

# Banking Reform: An Overview of the Restructuring Debate

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Proponents of banking reform, whether they be bankers, nonbank bankers, would-be bankers, or bank regulators, all agree on one thing: our current regulatory system is out of sync with the financial marketplace. Proponents of reform point out that regulatory restrictions prevent a firm that might be able to provide a financial service to customers at lowest cost from competing for customers' business, and that services that fill

the same customer needs and pose very similar risks—like making short-term loans and underwriting commercial paper—often cannot be provided by the same firm. They also have argued that as customer demand shifts from one product to another, financial firms frequently face a dilemma: to seek out ways to evade regulations or else to lose business.

Policymakers have tinkered with regulations and patched loopholes in response to marketplace changes, but this piecemeal approach always seems to leave regulators one repair behind, because financial changes have been so rapid. And each repair is time-consuming, both because

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of the amount of time required to analyze the issues being raised in each case and because many industry groups seek to influence the final outcome. There is a growing feeling that it is time for a more fundamental financial restructuring, guided by a longer-term blueprint. Reform would be made more coherent if public debate could be focused on a longer-term vision of a workable and efficient regulatory framework.

There is no shortage of complicated restructuring plans (see A BIBLIOGRAPHIC GUIDE TO THE RESTRUCTURING PROPOSALS), and evaluating the merits of the different proposals may seem like a daunting task. A helpful first step is to identify and explain the broad areas of agreement and disagreement among the various plans. Indeed, most participants in the debate

agree that bank powers should be expanded and that a limited safety net for banks should be retained. There is, however, much disagreement about what powers banking organizations should have, what types of holding company structures — if any — are desirable, and how holding companies should be regulated. While the disagreements are far-ranging, they stem primarily from disagreement about a single issue: can a bank be insulated from its affiliates?

### THREE BROAD AREAS OF AGREEMENT

**Bank Powers Should Be Expanded.** All the restructuring proposals agree that some expansion of bank powers would not only enhance the competitiveness of banks in financial markets but would also benefit consumers and businesses.

## A Bibliographic Guide to the Restructuring Proposals

To illustrate the various points of view on restructuring the banking system, this article focuses on the following proposals made by bank regulators:

**Comptroller of the Currency**—The main elements of the Comptroller's views are contained in the Statement of Robert L. Clarke, Comptroller of the Currency, before the Committee on Banking, Housing, and Urban Affairs, United States Senate, May 21, 1987.

**FDIC**—The views of the FDIC are contained in a staff study, *Mandate for Change: Restructuring the Banking Industry*, August 18, 1987, and L. William Seidman, *Perspectives on Financial Restructuring*, Remarks to an Economic Policy Conference, Federal Reserve Bank of Kansas City, Jackson, Wyoming, August 21, 1987.

**Federal Reserve System**—Although the Fed has not presented a formal long-term plan, the consensus viewpoint can be gleaned from testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, United States Senate, December 1, 1987. E. Gerald Corrigan's, *Financial Market Structure: A Longer View*, Federal Reserve Bank of New York, January 1987, while not an official statement of the Fed, is a good illustration of Fed thinking on many points.

Bank regulators are not the only participants in the debate. Other restructuring proposals include:

Association of Bank Holding Companies, "Financial Services Holding Company Act of 1988," draft IV, May 15, 1987.

Association of Reserve City Bankers, Emerging Issues Committee, "Proposals for a Financial Services Holding Company," May 1987.

Committee on Government Operations, "Modernization of the Financial Services Industry: A Plan for Capital Mobility Within a Framework of Safe and Sound Banking," House Report 100-324, U.S. Government Printing Office, Washington D.C., 1987.

Other useful summaries of the restructuring debate include:

Thomas F. Huertas, "Redesigning Regulation: The Future of Finance in the United States," *Issues in Bank Regulation*, Fall 1987.

Manuel H. Johnson, Statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, May 21, 1987.

While there is no universal agreement about which products and services banks should be permitted to sell, the possibilities include financial services—such as investment banking, underwriting and selling insurance, and real estate investment and brokerage—and even nonfinancial products. The reasons for proposing expanded bank powers are varied, but tend to focus on efficiencies that might be realized.

Under the current regulatory framework, customers for financial services have to use different types of firms even though the services being purchased are closely related. Proponents of expanded powers argue that aside from facing the simple inconvenience of dealing with more than one firm, the customer might be able to purchase several services at lower cost from a single firm. For example, the credit analysis performed by a bank processing a loan request will include information that would also be useful in determining the customer's insurance needs—what economists call an economy of scope.<sup>1</sup> Regulations that restrict the bank from providing both loans and insurance may increase the costs of producing both services and, in turn, the price that customers must pay for them. It should be noted, however, that the empirical evidence for significant scope economies is actually rather scanty.

Bank loans and commercial paper illustrate another potential benefit of an expanded menu of services for banks that has been proposed by proponents of reform: expanded powers would ease the flow of resources between markets as customer demand changes. Many large and medium-size firms have switched from bank loans to the commercial paper market as their primary source of short-term funds. But when a firm makes the switch, the bank's accumulated knowledge about the firm is effectively destroyed

as a valuable resource, because it is difficult to sell or transfer knowledge to another firm. Thus, the firm must pay the investment banker to develop the expertise that was lost. If the commercial bank were permitted to underwrite commercial paper, this added expense to the customer could be saved and the shift to satisfy the new customer demand would be facilitated.

While the case for expanded powers is most convincing for financial services, proponents of expanded powers also argue that economies of scope between financial and nonfinancial services may also exist. All of the major auto firms have finance subsidiaries, which were initially set up to coordinate the marketing and financing of new car purchases. And the successful entry by these finance subsidiaries into the expanding markets for other types of consumer loans—such as mortgages—illustrates the potential benefits of a free flow of resources between financial and nonfinancial sectors.

**Functional Regulation Is Desirable.** If banks are granted powers to sell insurance or underwrite securities, policymakers must make sure that regulatory rules do not favor banks over their competitors, or vice versa. All restructuring proposals agree, at least in principle, that different types of firms providing the same service—or function—should be subject to similar regulatory rules. This principle is called *functional regulation*. Although functional regulation does not necessarily mean that all providers of a particular service should be governed by the same regulator, it may be difficult to ensure uniform regulatory treatment when different regulators are involved. And while all proposals agree that functional regulation is desirable, there is no such agreement about who should regulate which services.

Functional regulation promotes competitive equity and invites firms to use their ingenuity to satisfy customer needs rather than to evade regulations. In the competitive battle for customers, the firm with the lowest costs and best products is supposed to win. But we cannot be sure that the well-run firm will win if it is saddled with more burdensome regulatory rules than its

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<sup>1</sup>For a more thorough discussion of economies of scope, see Loretta J. Mester, "Efficient Production of Financial Services: Scale and Scope Economies," this *Business Review* (January/February 1987) pp.15-25.



poorly run competitor. In fact, the well-run firm is not likely to take this situation lying down. Instead, the firm will spend much of its time figuring out legal ways to evade the regulations that place it at a competitive disadvantage. From society's standpoint, all this time and effort are sheer waste.

**A Strictly Limited Safety Net for Banks Is Needed.** Deposit insurance and access to the discount window are the two main ways in which the federal authorities provide a safety net for banks and their customers. The safety net is designed to guarantee stability in the payments system and to ensure that banks can play their special role in providing liquid funds to businesses and consumers, especially in times of financial stress. But since the safety net provides government guarantees to banks and their customers, it must be supplemented by regulations to make sure that the government is not writing bankers a blank check to take on risky activities. These regulations include capital requirements and periodic bank examinations.

Most proposals agree that firms providing deposits on demand should be protected by a safety net, yet no one wishes to see government guarantees and regulations extended willy-nilly to other types of activities and services; that is, the safety net should be limited in scope. But this is easier said than done. If banks' powers are expanded, how can the government hold the safety net under the bank when it provides "banking" services without extending the net to all the other services provided by the bank? This question raises a host of vexing issues concerning how bank holding companies should be organized and regulated. Here, agreement ends and the proposals part ways.

### RESTRUCTURING PROPOSALS DIFFER ON THREE MAJOR ISSUES

The institutions at issue are bank holding companies, which are firms that own one or more banks. Current law defines a bank as either a firm that offers federally insured deposits or one that offers demand deposits and makes com-

mercial loans. It is easier to see the differences among the restructuring proposals using just the first definition.

**What Activities Can Be Carried out within Bank Holding Companies?** Much of the immediate controversy over banking reform has been about the desirability of adding particular financial services to the bank holding company's menu of permitted activities. And, as a practical matter, only financial powers—underwriting and dealing securities, real estate investment and brokerage, and selling and underwriting insurance—are under serious consideration by federal legislators for the near future.<sup>2</sup> Each and every financial power has been hotly contested, partly because of opposition from entrenched firms who are unhappy with the prospect of new competitors, partly because of differences of opinion about the potential risks to bank safety, and partly because of different interpretations about the range of permissible powers under current banking laws. In particular, the federal bank regulators do not all agree about which of these financial services banks should be permitted. (See HOW THE REGULATORS LINE UP ON BANK POWERS.)

In the long term, however, perhaps the most important issue is whether bank holding companies should be permitted to offer just financial services or whether they should also be permitted to offer nonfinancial services and products, like automobiles. The example of a bank holding company selling cars is not unrealistic. General Motors already sells cars and also makes consumer loans. If it were permitted to offer insured deposits through its finance subsidiary, it would be a bank holding company that also produces cars.

Proposals coming from the Federal Reserve System take a narrow view of the issue of separating banking and commerce. Speaking for the

<sup>2</sup>For a summary of banking legislation before Congress, see Federal Reserve Bank of Philadelphia, *Banking Legislation and Policy*, Vol. 7, No. 1 (January/March 1988).

How the Regulators Line Up on Bank Powers						
REGULATOR	FINANCIAL					NON-FINANCIAL
	Investment Banking	Real Estate		Insurance		
		Investment	Brokerage	Underwriting	Sale	
Comptroller	yes	yes with restrictions	yes	yes	yes	no formal position
FDIC	yes	yes	yes	yes	yes	yes
Federal Reserve	yes	no with exceptions	yes	no formal position	no formal position	no

Fed, Chairman Alan Greenspan has argued that banking should be separated from commerce, which is just another way of saying that bank holding companies should not be permitted to offer nonfinancial services.<sup>3</sup> Gerald Corrigan, President of the New York Fed, has presented his own detailed restructuring plan that restricts bank holding companies to offering financial services. On the other hand, the Federal Deposit Insurance Corporation (FDIC) has proposed that bank holding companies be free to offer a full range of financial and nonfinancial services. Under that plan, General Motors could own a bank subsidiary or Citicorp could own an automobile factory.

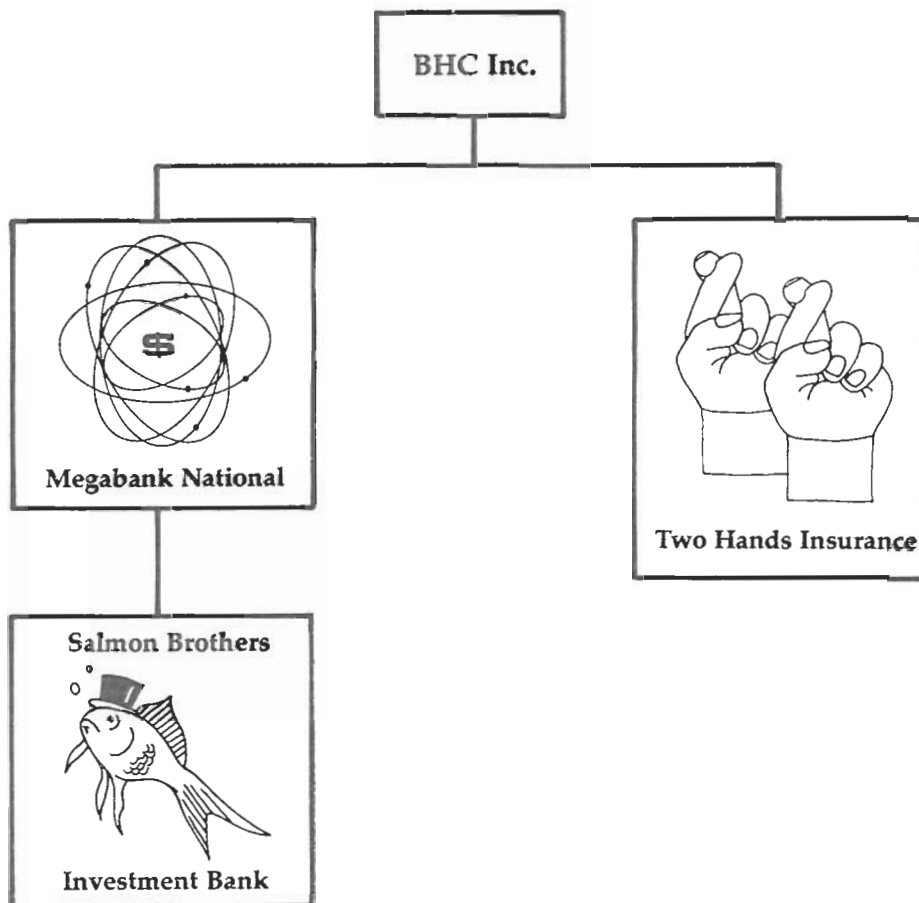
**Where Can Nonbank Activities Be Carried Out Inside the Bank Holding Company?** Anyone

<sup>3</sup>Actually, "banking" and activities "closely related to banking" as defined by regulators are not all financial services. The distinction between financial and nonfinancial activities, however, is a close approximation to the distinction between banking and commerce.

who has examined the organizational chart of a large company knows that internal organizational structures can be quite complex. (See AN IMAGINARY HOLDING COMPANY, p. 8.) With expanded powers, bank holding companies might choose a number of different ways to provide nonbanking services. Take the hypothetical example of a holding company that wishes to provide both commercial banking services and underwriting of securities. The holding company could create two separate subsidiaries, a commercial bank subsidiary and an investment bank subsidiary. Each subsidiary would be separately capitalized and have its own management. Or, the holding company could set up a commercial bank subsidiary which provides investment banking activities through its own investment bank subsidiary. That is, the holding company owns the commercial bank, which in turn, owns the investment bank. Finally, the holding company could simply create a single subsidiary that provides both services, perhaps in separate departments.

Although there are some analysts who would

### An Imaginary Holding Company



BHC Inc. illustrates a holding company structure that might arise if bank holding companies were permitted to offer underwriting and insurance services and if they were free to choose their own internal organization. The *parent company*, BHC, owns stock in its two subsidiaries: a *bank subsidiary*, Megabank National, and a *nonbanking subsidiary*, Two Hands Insurance. Normally, BHC will hold a large share of its subsidiaries' equity, because there are substantial tax benefits if the parent owns at least 80% of a subsidiary's stock. Megabank also has its own subsidiary, an investment banking firm, Salmon Brothers. The bank owns stock in Salmon Brothers, just as BHC owns stock in the bank and the insurance company. BHC and Two Hands Insurance are both *nonbanking affiliates* of Megabank. Megabank's own subsidiary, Salmon Brothers, is also considered a nonbanking affiliate of the bank.<sup>a</sup>

<sup>a</sup> Megabank might also have affiliates outside of the holding company. Under Section 23a of the Federal Reserve Act, the Federal Reserve System has substantial discretion in defining an affiliate. If business dealings between a bank and another firm are not "at arm's length," the Fed considers that firm an affiliate of the bank.



leave the bank holding company free to make any of these choices, none of the major restructuring proposals advocates the third possibility.<sup>4</sup> The major proposals are, however, divided between those which would permit banks to own nonbanking subsidiaries and those which would require that nonbanking services be provided through subsidiaries that are managed and capitalized separately from bank subsidiaries. President Corrigan, in his own proposal, and Chairman Greenspan, speaking for the Fed, have taken the approach that banking and nonbanking activities should be housed in separate subsidiaries of the holding company. The Comptroller of the Currency has taken the less restrictive stance that bank holding companies should be free to choose either organizational form. The FDIC, while nearer to the Comptroller's position, has agreed that separate subsidiaries might be required for some activities that regulators deem to be especially risky.

**What Parts of the Bank Holding Company Should Be Regulated By Bank Regulators?** On this question, the proposals are divided between those that advocate consolidated regulation of the bank holding company and those that would have bank regulators oversee just the bank subsidiaries of the holding company.

Consolidated regulation can mean different things to different people. In the official Fed position, consolidated regulation, at the minimum, would permit the bank regulator to set capital requirements for the parent company as well as for its bank subsidiaries.<sup>5</sup> The Corrigan proposal

takes a more expansive view of the supervisory powers of the holding company's regulator. In his proposal, the holding company's regulator could also set capital requirements for and exercise "prudential supervision" over each component part of the holding company. Thus, a separately capitalized investment banking subsidiary of the holding company would be subject to direct oversight by a bank regulator.

Both the FDIC and the Comptroller take a narrower view of bank regulators' oversight role. Specifically, bank regulators would set standards—like capital requirements and portfolio restrictions—for the bank, but not for the holding company or for any of the nonbanking subsidiaries of the holding company. The bank's regulators would, however, set and enforce rules governing relations *between* the bank and its nonbanking affiliates: the parent company, the nonbanking subsidiaries of the holding company, and the subsidiaries of the bank. For example, bank regulators would set rules limiting lending by the bank to an insurance affiliate or to the parent company.

**The Root of the Differences.** If we step back for a minute, we can see that the proposals' answers to each of the questions are linked. Proposals requiring strictly separate nonbanking affiliates also call for consolidated supervision of the holding company—the Corrigan view and the Fed view. Proposals granting bank holding companies more freedom to choose how to offer nonbanking activities do *not* call for consolidated supervision—the Comptroller and the FDIC view. And those who demand tighter restrictions on holding company organization and require consolidated supervision would also permit bank holding companies to offer fewer nonbanking services.

But how are the answers to these very different questions linked? The most important reason why President Corrigan and the Fed answer one

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<sup>4</sup>Analysts who advocate the third possibility believe that existing restrictions on interaffiliate transactions are a feasible alternative to restrictions on organizational choice. See, for instance, Anthony Saunders, "Bank Holding Companies: Structure, Performance, and Reform," in William Haraf (ed.) *Restructuring the Financial System*, American Enterprise Institute, Washington, D.C. (forthcoming).

<sup>5</sup>The recent Fed interpretation of its traditional position that the holding company should act as a "source of strength" to its bank subsidiaries implies an even stronger role for the consolidated capital of the bank holding company. Under the source of strength doctrine, regulators can require the

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holding company to provide financial support to a weakened or failing bank subsidiary when the holding company is in a position to do so.

way and the FDIC and the Comptroller another is that they have different views about the possibility of insulating the bank from non-banking affiliates within the holding company. Both President Corrigan and the Fed believe that insulation of the bank is quite difficult to guarantee, while both the FDIC and the Comptroller are more optimistic about the feasibility of insulating the bank.

### INSULATION OF THE BANK: THE KEY TO THE DEBATE

**What Does Insulation Mean?** In the debate over regulatory reform, the idea of insulating the bank has paraded under a number of colorful phrases such as the creation of "Chinese walls" or "fire walls" between the bank and its non-banking affiliates. Whichever term is used, the basic idea is that the safety net, which necessarily includes government guarantees to the bank and its depositors, should not be extended to nonbanking affiliates within the holding company.

In normal times, when the bank and its affiliates are financially healthy, insulation means that the holding company cannot use the bank to subsidize nonbanking activities. For instance, the bank might conceivably pay out "excessive" dividends to the parent company, which then reinvests these funds in an insurance subsidiary. These transfers may weaken the bank financially, but some of the increased risk is borne by the FDIC, which generally guarantees the bank's depositors against loss. *This type of policy, in effect, transfers the benefit of the government guarantees for bank depositors to the insurance affiliate.*

In times of crisis, when either the parent company or a nonbanking firm in the holding company is financially troubled, insulation means that neither the bank nor bank regulators will prop up the affiliate. Suppose a real estate investment affiliate's investments have shaky foundations and are beginning to fall in value. The parent company might direct the bank to make loans to the real estate affiliate, even though

these loans would normally be considered excessively risky. Should these loans threaten the health of the bank, bank regulators might step in to save the bank, effectively passing on losses from the real estate affiliate to the FDIC. An insulated bank would neither subsidize its affiliates nor prop up affiliates in trouble.<sup>6</sup>

**Why Is Insulation the Key?** Suppose banks can be insulated effectively from their non-banking affiliates. In that case, a whole host of problems disappear. There is little danger in permitting bank holding companies to offer a wide range of nonbanking activities. For example, regulators need not worry that the highly cyclical demand for automobiles could lead to periodic problems for the bank subsidiary of a holding company that also produces cars. The parent company can also be given substantial freedom in choosing its own internal organizational structure. If loans and other types of financial transfers between a bank and a real estate subsidiary of the bank can be easily monitored and controlled, then it makes little sense to force the holding company to house banking and real estate activities in separately managed subsidiaries. The holding company can choose the most efficient organizational form without endangering the banking system or extending the safety net to the real estate industry. Finally, bank regulators will not need to supervise the holding company or its nonbanking subsidiaries. Regulators can direct their attention to the bank alone

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<sup>6</sup>Although this account stresses the importance of the behavior of holding company management and regulators for ensuring insulation, the beliefs of the public—investors and customers of the bank and its affiliates—and the willingness of the courts to enforce the doctrine of corporate separateness are also important. The debate over insulation is closely related to the debate over so-called conflicts of interest. Both among regulators and academics, there is substantial disagreement about the incentives for holding companies to weaken the financial condition of the bank, even in the absence of regulatory safeguards to ensure insulation. See Anthony Saunders, "Securities Activities of Commercial Banks: The Problems of Conflicts of Interest," this *Business Review* (July/August 1985) pp.17-27, for a complete discussion of these issues.



and permit the nonbanking affiliates to make unfettered business decisions, risky or otherwise. Insulation guarantees that risky or imprudent decisions by a nonbanking affiliate will not increase the bank's risk or the regulator's exposure. None of this is true, however, if the bank cannot be insulated or if the regulatory costs of ensuring insulation are too large.

### IS INSULATION POSSIBLE?

**If Bank Holding Companies Are Highly Integrated, Insulation Is a Bigger Problem.** The organizational chart of a holding company provides only a partial picture of the way the business is actually run. Consider the example of a hypothetical holding company, BHC Inc., which owns just two subsidiaries, a bank and an insurance company. This organization might be run in many different ways. One extreme possibility is that BHC Inc. leaves the two subsidiaries alone to make all important business decisions, such as how profits are to be used, which investments should be made, and which new markets should be entered. In this case, BHC Inc.'s managers act like passive investors owning a two-firm portfolio. They might act this way if the sole reason for investing in both the bank and insurance companies were to diversify, that is, to reduce fluctuations in the returns on their total investment.

At the other extreme, BHC might centralize all decisionmaking at the holding company level. BHC might decide how all profits made by the bank and the insurance company should be reallocated between the two companies, which types of investments should be made by each, and which new markets should be entered. In this case, the entire holding company is operated as a single consolidated organization.

While these extreme cases are unrealistic, they help to illustrate the connection between the level of integration of the holding company and the possibility of insulating the bank. If a bank holding company is merely a portfolio of completely independent firms, then the bank is clearly insulated from both the parent and the

insurance affiliate. Without direction from BHC, the bank acts exactly like a bank without any affiliates. If, however, all decisionmaking is centralized, then situations may arise where BHC's management views the profitability and safety of its bank subsidiary as a secondary concern, less important than the profitability of the holding company as a whole. Also, bank regulators will find it difficult to separate the affairs of the bank and its affiliates should the holding company experience financial difficulties.

The empirical evidence about how bank holding companies are actually run suggests that they are not merely portfolios of independently run firms.<sup>7</sup> For instance, banks inside holding companies normally pay out more dividends and hold less capital than independent banks.<sup>8</sup> Survey evidence shows that parent companies centralize some decisions but not others. Gary Whalen finds that parent companies often set dividend payments by bank subsidiaries and make other capital management decisions like how external funds should be raised.<sup>9</sup> In

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<sup>7</sup>See Anthony Cornyn, Gerald Hanweck, Stephen Rhoades, and John Rose, "An Analysis of the Concept of Corporate Separateness in BHC Regulation from an Economic Perspective," *Proceedings of A Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago (May 1986); Timothy Hannan, "Safety, Soundness, and the Bank Holding Company: A Critical Review of the Literature," Working Paper, Board of Governors (1984); and Anthony Saunders, "Bank Holding Companies: Structure, Performance, and Reform," for reviews of the empirical literature.

<sup>8</sup>This does not necessarily mean that banks inside holding companies are being used to subsidize affiliates or that they have a greater risk of failure. In part, dividend payments are used to retire holding company debt used to purchase the bank. While lower capital, by itself, tends to increase the bank's risk of failure, the bank's expected profits and the variability of profits must also be considered. Empirical studies of the risk of failure for banks in holding companies have reached varying conclusions.

<sup>9</sup>Gary Whalen, "Operational Policies of Multibank Holding Companies," Federal Reserve Bank of Cleveland, *Economic Review* (Winter 1981/82). For the most part, empirical studies have concentrated on the relationships between the parent company and its bank subsidiaries. Evidence about the degree of coordination of banking and nonbanking activities by the parent company is scanty and anecdotal.

addition, parent companies often have the final say over major investment decisions by bank subsidiaries. On the other hand, Whalen finds that the parent company is likely to leave portfolio management decisions and pricing decisions to its bank subsidiary.

Since the degree of integration of bank holding companies appears to be substantial, insulation of the bank may be a problem. But bank regulators need not be, and are not, helpless observers, whose only tools for influencing the behavior of bank holding companies are a wish and a prayer. And strict limitations on permissible products and services, extensive restrictions on organizational structure, and consolidated supervision are not the only regulatory alternatives.

**Existing Regulatory Safeguards Enhance Insulation . . .** Among the safeguards that are already in place, perhaps the two most important are the restrictions on interaffiliate transactions written into Section 23 of the Federal Reserve Act, and regulatory capital requirements for banks. The FDIC proposal, in particular, lays great stress on these regulatory safeguards as a workable alternative to more extensive regulation of bank holding companies.

Sections 23a and 23b of the Federal Reserve Act are designed to limit a bank's exposure to its nonbanking affiliates and to prevent a bank holding company from using its bank subsidiary to subsidize nonbanking activities. Section 23a places quantitative limits on financial transactions between a bank and its affiliates, including loans, equity investments, and certain types of guarantees such as letters of credit.<sup>10</sup> To see how these limits work, consider BHC Inc. again and imagine, for simplicity, that the only types of internal financial transactions are loans from the bank to BHC Inc. and its insurance subsidiary. Under Section 23a, bank loans to either affiliate

could not exceed 10 percent of the bank's capital. Further, the total loans made by the bank to both its affiliates together could not exceed 20 percent of the bank's capital. Thus, in the extremely unlikely event that both the parent company and the insurance company were unable to repay any of their loans, the most the bank would stand to lose is 20 percent of its capital, a painful, but not necessarily fatal, loss as long as the rest of the bank's portfolio is healthy. Of course, a 20 percent decline in the bank's capital is no trivial matter, but recent evidence from a study at the Board of Governors of the Federal Reserve System suggests that, in practice, banks do not approach the regulatory limits.<sup>11</sup> In fact, the Board study shows that net financial flows from banks to their affiliates tend to be negative; that is, funds flow from the affiliates to the bank rather than the other way around.

Section 23b requires that any transactions between the bank and the insurance affiliate must be on terms at least as favorable to the bank as a similar transaction with an insurance company outside the holding company. Thus, if the bank would demand a 10 percent rate of interest on a one-year loan to a nonaffiliated insurance company, it could demand no less from the insurance subsidiary of BHC Inc.

Of course, regulations are only as good as the information available to regulators. Unless bank regulators have timely and accurate information about financial flows between banks and affiliated companies, they cannot be sure that attempts to breach restrictions will be caught in time. All of the restructuring plans agree that more stringent and detailed reports from banks about transactions with affiliates are a necessary price to pay for

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<sup>10</sup>See "The Banking Affiliates Act of 1982: Amendments to Section 23a," *Federal Reserve Bulletin* (November 1982) for a more detailed description of Section 23a.

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<sup>11</sup>See John Rose and Samuel Talley, "Financial Transactions Within Bank Holding Companies," Staff Study #123, Board of Governors (May 1983). Their results are only suggestive, because they do not include all types of financial flows. Also Section 23a limits do not net out offsetting financial transactions between the bank and its affiliates. It is possible for the bank to make loans to affiliates equal to 20% of its capital yet still have a net inflow of funds.



permitting bank holding companies to offer more nonbanking services.

Minimum capital requirements for banks also insulate the bank from its affiliates' financial losses, because capital serves as a cushion against potential losses. In fact, capital standards serve a double duty in this regard, because the quantitative limitations in Section 23a are all expressed as fractions of the bank's capital. A bank without much capital faces severe limits on the dollar value of loans or guarantees to its affiliates. If the bank is pressing against its limits, yet wishes to expand financial transactions with affiliated firms, it must increase its capital, perhaps by selling new equity.

If bank capital cushions the bank and the FDIC against losses, won't additional capital requirements for the parent company or nonbanking subsidiaries of the holding company work even better? It is true that the FDIC's potential losses are smaller if the consolidated organization has a larger capital cushion. However, it doesn't necessarily follow that any additional capital should be held by the parent company or other nonbank subsidiaries, as long as bank regulators enforce capital requirements for each bank stringently. Requiring holding company capital to serve as a backup for bank capital only makes sense if regulators believe that banks in holding companies are riskier than independent banks. But if there is reason to believe that banks inside holding companies should hold more capital than independent banks, then an alternative is for regulators to impose a supplemental requirement on the banks directly, rather than on the parent company or nonbanking subsidiaries. This alternative approach would not only be more direct but would also be more consistent with the principle of functional regulation.

**... But Insulation Is Possible Only if Regulators Will Keep the Bank Separate.** Inevitably, situations will arise where the parent company or a nonbanking affiliate is in serious financial trouble, while the bank is financially healthy. Much of the debate about the feasibility of insulation has focused on the behavior of the

holding company's management in these situations. Equally important—maybe more so—is the behavior of bank regulators. If regulators feel compelled to extend guarantees to troubled affiliates out of fear that the public will lose confidence in the bank when an affiliate fails, then insulation is not feasible.<sup>12</sup>

The regulator might reason that since a troubled nonbanking subsidiary and the bank are part of the same organization, the public will interpret troubles in the nonbanking company as evidence of weak management of the holding company and, in turn, of the bank. If regulators, who by nature take a wary and conservative view of the dangers of financial instability, do reason this way, then public pronouncements that the safety net will not be extended to nonbank activities are not credible. And if regulators cannot credibly commit to separate the bank from its troubled affiliates, then the holding company management won't take as seriously regulatory restrictions designed to keep the bank separate.

The credibility of regulators' commitment not to extend guarantees to nonbanking affiliates also will depend on how the financial and regulatory system is restructured. A bank regulator who supervises the holding company on a consolidated basis may have considerable power to intervene to save a struggling nonbanking affiliate. The consolidated supervisor of the holding company might be sorely tempted to devise complicated recovery plans involving transfers between the firms in the holding company to save the organization from failure. On the other hand, a regulator whose supervisory role is limited to setting standards for the bank alone will have fewer options to extend guarantees to nonbank affiliates.

One likely effect of expanded powers for bank

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<sup>12</sup>See Anthony Cornyn, et. al., "An Analysis of the Concept of Corporate Separateness..." pp.185-191, and Anthony Saunders, "Bank Holding Companies: Structure, Conduct and Reform," pp. 32-37, for contrasting readings of the empirical evidence about public attitudes.



holding companies is the emergence of larger organizations, which will also affect the options facing regulators. This development cuts two ways. In general, regulators are much more concerned about the potential failure of a large banking organization than a small one, because the disruptive effects to the financial system of the failure of a large organization are more widespread. Commitments to keep the bank separate when a very large bank holding company is on the edge of collapse may be very difficult to honor. But the emergence of larger banking organizations may also mean that there will be more firms that could purchase a bank from a financially troubled holding company. The greater the number of firms that can afford to purchase the bank, the more credible regulators' commitment to keep the bank separate from the holding company's problems.

## CONCLUSION

Diverse as the recent proposals for restructuring the financial system are, they agree on some basic principles: bank holding company powers should be expanded, functional regulation is desirable, and a strictly limited safety net for banks should be maintained. How far powers should be expanded, how bank holding companies should be organized, and how much of the bank holding company should be supervised by bank regulators are the major sources of disagreement. These disagreements flow in large part from different beliefs about the possibility of insulating the banks from their affiliates.

Whether banks can be insulated is a complicated, and unresolved, issue. The effectiveness of Section 23a and 23b restrictions have yet to be tested in an environment where bank holding companies engage in a wide range of financial, and perhaps nonfinancial, services. Whether regulators can keep the bank separate and avoid extending the safety net to nonbanking affiliates in large bank holding companies is another open question. Bank regulators' behavior since the rescue of Continental Illinois Bank, however, does provide some evidence on this issue. In recent years, regulators have gained substantial experience in dealing with large troubled banking organizations, especially in Texas and Oklahoma. For the most part, regulators have avoided bailing out parent companies when the troubled banks were reorganized or sold.<sup>13</sup>

Ultimately, debates over economic issues inform but don't dominate the course of legislative reform. Self-interested industry groups will all have their say, and legislators and regulators are unlikely to ignore their pleas. As the banking bills now winding their way through the House and Senate show, restructuring will occur in fits and starts and will not be as coherent as the formal plans that have been presented. Public debate over the economic issues, however, can only improve the coherence of regulatory reform as it unfolds.

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<sup>13</sup>See FDIC, "Mandate for Change..." for a summary of regulators' experience with bank failures since Continental Illinois' rescue.