

## Banking and Commerce: A Dangerous Liaison?

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**S**everal of the proposals in last year's Treasury Department plan to reform the financial services industry made it into the FDIC Improvement Act passed by Congress at the end of 1991. But one of the more controversial provisions did not survive: a recommendation that commercial firms be allowed to own banks. Congress hasn't been the only group hard to

convince—a recent survey, conducted by CPA firm Grant Thornton, Chicago, of over 600 senior bank executives indicated that almost 70 percent were against commercial firms' owning banks. Why was this proposal hard to sell? And what are the costs and benefits of allowing banks and commerce to mingle?

The arguments for and against commercial ownership of banks are tied to the regulatory and deposit insurance structures. Without necessary changes to the current structures, the evidence suggests that the potential costs of allowing banking and commerce to mix out-

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weigh the potential benefits. But if recently enacted reforms work as expected, prohibitions against commercial firms' owning banks and vice versa will need to be reconsidered.<sup>1</sup>

### THE CURRENT LAW AND A BIT OF HISTORY

Current U.S. law prohibits commercial firms from owning banks and banks are prohibited from owning commercial firms. In general, banks are not allowed to engage in nonbank activities, and a bank holding company can own only 5 percent of the voting shares of any nonbank commercial corporation without regulatory approval.

The separation between banking and commerce goes all the way back to 1694, when the act establishing the Bank of England prohibited it from dealing in merchandise. There was no explanation for the prohibition, but according to researcher Bernard Shull, it might have been because merchants were suspicious that the Bank could exploit monopoly power granted to it by the Crown.<sup>2</sup> The earliest U.S. national banks followed the English tradition, so the separation has existed for nationally chartered banks in the U.S. since colonial times.

Despite this long history, there is some debate about how traditional the separation between banking and commerce actually is. While Congress may have intended to separate bank-

ing and commerce all along, it hasn't been entirely successful. Banks and firms have found ways of circumventing the policy. For one thing, individuals have always been allowed to own a controlling interest in both a bank and a commercial firm (as long as it isn't a securities firm). Also, some of the largest banks in the U.S. were state-chartered banks that actually grew out of commercial companies. The Bank of the Manhattan Company (later known as Chase Manhattan Bank) was created when New York state permitted Aaron Burr to establish a water utility company and a bank in 1799. The New York Chemical Manufacturing Company, founded in 1823, was granted banking powers in 1824.

Within a holding company structure, the Bank Holding Company Act of 1956 (BHCA) prohibited nonbank corporations from owning more than one commercial bank. But the main intention of the Act was to inhibit interstate banking rather than corporate ownership of banks. If a nonbank corporation owned only one bank, it could enter any business except securities. And there were many one-bank holding companies—W.R. Grace and Co., Macy's, and Goodyear all owned banks. Banks that converted to one-bank holding companies could own nonbank companies—for example, First National City (Citicorp) converted to a bank holding company in 1968 and entered many activities.<sup>3</sup>

In 1970 the BHCA was amended to close part of the one-bank holding company loophole by proscribing nonbanks from owning one bank and by tightening regulations on banks' "nonbanking" activities. Banks were permitted to perform only those activities that were closely related to banking and were beneficial

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<sup>1</sup>I am indebted to two articles that do an excellent job of presenting the pros and cons of mixing banking and commerce: A. Saunders, "The Separation of Banking and Commerce," New York University Salomon Center, Working Paper S-91-19, 1991, and T. Huertas, "Can Banking and Commerce Mix?" *Cato Journal* 7 (Winter 1988), pp. 743-62. Unlike me, both conclude the separation of banking and commerce should be ended.

<sup>2</sup>B. Shull has a nice historical piece, "The Separation of Banking and Commerce: Origin, Development, and Implications for Antitrust," *The Antitrust Bulletin* 28 (Spring 1983), pp. 255-79.

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<sup>3</sup>R. Casey discusses the legislative history in "Banking-Commerce Ties: As American as Apple Pie," *United States Banker* 101 (January 1991), pp. 13-18.

to the public. But at the same time another loophole was opened up—Congress redefined “bank,” for the purposes of bank holding companies, to be an institution that makes commercial loans and accepts demand deposits. Banks that fulfilled one condition but not the other could be owned by any other corporation. Thus, “nonbank” banks emerged.

But in 1987 this nonbank bank loophole was closed by again redefining “bank” as any institution with FDIC deposit insurance or any institution that makes commercial loans and accepts demand deposits. Those nonbank banks already established were grandfathered with the restriction that their assets could not grow more than 7 percent in any 12-month period. There are many examples of nonbank banks: General Motors owns GMAC Mortgage Corporation, one of the largest mortgage banks; Ford Motor Company owns Associates National Bank, a credit card bank; IBM owns IBM Credit Corporation, which provides financing for other commercial firms; American Express owns three nonbank banks; and Sears, Roebuck and Company also owns several nonbank banks. Nonbank corporations are still permitted to own one thrift without growth restrictions—for example, Ford owns First Nationwide.

#### POSSIBLE BENEFITS OF COMMERCIAL FIRMS’ OWNING BANKS

Whatever Congress’s intent, there is historical precedent for commercial ownership of banks, and commercial firms are indeed interested in owning banks. Some firms that currently own nonbank banks would prefer to own commercial banks, which are able to fund loans with insured deposits: Sears would turn its nonbank banks into full-service commercial banks if allowed, and American Express claims that it could perform its business more efficiently if the separation of banking and commerce were ended.<sup>4</sup> Presumably, this interest in owning banks stems from the firms’ belief that they could earn a better return if they

invested in banking rather than other types of activities. But will permitting commercial ownership of commercial banks be in society’s best interests?

Advocates of allowing the mix cite several social benefits such as a reduction in the number of bank failures or lower costs of producing bank and commercial products.<sup>5</sup> If U.S. banks were able to become more competitive with nonbank providers of financial services and with foreign banks, then the safety and soundness of the U.S. banking system would be improved. While these benefits potentially exist, the evidence concerning their magnitude isn’t very compelling.

**Additional Capital.** The U.S. banking industry is going through tough times. Bank failures are at their highest level since the Depression, and regulators have increased banks’ capital requirements. Since capital serves as a cushion for loan losses at banks, extra capital lowers the expected cost to the FDIC—and so to the taxpayer—of bank failures. Increasing the capital requirements can also reduce a bank’s taste for excessively risky activities by raising the amount bank owners have at stake.

One potential benefit of allowing commercial firms to own banks is that by expanding the field of owners, new capital might be brought to the banking industry. While this is true, it isn’t clear that additional capital is needed at the industry level—just because individual banks may be undercapitalized doesn’t mean the banking system as a whole is. Consolidation within the industry, which is beginning to happen now, will probably yield enough capital to enable the remaining banks to meet their

<sup>4</sup>See S. Zuckerman, “As Washington Dithers, Nonbanks Advance,” *American Banker* 156 (March 15, 1991), p. 1.

<sup>5</sup>See A. Saunders, “The Separation of Banking and Commerce,” and T. Huertas, “Can Banking and Commerce Mix?”

capital requirements.<sup>6</sup> And the commercial firms most interested in banking probably would expand their own bank-like operations rather than buy existing full-service banks if permitted to do so. This would increase the number of commercial banks, but not the amount of capital in the industry relative to assets.

**Cost Synergies.** Another widely claimed benefit for permitting commercial firms to own banks is that the combination may lower the cost of providing services through scale or scope economies. If the average cost of producing financial services falls as the scale of operations increases, then large banks operate more efficiently than small banks. To the extent that commercial firms could bring additional capital into the banking industry to support larger institutions, allowing commercial firms to own banks could lead to more efficient production if there are significant economies of scale in banking.<sup>7</sup> Similarly, combining commercial products with financial products might lower the cost of production if, for example, inputs are shared across the products. For instance, a manufacturing firm and a bank might be able to use the same computer to keep track of inventory and accounts. If such scope economies exist, then again it would be more efficient to allow banks and commercial firms to mix. And a move toward more efficient production would benefit society by freeing up resources for other productive activities.

While theoretically there are potential synergies between banking and commerce, the evidence to date suggests they probably aren't very significant. Most studies of scale econo-

mies in banking suggest that they are exhausted at banks of a relatively small size (at around \$100 million in deposits), or if present in larger banks, they are slight.<sup>8</sup> Most studies find no evidence of scope economies between different bank products, such as commercial loans and consumer loans. Since banking and commerce have for the most part been separated, there isn't much in the way of empirical evidence on cost synergies between commercial activities and bank products. However, in a 1992 empirical study, I found diseconomies of scope between traditional commercial bank activities and nontraditional activities of loan selling and buying, which resemble investment banking activities.<sup>9</sup> Thus, the evidence doesn't support the view of significant cost savings from combining banking and other activities.

**Revenue Synergies.** It may be that consumers would prefer one-stop shopping to save on transactions and search costs. Combining banking and commerce may yield enhanced revenue through cross-marketing of bank products and commercial firm products. There is some evidence of this—for example, many people get their financing for a new car at the dealership. But there don't seem to be significant revenue synergies or cost synergies—if there were, we'd expect to see higher profits at firms that can provide both commercial and financial activities. While competitive with commercial banks, nonbank banks have not really outpaced them. A study by Linda Aguilár, which compared large bank holding companies with nonbank banks, showed that nonbank banks' market share of finance receivables fell between 1982 and 1987, while that of bank

<sup>6</sup>As of December 1991, the ratio of total tier-one capital to total assets for all domestic banks was 6.6 percent, well over the required 3 percent.

<sup>7</sup>If banking and commerce were permitted to mix, it would be within a holding company structure, and the average asset size of banks within multibank holding companies is over 10 times that of independent banks.

<sup>8</sup>See L. Mester, "Production of Financial Services: Scale and Scope Economies," this *Business Review*, January/February 1987, pp. 15-25, for a review of the literature.

<sup>9</sup>See L. Mester, "Traditional and Nontraditional Banking: An Information-Theoretic Approach," *Journal of Banking and Finance*, forthcoming 1992.

holding companies increased. And nonbank banks have begun to experience problems with loan portfolios and profits just as banks have.<sup>10</sup>

**Increased International Competitiveness.** Other countries tend to be more liberal in allowing banking and commerce to mix. (See

*Banking and Commerce Arrangements in Other Countries.*) So to the extent that commercial and banking mixes are more efficient, U.S. banks would be at a disadvantage compared with foreign banks. But the evidence suggests that while U.S. banks are no longer on top in terms of asset or capital size, they still outperform foreign banks. According to a report by IBCA Limited, in 1990 only two U.S. banks ranked in the world's top 50 by asset size, but their average return on assets and return on equity were

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<sup>10</sup>See L. Aguilar, "Still Toe-to-Toe: Banks and Nonbanks at the End of the '80s," *Economic Perspectives*, Federal Reserve Bank of Chicago, January/February 1990, pp. 12-23.

## BANKING AND COMMERCE ARRANGEMENTS IN OTHER COUNTRIES

**Germany:** Universal banking exists here—banks can perform commercial and investment banking activities directly (no holding company structure is required) and insurance and real estate activities via subsidiaries; banks can own commercial firms directly (but in practice their ownership is small); commercial firms can own banks (but few do, given the regulations they must meet).

**United Kingdom:** Clearing banks, including Barclays, Lloyds, Midland, and National Westminster, engage in commercial and investment banking, and in merchant banking, insurance activities, and real estate activities via subsidiaries; there is no formal policy separating banking and commerce, but tradition has encouraged it by restraining bank investments in nonfinancial firm equity, and such investments are not common; the Bank of England must approve firms taking a 15 percent or greater stake in a U.K. bank, and individuals who own more than a 5 percent stake in a U.K. bank must report it to the Bank of England.

**Japan:** The banking system here was modeled on the U.S. system after World War II, and commercial and investment banking were separated then; Japanese banks can perform commercial bank activities and have minority ownership (5 percent or less) in subsidiaries that perform leasing, insurance, credit card business, and management consulting; until 1987, banks could hold up to 10 percent of the outstanding shares in any company, but through cross-holdings could effectively hold much more; a bank can be a main bank in keiretsu (a conglomerate group) and so have large ties to commercial firms.

**The EEC:** As of 1992, banks are allowed to do commercial and investment banking activities but not insurance activities; a bank is limited to 10 percent of its own equity as a stake in an individual commercial firm, with the total stake in commercial firm equity not to exceed 50 percent of bank capital; commercial firms may own banks if such action is considered suitable by the national regulator.

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Sources: A. Saunders, "Separation of Banking and Commerce," New York University Salomon Center, Working Paper S-91-19, 1991, and A. Daskin and J. Marquardt, "The Separation of Banking from Commerce and the Securities Business in the United Kingdom, West Germany and Japan," *Issues in Bank Regulation* 7 (Summer 1983), pp. 16-24.

higher than those of foreign banks ranked in the top 50 by asset size. And when banks were ranked in terms of IBCA's real profitability index (return on equity adjusted for inflation and differences in equity-to-assets ratios), the U.S. accounted for 16 of the top 50 banks, more than any other country.<sup>11</sup> So the current separation of banking and commerce in the U.S. doesn't appear to be too much of a burden on U.S. banks.

**Lower Risk of Failure.** Allowing a firm to diversify into financial services and commercial production might lower the firm's risk. This would happen if profits in the commercial line of business could be used to offset losses in the financial services line of business. Lower risk would benefit society, since it would mean fewer bank failures.

The empirical evidence on such diversification benefits is mixed.<sup>12</sup> In one study, Anthony Saunders and Pierre Yourougou found that there is a potential for lower risk via diversification because when returns on bank stock are low, returns on commercial firm stock tend to be high, and vice versa.<sup>13</sup> In another study, Robert Eisenbeis and Larry Wall found that when the returns for commercial banks are high, the returns to general merchandise stores are low, and vice versa.<sup>14</sup> So potentially, a firm could combine banking and commerce to

achieve a less volatile total return and so be less likely to fail. But a study by John Boyd and Stanley Graham and another by these authors and R. Shawn Hewitt found that allowing bank holding companies to expand into the nonbanking activities of securities or real estate development increases the probability of failure and the volatility of the holding company's returns.<sup>15</sup> Eisenbeis and Wall's study found that returns for commercial banks and returns for food stores are positively correlated.

Even if the potential for diversification benefits exists, it isn't clear that the management of a bank-commercial holding company would choose to diversify in ways that reduce risk. The current fixed-rate deposit insurance system and the regulatory system, which has been slow to close insolvent banks, encourage banks to take on too much risk. A bank's equity holders get all the upside benefits if the risk pays off, but they don't pay more for taking on more risk. Banks currently pay the same insurance premium regardless of the riskiness of their portfolios, and while bank supervision is supposed to control risk-taking, it hasn't been that successful. Insured depositors have no incentive to monitor a bank's risk-taking, since they are paid off whether the bank fails or not. And often at the larger banks, large depositors, who are supposedly uninsured, don't demand much of a risk premium, since typically they don't suffer losses when a large bank fails.<sup>16</sup>

<sup>11</sup>See IBCA Limited, *Real Banking Profitability*, November 1991.

<sup>12</sup>See A. Saunders, "The Separation of Banking and Commerce," for a more detailed review of this empirical evidence.

<sup>13</sup>A. Saunders and P. Yourougou, "Are Banks Special: The Separation of Banking From Commerce and Interest Rate Risk," *Journal of Economics and Business* 42 (May 1990), pp. 171-82.

<sup>14</sup>R. Eisenbeis and L. Wall, "Risk Considerations in Deregulating Bank Activities," *Economic Review*, Federal Reserve Bank of Atlanta, May 1984, pp. 6-19.

<sup>15</sup>J. Boyd and S. Graham, "The Profitability and Risk Effects of Allowing Bank Holding Companies to Merge with Other Financial Firms: A Simulation Study," *Quarterly Review*, Federal Reserve Bank of Minneapolis, Spring 1988, pp. 3-20. And J. Boyd, S. Graham, and R. S. Hewitt, "Bank Holding Company Mergers with Nonbank Financial Firms: Effects on the Risk of Failure," Working Paper 417, Federal Reserve Bank of Minneapolis, January 1992.

<sup>16</sup>See L. Mester, "Curing Our Ailing Deposit Insurance System," this *Business Review*, September/October 1990, pp. 13-24, for a discussion of reforming federal deposit insurance.

Under recently implemented risk-based capital standards, banks are required to hold more capital against riskier assets. While a move in the right direction, the risk-based capital requirements are not a complete remedy to excessive risk-taking on the part of banks, since the four risk categories considered are very broadly defined—for example, all commercial and industrial loans are assigned to the same risk category. The recently passed FDIC Improvement Act includes changes to remedy some of the risk-distorting problems in the current system. But several of these changes won't be implemented immediately. (The FDIC will be required to charge different insurance premiums based on the riskiness of the bank, but risk-based premiums don't have to begin until 1994. Recently, however, the FDIC announced that it plans to implement risk-based premiums next year.) Until the changes are made, banks will still have the incentive to take on more risk than is best for society.

### POSSIBLE COSTS

Opponents of allowing banking and commerce to mix cite the concentration of resources this would entail and the risks posed to the "safety net," which includes the deposit insurance system, the electronic payments system, and borrowing at the discount window. Most of these costs apply not only to allowing commercial firms to own banks but also to any expansion of a bank's permitted activities. We have heard the safety net arguments before in the debate about whether banks should be permitted to underwrite securities.<sup>17</sup> The difference here is that if commercial firms were allowed to own banks, a new set of firms would become part of the financial services system. The banking system has been undergoing a

restructuring that has required regulatory reform to stem abuses. Until the restructuring and reform are complete, it may make sense to delay extending the system. This is perhaps the best argument in favor of the status quo for the time being; other arguments against mixing banking and commerce just aren't as strong.

**Monopoly Power.** One argument for disallowing the entrance of commercial firms into banking is that it may end up concentrating banking in the hands of a few large corporations. These large commerce and banking conglomerates would exploit their monopoly power, so the argument goes, harming their corporate competitors by denying them the credit they need to do business and harming consumers by offering low deposit rates and high loan rates. Moreover, consumers wishing to purchase just the banking or just the commercial product from the conglomerate might be forced to purchase the other product as well.

Again, the empirical evidence on economies of scale and scope can be brought into the argument, but this time against this potential cost. There is little evidence that the banking industry would become monopolized if commercial firms could own banks. None of the scale and scope studies suggest that banking services could be most efficiently produced with a very few large banks. While commercial ownership may allow banks to grow larger and may lead to some consolidation in the industry, it is unlikely to lead to overconcentration. Even in smaller local markets there is likely to be a number of banks competing for business (especially since there are already bank regulations that guard against monopolization). And global competition would help keep the industry competitive.<sup>18</sup>

As corporations would have access to other banks and to nonbank credit sources such as the

<sup>17</sup>See A. Saunders, "Securities Activities of Commercial Banks: The Problem of Conflicts of Interest," this *Business Review*, July/August 1985, pp. 17-27.

<sup>18</sup>See A. Saunders, "The Separation of Banking and Commerce," for a discussion of this point.

commercial paper market, the commercially owned bank couldn't effectively restrict credit to its competitors. Consumers would also be able to get loans or make deposits at other institutions, and tie-ins wouldn't be a problem as long as the firm was not a monopolist in the market for its commercial product. (If it was, then the antitrust laws could be used to curb any anticompetitive problems.) In fact, experience from the nonbank banks already suggests that tie-ins wouldn't be a problem. All three finance subsidiaries owned by the U.S. automakers, for example, make loans for their competitors' products.<sup>19</sup>

Other arguments against mixing banking and commerce are not as easy to dismiss as the monopoly power argument, at least until financial system reforms are completed.

**Extending the Problem of "Too-Big-to-Fail."** Because failures of large banks could potentially disrupt the payments system, regulators often treat these failures differently from failures of small banks. Despite an explicit insurance ceiling of \$100,000 per deposit, the FDIC often, de facto, insures the large depositors and uninsured creditors of large banks and so bears most of the cost of excessively risky actions by these banks. This gives large banks an incentive to take on more risk than they would otherwise. The recently enacted FDIC Improvement Act will curb some of the problem by restricting the FDIC's ability to protect uninsured depositors or creditors if it would mean a loss to the insurance fund. But the provision won't take effect until 1995, and market participants will have to see some large banks actually fail before they believe "too-big-to-fail" is truly dead. Until then, expanding the size of banks, which is likely to occur at least to some extent under commercial ownership, may be costly.

#### **Increased Risk From Affiliate Transactions.**

Although some argue that allowing commercial firms to own banks would lower risk, others claim it would raise risk, lead to more bank failures, and increase the FDIC's costs. If a commercial firm persuades a bank it owns to pay very large dividends or management fees to the commercial firm owner or even make loans to prop up the owner, the bank could be weakened at the benefit of the commercial owner. The bank would also suffer if the owner could make the bank purchase low-quality assets from other affiliates.<sup>20</sup> In this way the commercial holding company would be able to take advantage of the bank's creditors and the FDIC, since the holding company would have limited liability if the bank failed.

How likely are these scenarios? Two strategies regulators have for dealing with potential conflicts of interest between the holding company and its banks are "firewalls" and the "source-of-strength" doctrine.

*Firewalls.* Current provisions of the Federal Reserve Act (Sections 23A and 23B) limit transactions between affiliates. Section 23A limits loans to an affiliate to 10 percent of the bank's capital, and loans to all affiliates combined to 20 percent of capital. And these loans must be fully collateralized. Section 23B restricts all interaffiliate transfers to be on the same terms as those with nonaffiliates—in other words, to be arm's-length transactions.

In general, these restrictions seem to be working. But the question is whether these firewalls will be disregarded in times of stress and whether they will need to be strengthened if commercial firms are permitted to own banks. Even with currently permitted activities, the firewalls have crumbled at times. Continental Illinois extended loans to its options subsidiary over agreed-to limits when the subsidiary got

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<sup>19</sup>T. Paré, "Tough Birds That Quack Like Banks," *Fortune*, March 11, 1991, pp. 79-84.

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<sup>20</sup>See A. Saunders, "The Separation of Banking and Commerce," for more on these types of transfers.



into trouble during the October 1987 stock market crash. Hamilton National Bank of Chattanooga failed in 1976 after an illegally large amount of poor-quality real estate loans was transferred from its mortgage bank affiliate to the commercial bank.<sup>21</sup>

Restrictions on transactions between a bank and its owner or affiliates are hard for regulators to enforce, since they have less information than the bank or its holding company. It's difficult for a regulator to determine whether the management fees paid by a bank are excessive or whether the transactions are on terms fair to the bank. Perhaps all transactions between a bank and its nonbank affiliates could be banned to stem possible abuses, but if the firewalls are strengthened too much, any potential synergies and benefits of product diversification would be defeated.<sup>22</sup>

*Source of Strength.* Another way the Federal Reserve, regulator of bank holding companies, has chosen to alleviate potential conflicts of interest between a bank and its affiliates is the "source-of-strength" doctrine. Under this policy, a bank holding company must serve as a source of financial strength to its subsidiary banks and must have adequate capital itself. The rationale runs this way: if the holding company knows its funds would be used to prop up its bank in trouble, then it would have no incentive to move funds from the bank to the holding company. Although the FDIC Improvement Act moves toward Congressional

authorization of the source of strength doctrine (see *The Source-of-Strength Doctrine*, pp. 26-27), the courts have not been very receptive to it, since this doctrine runs counter to the concept of corporate separateness. A premise of corporate law is that each affiliate of a holding company is a separate corporate entity with limited liability: if one affiliate gets into trouble, the resources of another don't need to prop up the failing affiliate.

#### **Extending the Deposit Insurance Subsidy.**

Even if they didn't weaken the bank, transactions between a bank and its corporate parent would still need to be controlled to prevent the FDIC from subsidizing the risky activities of commercial firms. Until the new provisions of the FDIC Improvement Act take effect, banks can continue to invest in risky activities without paying a risk premium for their funds. If commercial firms had access to bank deposits by affiliate transactions, then the deposit insurance subsidy would be extended to the owners, creditors, and customers of the commercial firm. To prevent this, regulators would have to tighten firewalls or keep a close eye on the risky activities of the holding company until the subsidy is removed by reform of the deposit insurance system. Of course, such extended regulation may make bank ownership unpalatable to commercial firms.

**Contagion From Affiliates to Bank.** Even without the source-of-strength doctrine, evidence suggests that the market views a bank holding company as a single corporate entity, and indeed, holding companies tend to behave this way. Management studies suggest that the management of a parent and its subsidiaries is usually centralized, and banks have acted to prop up ailing affiliates even when under no legal obligation.<sup>23</sup> Last year, when rating agen-

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<sup>21</sup>See A. Cornyn, G. Hanweck, S. Rhoades, and J. 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), pp. 174-212.

<sup>22</sup>The FDIC Improvement Act calls for the Federal Reserve Board to prescribe standards, effective in a year, to limit the risks posed by a bank's exposure to another bank via interbank transactions, such as credit extensions, interbank deposits, and purchases of securities.

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<sup>23</sup>In the mid-1970s, banks put funds into the real estate investment trusts they sponsored when the REITs got into trouble.

## The Source-of-

Although the Fed has followed a source-of-strength policy since the Bank Holding Company Act was enacted in 1956, the doctrine became official only in 1983. According to Regulation Y:

“A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operation in an unsafe or unsound manner.”

As explained in an April 1987 policy statement, the rationale behind the policy is as follows:

“A bank holding company derives certain benefits at the corporate level that result, in part, from the ownership of an institution that can issue federally insured deposits and has access to Federal Reserve credit.”

The Supreme Court was expected to rule on the validity of the Fed’s source-of-strength doctrine when it considered the case of MCorp, a Texas-based bank holding company, during its 1991-92 session. After 20 of MCorp’s 25 subsidiary banks failed in 1989, the Fed charged that MCorp had failed to act as a source of strength to its remaining subsidiary banks. The case reached the Fifth Circuit Court of Appeals, which ruled that the Fed had no authority to assert the source-of-strength doctrine under the Bank Holding Company Act and could not order the holding company to transfer funds downstream to troubled subsidiary banks. On December 3, 1991, the Supreme Court overturned the Appeals Court’s decision but did not rule on the validity of source of strength. Instead, the Court decided the case on the grounds of jurisdiction, ruling that the federal courts cannot block Fed proceedings before the agency issues a final order. The Court indicated that MCorp can still challenge the source-of-strength doctrine after the Fed completes its enforcement actions.

The Federal Deposit Insurance Corporation Improvement Act of 1991 moves toward Congressional authorization of source of strength. An undercapitalized bank is required to adopt an

cies lowered Chrysler Corporation’s debt rating, Chrysler Financial’s credit rating was lowered too. If the market views management as being the same, then it would view problems in one affiliate as signaling problems in other affiliates. This is a problem when one of the affiliates is a bank because troubles in nonbank affiliates may cause depositor runs at the bank, which would jeopardize the payments system. Runs on individual banks are costly if they result in the failure of an otherwise healthy bank, and they are even more dangerous if they are contagious, causing depositors to lose all confidence in the banking system itself.

We have evidence of the first type of run. In 1973, Beverly Hills Bancorp, parent of Beverly Hills National Bank, defaulted on its commercial paper, causing large-scale runs on the bank,

which led to its failure. More recently, Sunbelt Bank and Trust failed in 1984 after some of its nonbank affiliates failed.<sup>24</sup> Less evidence of contagious bank runs exists, but the savings and loan crises in Maryland and Ohio are examples.<sup>25</sup> And Continental Illinois’ troubles

<sup>24</sup>Both examples are from A. Cornyn, et al.

<sup>25</sup>In March 1985, news of losses at Home State Savings Bank in Cincinnati caused a run at the bank. When the private state insurance fund that insured Home, the Ohio Deposit Guarantee Fund, was unable to bail out Home’s depositors, the run spread to other S&Ls insured by this private fund. A similar panic occurred in Maryland in May 1985. When losses at two S&Ls exceeded the reserves of the private Maryland Savings-Share Insurance Corporation which insured them, depositor runs began at other institutions insured by this fund.

## Strength Doctrine

acceptable capital restoration plan, and the bank's holding company must guarantee compliance with the plan. The holding company liability is limited to the lesser of 5 percent of the bank's total assets at the time the bank became undercapitalized or the amount necessary to bring the bank into compliance with its capital requirement as of the time the bank falls out of compliance with its recapitalization plan.

Several arguments have been made against the Fed's source-of-strength doctrine. The policy would seem to run counter to the idea that insolvent banks should be closed as soon as possible to limit the FDIC's losses. To avoid this inconsistency, the policy could be amended to make the bank holding companies legally liable for any losses incurred by the FDIC in closing or liquidating their banks, but not force the holding companies to recapitalize their troubled banks to keep them open\*

Another potential problem is that the policy may deter corporations, once they are permitted to do so, from investing in banks or deter bank holding companies from diversifying into nonbank activities. However, if the diversification reduces risk, then the risk-based insurance premiums and capital requirements for the well-diversified firm would be lower, encouraging the diversification.

A third problem with the policy is that it runs counter to the idea of corporate separateness. By encouraging the market to treat a holding company and a bank as a single entity, the policy might increase the potential for contagion.

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\*This was suggested in the House Government Operations Committee 1987 report. Under a cross-guarantee provision of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, when a depository institution in a holding company fails, the other depository institutions in the holding company can be required to reimburse the FDIC for any losses it incurs in resolving the failed institution. However, the FDIC can waive these cross guarantees. See W. Keeton, "Bank Holding Companies, Cross-Bank Guarantees, and Source of Strength," *Economic Review*, Federal Reserve Bank of Kansas City, May/June 1990, pp. 54-67.

in the spring of 1984 raised the insolvency risk of other banks by raising their cost of obtaining large CDs and Eurodeposits.<sup>26</sup>

To use contagion effects as an argument against *commercial firm* ownership of banks presumes that commercial firms are more likely to fail and so more likely to threaten an affiliate bank than a financial firm affiliate would be. Though this could be true, the evidence is weak. Corporate bond defaults for commercial firms have not been higher than those for finan-

cial firms. But having a large parent hasn't prevented some securities firms from having more trouble than their smaller, independent siblings.<sup>27</sup>

**Contagion From Affiliates to the Electronic Payments System.** If problems in a nonbank affiliate cannot be isolated from the bank, they may be transmitted to the electronic settlements system, which is becoming an increasingly important part of the payments system. At any point during the day, a bank may have transferred more money out of the settlements system than it has received. These daylight

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<sup>26</sup>See A. Saunders, "Bank Holding Companies: Structure, Performance, and Reform," pp. 156-202 in *Restructuring Banking and Financial Services in America*, W. Haraf and R. Kushmeider, eds. (American Enterprise Institute: Washington, D.C., 1988).

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<sup>27</sup>W. Power, "Struggling Securities Firms Increasingly Being Bailed Out by Their Rich Owners," *Wall Street Journal*, November 14, 1990, p. C 7.

overdrafts, which currently exceed \$140 billion a day, pose a risk to the financial system, since the failure of one bank to settle its position could start a chain reaction in which the creditors of the first bank are pushed into net debit positions and eventual default, which causes its creditors to default and so on down the line. To avoid the reaction, the Fed would need to intervene and assure payments to all involved. The potential losses for the Fed would be large. In effect, the Fed would be rescuing the affiliated bank, and indirectly its troubled corporate owner, to the extent that funds given to the bank could be transferred to the parent.

One way to protect the payments system is to control overdrafts. Plans for doing so exist, but they have not yet been fully implemented. In 1986, the Fed began a program in which banks set voluntary caps on their intraday credit exposure on the Fed's electronic settlements system. In 1989, the Fed proposed to price these daylight overdrafts and will probably start charging banks for their overdrafts sometime in 1993. Until the programs for controlling payments-systems risk are up and running and can be evaluated, the potential exists for problems in nonbank affiliates to spread to the payments system. This is true for all nonbank affiliates, not just commercial affli-

ates. But extending ownership of banks to commercial firms would involve a possible extension of the safety net to commercial firms, and is probably cause to delay corporate ownership of banks.

## CONCLUSIONS

Although included in the Treasury's proposal to reform the financial services industry, commercial firm ownership of banks did not make it into the recently passed FDIC Improvement Act. I have examined several arguments for and against commercial ownership of banks. Similarly, bank ownership of commercial firms is also arguable. (See *Should Banks Own Commercial Firms?*) In many cases, validity of these arguments depends on the ability of regulators to control possible abuses of the financial system by its participants. Without necessary changes to the current system, the potential costs of allowing banking and commerce to mix outweigh the potential benefits. However, as the reforms contained in the new banking act, such as risk-based deposit insurance premiums and limits on "too-big-to-fail," are implemented, the prohibitions against commercial firms' owning banks and vice versa will need to be reconsidered.

## Should Banks Own Commercial Firms?

Currently, banks are not allowed to engage in nonbank activities. Bank holding companies can hold, at most, 5 percent of the shares of any nonbank commercial corporation and cannot simultaneously lend to a commercial firm and hold its equity. As with commercial firm ownership of banks, a cost-benefit analysis suggests it would be prudent to wait until the FDIC Improvement Act's reforms to the financial services industry are in place and working before considering bank ownership of commercial firms.

**Potential Benefits.** Some argue that allowing banks to own equity would lower the firm's funding costs and benefit society by permitting more investment and economic growth. If a bank owns equity in a firm it has lent to, then it is less likely to force the firm into bankruptcy when it encounters temporary financial problems, because equity ownership gives the bank a share of the upside gain should the firm turn around in the future. Since the firm's chance of bankruptcy would be lower, the firm's debtors would charge a lower risk premium, and the firm would thus pay less to fund its activities.

Equity ownership would also make the bank an insider and so privy to more information than outside lenders would have. This would make it easier for the bank to monitor the firm, and it would pass along some of its cost savings to the firm in the form of a lower loan rate. Also, being an insider, the bank would have a greater say in the management of the firm. In the event the firm does fail, the actual bankruptcy costs would be lower, since the assets of the firm needn't change hands.

Some empirical evidence supports this view. Albert Ando and Alan Auerbach found that in Japan, where banks have been allowed to hold large equity positions in commercial firms, the cost of capital may have been as little as half of that in the U.S. in the 1967-88 period.<sup>a</sup> And according to Sun Bae Kim, large Japanese firms avoid bankruptcies in situations that would have meant bankruptcy in the U.S., and when bankruptcy does occur, reorganizations are less disruptive than in the U.S.<sup>b</sup>

**Potential Costs.** The danger of allowing banks to own equities stems from equities' being riskier investments than debt. Extending the set of permissible activities to include riskier ones increases banks' opportunity to take on too much risk, which will continue to be a problem until recent reforms have an impact.

Also, unless the banks have some kind of expertise in the businesses they own, being an insider may not be beneficial.

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<sup>a</sup>A. Ando and A. Auerbach, "The Cost of Capital in Japan: Recent Evidence and Further Results," *Journal of the Japanese and International Economies* 4 (1990), pp. 323-50.

<sup>b</sup>S. Kim, "Banking and Commerce," *Weekly Letter*, Federal Reserve Bank of San Francisco, March 29, 1991.