking and Economic Review* (September/October 1986):11-20.

[4]James Chessen, "Regulatory Proposals for a Supplemental-Adjusted-Capital Measure," Federal Deposit Insurance Corporation *Banking and Economic Review* (March 1986):11-17.

[5]In 1983, the FDIC published guidelines to be used in evaluating requests for open-bank assistance; these were revised in 1986. See, "FDIC Statement of Policy and Criteria on Assistance to Operating Insured Banks," 48 *Fed. Reg.* 38669, August 25, 1983; 51 *Fed.Reg.* 44122, December 8, 1986.

[6]Federal Deposit Insurance Corporation, *Deposit Insurance in a Changing Environment*, Chap. III.

[7]In the absence of a *de facto* guarantee, foreign central banks could freeze assets in branches of U.S. banks to satisfy creditor claims. Thus, a modified payoff or similar transaction could result in creditors of foreign offices obtaining a senior position with respect to failed-bank assets.

[8]It should be pointed out that not every informed observer would agree with the views expressed in this paragraph. Some feel that risks to the system if uninsured depositors are placed at risk are overemphasized, and that "market-insolvent" institutions should be closed. Moreover, these same observers feel that protecting uninsured depositors will increase long-term costs to the FDIC by encouraging banks to assume more risks. For an example of this line of reasoning, see Edward J. Kane, *The Gathering Crisis in Federal Deposit Insurance* (Cambridge, MA: MIT Press, 1985).

[9]Also see, Federal Deposit Insurance Corporation, "FDIC Requests Comment on Ways to Achieve Market Discipline," Press Release 57-85, May 6, 1985.

[10]See, Stanley C. Silverberg, "A Case for Depositor Preference," Federal Deposit Insurance Corporation *Banking and Economic Review* (May 1986):7-12.

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