Joint Ventures: Meeting the Competition in Banking

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In recent years, banks have grown less content to be simply "banks." Faced with increasing competition in their traditional product markets, banks have sought to broaden the range of their activities. They have introduced new products, such as securities backed by consumer loans. They have pressed successfully for permission to engage in activities that were once legally off-limits, such as discount brokerage and investment advice. And they have proceeded to exploit various loopholes in the legal and regulatory structure. For instance, the Federal Reserve permits bank holding companies to underwrite and deal in some securities deemed ineligible under the Glass-Steagall Act so long as they do so through a subsidiary that is not "principally engaged" in those activities. As a result, a number of bank holding companies now underwrite and deal in commercial paper, mortgage-backed securities, municipal revenue bonds and consumer-related receivables through such subsidiaries.

One way banking organizations expand is

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through "joint ventures" with other banks or with a nonbanking firm. Indeed, the trend towards greater product variety in banking has generated an increase in joint venture activity. Between 1971 and 1982, joint ventures among financial service firms were not very common, with, on average, about three joint subsidiaries formed per year. But in 1983, 36 joint subsidiaries were formed, signaling the start of the new trend. Bank holding companies, in particular, became more active in forming joint subsidiaries at about that time, going from about two per year between 1971 and 1982 to 12 in 1983 and 12 again in 1984. Joint ventures not involving the creation of a joint subsidiary have also become more common. For instance, many banking organizations are now offering mutual funds to their customers by participating in joint ventures with mutual fund companies.[1]

If deregulation proceeds and banks are allowed to engage in a wider range of nonbanking activities, joint venture activity is likely to continue at a robust pace. Although some banking organizations have used joint ventures as a way around regulatory restrictions, others have found them the least costly, most efficient way to expand into permissible activities.

What lies behind the recent upsurge in joint venture activity? What advantages do joint ventures have over other expansion strategies? What are some of the potential pitfalls of joint ventures? Little has been written on how these issues pertain to banking organizations, and the time is ripe to begin investigating these questions.

WHAT IS A JOINT VENTURE?

A joint venture between two firms differs sharply from a mere producer-supplier relationship. A correspondent bank and its commercial bank customer do not have a joint venture—the commercial bank simply "produces" checking accounts by buying check-processing services from a correspondent bank. In a joint venture, however, the firms share ownership at some stage of the production process.

In a vertical joint venture, the partners share supply or distribution facilities, but their products retain distinct identities. A check-printing shop that is jointly owned by two banks is a shared supply facility. Automated teller machines (ATMs), when jointly owned by a group of banks, are shared distribution facilities. ATMs give a retail customer access to his bank account without altering the identity of that account as a product of the customer's bank. The bank retains control over account fees and services; ATM access is simply a service provided in conjunction with an account. Frequently, vertical joint ventures serve to make banks' supply or distribution more efficient.

Banks often engage in horizontal joint ventures in order to expand a product line or customer base. In a horizontal joint venture, the firms create a distinct, joint product. Each firm contributes labor, materials, expertise, or assets to the venture, and the firms share ownership of the final product.

One kind of horizontal joint venture is a jointly owned subsidiary providing a special product or service. A trust company owned by two banks is a case in point. But horizontal joint ventures can involve other types of arrangements as well. For instance, banks and mutual fund companies have cooperated to offer investment packages that include both mutual funds and time deposits.

[1]These figures come from Kathryn R. Harrigan, "Joint Ventures and Competitive Strategy," First Boston Working Paper Series, Columbia University School of Business, (December 1984); *Bank Expansion Reporter* (December 19, 1983) pp. 16-18 and (June 3, 1985) pp.16-17; and "Rising Number of Banks Offer Mutual Funds to Customers," *American Banker* (October 28, 1986) pp. 31ff. According to the *American Banker* article, about seven out of ten banks now offer mutual funds to their customers. The article states that close to 40 percent of these banks make mutual funds available through "their investment area (23 percent), trust department (9 percent), or retail department (7 percent)," with the rest simply providing access to mutual funds through a discount brokerage service or self-directed IRA. Those banks making mutual funds available through their investment, trust, or retail departments are probably engaged in joint ventures with mutual fund companies.

Banks that offer mutual funds to their customers through cooperative ventures with mutual fund companies are, in a sense, circumventing regulations that prohibit them from sponsoring mutual funds. Sometimes, cooperating with another financial firm in a joint venture is the only legal way a bank could participate in a restricted activity, of which there are many. For example, Federal Reserve member banks are prohibited by the Glass-Steagall Act, enacted in 1933, from underwriting and dealing in stocks, corporate bonds, or stock and bond funds. Also, the insurance activities of member banks are limited by the Bank Holding Company Act of 1956 and by the Garn-St. Germain Act of 1982. For state-chartered banks, which need not be members of the Federal Reserve, each state has its own restrictions on their nonbanking activities. In addition, the Bank Holding Company Act of 1956, as amended in 1970, permits a bank holding company to engage only in those activities that are "closely related to banking." Once a nonbanking activity is shown to be closely related to banking, the expected public benefits from a bank holding company engaging in that activity must then be shown to outweigh any possible adverse effects. In most cases, the Board of Governors of the Federal Reserve determines which activities are permissible according to these criteria.

Bank holding companies have used horizontal joint ventures to expand into various permissible activities. The Fed's Regulation Y lists commercial financing, leasing, financial planning, investment advice, and various other activities as generally permissible for bank holding companies. The Glass-Steagall Act authorizes banks to engage in certain municipal bond financing activities. Forming a joint subsidiary to pursue these activities, however, must be approved by the Federal Reserve Board. If two banking organizations wish to form a joint subsidiary, the Board takes into account the financial strength of the organizations, as well as the potential for adverse competitive effects. If a bank holding company and a nonbanking firm wish to form a joint subsidiary, the Board also takes into account the degree of separation between the joint subsidiary and the nonbanking firm.[2]

COMPETITION HAS MADE JOINT VENTURES MORE ATTRACTIVE

The push by banks to expand into new activities stems from stiffer competition, both from outside the banking industry and within it. From outside, competitors have made inroads into banks' traditional base of deposit and loan customers. On the lending side, securities firms that offer commercial paper and commercial bond financing have become increasingly sophisticated and aggressive.[3] On the deposit side, mutual fund companies compete by offering stock and bond funds as well as money market funds that provide checking and debit card services. Since the Garn-St. Germain Act of 1982 liberalized regulation of the thrift industry, thrifts have competed with banks on both fronts, in the market for commercial loans, as well as for demand deposits. Perhaps the greatest threat comes from the "financial supermarkets," commercial firms such as Sears, K Mart, and J. C. Penney that provide various kinds of banking services packaged with insurance and discount brokerage.

Within the banking industry, new technology and deregulation have tightened competition. The development of ATM networks and electronic payments systems has greatly enhanced customer access to bank services. As a result, just about any bank faces competition from within a larger geographic area. Deposit rate deregula-

[2]For a discussion of Federal Reserve policy towards joint ventures, see William J. Sweet, Jr. and John D. Hawke, Jr., "Joint Ventures Provide Vehicle for Nonbanking Activities," *Issues in Bank Regulation* (Spring 1984) pp. 25-36. For a discussion of antitrust issues related to joint ventures, see Steven D. Felgran, "Shared ATM Networks: Market Structure and Public Policy," *New England Economic Review*, Federal Reserve Bank of Boston (January/February 1984) pp. 23-38.

[3]For details concerning the growth of the commercial bond market, see Jan Loeys, "Low-Grade Bonds: A Growing Source of Corporate Funding," this *Business Review* (November/December 1986) pp. 3-12.

tion has also been an important factor. Regulatory ceilings on deposit interest rates were gradually removed over the period 1982-1986. To the extent that these ceilings were binding, banks must now pay more competitive rates on deposits. Geographic deregulation has further enhanced competition in banking. In the last few years, most states opened their borders to entry by out-of-state bank holding companies. Large regional and money center banking organizations are now moving into new markets nationwide, increasing the competitive pressures on banks in those markets.[4]

Horizontal joint ventures are one way that banks have gone forth and met the competitive challenge. Through joint ventures, banks have expanded the variety of products they offer to their customers, strengthening customer ties against the pull of competition. Also through joint ventures, banks have found new sources of revenue, easing competitive pressures on their profitability.

HOW JOINT VENTURES WORK

One of the most common types of joint ventures is between a bank and an insurance company, a partnership which enables a bank to offer its customers a convenient package of banking and insurance products. The bank is thus able to counter the competitive threat posed by financial supermarkets that offer "one-stop financial shopping." At the same time, a bank engaged in an insurance joint venture generally earns some rental income.

In an insurance joint venture, an insurance company sets up shop in the bank's lobby and pays the bank either a flat rental rate or a rate that is tied to the number of insurance sales originated there. In addition, the bank may provide for automatic payment of insurance premiums out of customer accounts. In most cases, federal or state regulations curtail the bank's insurance marketing activities. What is permissible, however, is for the bank to place the insurance sales staff in a prominent spot, and to include an advertisement from its venture partner in its customer mailings. The John Hancock Mutual Life Insurance Company took a creative approach in 1986 in a joint venture with Wilbur National Bank, a small bank in upstate New York. The bank leased space in its main branch in Oneonta to the insurance company to set up an office to sell life and disability insurance products. The office is conveniently located, accessible both from the bank's lobby and through a separate, external entrance, enabling the insurance agents to keep separate hours from those of the bank. In addition to advertising through the mail to bank customers, Hancock tries to attract customers by offering basic financial planning services free of charge. The Hancock agents generate some referrals for the bank's products when counseling customers, but they do not receive commissions.[5]

Many banks are engaged in joint ventures with mutual fund companies. By making stock and bond funds available to its customers, a bank can retain the loyalty of depositors who might otherwise abandon the bank in favor of a mutual fund company. In addition, the bank can earn substantial fee income. Most commonly, a bank acts as a sales agent for a mutual fund sponsor; since it neither sponsors nor underwrites the fund itself, it does not violate the Glass-Steagall Act. Chase Manhattan Bank took a more unusual approach when it teamed up with The Dreyfus Corporation in 1985. Chase acts as the organizer and manager of the "Park Avenue Funds," while Dreyfus acts as the sponsor and distributor of these funds. Chase informs its bank and Visa Card customers in statement stuffers that these funds are available through

[4]For an analysis of how interstate banking is affecting competition in banking markets, see Paul Calem, "Interstate Bank Mergers and Competition in Banking," this *Business Review* (January/February 1987) pp. 3-14.

[5]Details on this joint venture are found in "One Bank/Insurer Venture that Works," *ABA Banking Journal* (February, 1987) p. 84.

Dreyfus. In announcing the venture, the chairman of Chase said it "will provide our customers with a convenient means of obtaining the benefits of mutual fund investments."[6] The arrangement also enhances the bank's prestige, since the bank is providing its own original mutual fund.

Strengthening customer relationships is only one of several reasons that banks have turned to joint ventures. As banks have faced more competitive conditions in their traditional markets, and have watched their profit margins decline, they have sought out new sources of revenue. Sometimes banks have used joint ventures to expand into new, specialized kinds of lending or assets, such as municipal bond guarantees. In other cases, they have sought to expand geographically or broaden their customer base, as when a U.S. bank holding company teams up with an automobile manufacturer to form a motor vehicle financing subsidiary. (For details on these arrangements, see HORIZONTAL JOINT VENTURES: TWO CASE STUDIES.)

ADVANTAGES OF JOINT VENTURES...

Although joint ventures may be the only legal route to expansion into restricted activities like insurance and mutual funds, banks have found them a useful way to engage in permissible activities as well. But they are not the only way. Bank holding companies also have responded to changing competitive conditions by acquisition or merger, by developing new products on their

[6]This joint venture was reported in "Dreyfus and Chase Join Forces on Mutual Funds," *American Banker*, (November 13, 1984) p. 32.

Horizontal Joint Ventures: Two Case Studies

A Motor Vehicle Financing Joint Venture: On December 9, 1987, the Federal Reserve Board Approved the formation of a joint subsidiary by Marine Midland Bank and Subaru. The subsidiary, Marine Midland Automotive Financial Corporation, will offer various kinds of financing and leasing services to Subaru dealers and their customers, including retail financing for Subaru purchasers and inventory financing for Subaru dealers. Since the joint venture puts Marine Midland in direct contact with Subaru dealers and their customers, it will enable the bank to expand its automobile financing and leasing activities. Subaru stands to benefit from Marine Midland's experience and know-how in the area of motor vehicle financing, and from the bank's ability to supply funds for the subsidiary's activities.[a]

A Municipal Bond Insurance Venture: In 1984, Bankers Trust New York Corporation, Xerox Credit Corporation, Phibro-Salomon Inc. and American International Group Inc. formed a joint insurance subsidiary specializing in municipal bond insurance. The venture, Bond Investors Guarantee Insurance Company, guarantees the timely payment of principal and interest on newly issued municipal bonds and bond portfolios. What apparently attracted Bankers Trust to this venture was the rapidly expanding market for municipal bond insurance and the expectation of generating substantial premiums. According to one industry analyst, "demand for this coverage has widely outstripped the supply."

Each of the venture partners has some experience in areas related to municipal bond coverage. Bankers Trust and Phibro-Salomon are both major municipal bond underwriters. AIG underwrites and sells various kinds of financial guarantee insurance, including, on occasion, municipal bond insurance. Xerox Corp., through certain subsidiaries, has been involved in insuring hospital municipal bonds as well as packaging municipal unit trusts. In addition, Bankers Trust brings to the venture its credit analysis skills. In the words of one insurance expert, "municipal bond insurance is a form of financial guarantee and basically involves a credit analysis decision."[b]

[a]Details on this joint venture are found in "Marine Midland Teams Up With Subaru," *Bank Expansion Reporter* (January 4, 1988) pp. 15-16.

[b]This joint venture is reported in "Bankers Trust Joins Venture in Thriving Municipals Market," *American Banker* (July 20, 1984) pp. 3ff.

own, and by introducing new products that are obtained from a wholesaler. So why is a joint venture sometimes preferred to these expansion strategies?

...Compared to Internal Expansion... Risk and financing considerations can make a joint venture a more attractive option than internal expansion. The parties to a joint venture share whatever risks are involved, while internal expansion requires a firm to face those risks alone. A joint venture may also offer financing advantages. A single organization, especially a small or moderate-sized one, may not have access to the capital needed for expansion. Internal financing may be unavailable, and raising outside capital may be too expensive. Outside investors will require an unnecessarily high risk premium if they cannot adequately evaluate the organization's ability to expand.[7] Moreover, obtaining a loan or floating a new stock issue involves transactions costs, such as the costs of finding, negotiating with, and paying an underwriter. These costs are present regardless of whether the amount of funds raised is large or small. By engaging in a joint venture, individual companies can pool their resources. Thus, the partners to a venture may be able to provide their own financing, or at least provide enough collateral to reduce the risk premium required by outside investors. Moreover, a joint venture may be able to reach a larger market than its partners would reach individually, resulting in comparatively large scale operations and financing needs. Outside financing will then involve a comparatively small transactions cost per unit of funds raised. The joint venture will thus achieve economies of scale in raising capital.[8]

A joint venture may achieve other kinds of scale economies as well. Consider a mortgage banking joint venture, in which the venture partners find themselves serving a fairly large market. The venture can improve its productivity by hiring highly trained mortgage banking specialists, because the large scale of the enterprise ensures that their talents will be fully used.[9]

Another advantage a joint venture might have over internal expansion is the ability to use complementary technology, skills, or information. A U.S. bank holding company familiar with the products of American exporters might team up with a Japanese bank familiar with the needs of Japanese firms to form an export trading company. Or a Texas bank holding company familiar with the regional real estate market might pool its skills with an investment banking firm experienced in the area of investment advice to form a real estate investment advisory firm.

While a bank may be able to achieve any or all of these advantages through merging with or acquiring the venture partner, those options may be ruled out for some activities by regulation. The Bank Holding Company Act would prohibit a bank holding company from acquiring a commercial firm, and interstate banking restrictions could prevent a merger between bank holding companies located in different parts of the country. But even when a merger or acquisition is feasible, a joint venture may be the more attractive option.

...Compared to Mergers or Acquisitions... An agreement regarding a joint venture might be quick and easy to achieve as compared with a merger or acquisition, where negotiations can be costly and time-consuming. Also, a joint venture is relatively easy to dissolve. Hence, it may be preferred by banks that wish to achieve a short-term objective, or engage in activities of uncertain profitability.

[7] As compensation for the perceived riskiness of a security, investors require a risk premium, that is, a discount on the purchase price of the security. There is some statistical evidence that higher risk premiums are associated with smaller firms. See F. M. Scherer, *Industrial Market Structure and Economic Performance* (Boston: Houghton Mifflin Company, 1980) pp. 104-108.

[8] A joint venture may also have relatively more bargaining power with a prospective lender or underwriter, since the lender is dealing with more than one corporation.

[9] For a full discussion of economies of scale in banking, see Loretta Mester, "Efficient Production of Financial Services: Scale and Scope Economies," this *Business Review* (January/February 1987) pp. 15-25.

Also, two banks may prefer a joint venture to a merger if they complement each other in ways specific to the venture, while in other respects the two organizations are incompatible. The Japanese bank in the above example may be highly decentralized, with individual departments operating fairly independently, while the U.S. bank holding company may be far more hierarchical, with the bank president and other top officers exercising considerable control. One organization may be more aggressive, accustomed to making riskier investments for the sake of a higher return, and the other may be more conservative. Or the organizations may have very different procedures for handling employee relations and business practices. Eliminating such conflicts subsequent to a merger could require costly restructuring of the combined organization.

...Compared to Franchising. A practical expansion strategy for a bank holding company is to package and sell a product obtained from a wholesale provider. For instance, many banking organizations have introduced discount brokerage by linking into the franchise services provided by companies such as Fidelity Brokerage Services and INVEST.[10] If insurance agency activities become permissible for bank holding companies, conceivably some banks would sell insurance as part of such a franchise network. However, not all products and services a bank might wish to provide can be obtained through a wholesale distribution network. Hence, an organization limiting itself to this strategy might pass up some profitable opportunities for product expansion.

The more customized a product, the less likely that it will be available wholesale. When a bank is trying to fill a customer's special needs with a tailored product, wholesale distribution will be inappropriate. Investment advice is a product that is often customized. An individual investor is likely to have unique needs and a special relationship with her bank; face-to-face discussions and a working relationship between the investor and a specialist may provide the best framework for evaluating her investment needs.[11]

Suppose that "Fourth National Bank of the Rockies" wants to advise individual and institutional investors on real estate investment opportunities in the west. Because a franchise arrangement would be inappropriate, the bank might set up an internal operation. Alternatively, the bank might engage in a joint venture with an established investment counseling firm. A joint venture may be chosen over internal expansion for any one of the reasons discussed earlier. For instance, while Fourth National may be quite familiar with the western real estate market, its customer base may be too narrow to justify setting up its own specialized subsidiary.

While joint ventures can offer some distinct advantages over other expansion strategies, they are not without problems of their own. Generally speaking, the aspect of joint ventures that is most likely to be troublesome is the relationship between the venture partners.

JOINT VENTURES AND THE CONTRACTING PROBLEM

A joint venture is like any other contractual relationship: it can be disrupted by disagreements, misunderstandings, conflicts of interest, or opportunistic behavior. These problems arise when it is not possible to write a con-

[10]Details concerning such franchise networks are found in Steven D. Felgran, "Bank Entry into Securities Brokerage: Competitive and Legal Aspects," *New England Economic Review,*" Federal Reserve Bank of Boston (November/December 1984) pp. 12-33, and "Networking in Retail Financial Services," *TransDataCorp Deposits and Credits Advisor* (November 1986).

[11]Of course, a bank can offer limited investment advice through a franchise arrangement. The bank can provide a standard form for customers to fill out and mail to the wholesaler, who evaluates the customers and provides recommendations. However, truly customized investment advice cannot be provided in this way.

tract that allocates specific rights and responsibilities, or specifies actions to be taken, under all possible contingencies. One of the main problems is when both parties have different information. Suppose the parties to a joint venture want the revenues to be divided according to each party's share of the costs. The parties cannot enforce such a contract unless they know a lot about each other's costs. Unlike people who split the cost of a lottery ticket, and can divide their winnings proportionately, it is difficult if not impossible for two firms who produce a joint product to verify each other's costs.

Problems also arise when future contingencies cannot all be anticipated, or when the appropriate contract terms are not evident until a particular contingency arises. Consider, for instance, a joint venture in municipal bond underwriting. It is virtually impossible for the venture partners to write a contract specifying all future bond offerings they will be willing to bid on.

Individuals and firms interacting in a marketplace, and workers and managers interacting within a firm, rely on various institutional mechanisms to minimize contracting problems. In repeated market transactions, contracting problems are made manageable by the use of standardized, legal contracts, and by the need of contracting parties to maintain a reputation for reliability. The use of a standardized contract reduces ambiguity and discourages bickering over the interpretation of contract terms. When a contingency arises that is not covered in the standard contract, a party that behaves "unreasonably" would see his reputation tarnished. Within a single organization, transaction costs are minimized by such institutional structures as the division of a firm into profit centers and cost centers and hierarchical control. For instance, division managers have a certain amount of authority to determine their division's response to unforeseen contingencies, but they must defer to their superiors on major decisions.[12]

The parties to a joint venture are not engaged in a series of "arm's length" interactions in a marketplace. Nor are they integrated into a single organization; they retain their independence. As a result, the parties to a joint venture are less able to rely on institutional mechanisms to reduce contracting problems, so they are especially vulnerable. Opportunistic behavior or haggling over rights and responsibilities may bring a joint venture to a screeching halt, or may keep it from getting started in the first place. The parties to a joint venture have to reconcile differing goals and expectations and build mutual confidence, trust, and understanding in order to succeed. Indeed, just as clashing corporate cultures can make a merger difficult to accomplish, it can cause instability in a joint venture.

Consider a joint venture between a bank and a mutual fund company. The bank may have a simple objective—making mutual funds available to its customers. It might make a minimal effort to market the funds, which are competitive with the bank's traditional products. The mutual fund company may expect the bank to make more of an effort to market the funds. Interpreting the bank's passivity as a breach of understanding, it may pull out of the relationship.

Or consider a joint venture by several banks in municipal securities underwriting. At some point, one of the banks may wish to bid independently to underwrite a security; the issuer of the security could be a longtime client of the bank, so the bank is willing to accept a lower margin of profit on the security than its partners want. The other partners may consider such independent bidding a breach of the joint venture agreement.

The relative instability of joint ventures is the primary reason why they are less common than alternative expansion strategies, such as mergers or acquisitions. Parties deciding whether or not

[12]For an examination of contracting problems and the mechanisms that have evolved to deal with them, see Oliver Williamson, "Transaction Cost Economics: The Governance of Contractual Relations," *The Journal of Law and Economics* 22 (October 1979) pp. 233-261.

to engage in a joint venture weigh the expected advantages against the potential for instability. A joint venture agreement between a bank and mutual fund company could carefully spell out how the bank will go about marketing mutual funds. Similarly, the agreement governing an underwriting joint venture could delineate circumstances under which independent bidding would be allowed. To some extent, then, the threat of instability can be reduced through foresight and ingenuity when a joint venture agreement is fashioned.

CONCLUSION

Faced with increasing competition from outside the banking industry and from within, banks have sought to strengthen customer ties and generate new sources of revenue through product expansion. To these ends, joint ventures involving banking organizations and other financial firms have grown substantially in number. Through horizontal joint ventures, banking organizations have participated in some activities they could not legally engage in on their own. But banking organizations have also taken the joint venture route to expand into permissible activities, because joint ventures can offer various advantages over other expansion strategies. Thus, joint ventures are likely to remain an important expansion strategy even if deregulation makes securities, insurance, and other activities permissible for bank holding companies.

In contrast to internal expansion, a joint venture might allow for firms to share risks and to achieve greater economies of scale. And a joint venture is often easier to arrange than a full-scale merger or acquisition, which may be encumbered by a clash of corporate cultures or long, drawn-out negotiations. But while joint ventures may offer some distinct advantages, they also are particularly vulnerable to disputes over rights and responsibilities and other such contracting problems. The parties to a joint venture have to overcome conflicting goals and develop confidence in their relationship in order to succeed.