Can Banking and Commerce Mix?

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The mixture of banking and commerce is hardly a revolutionary concept. Banking and commerce have been mixed in the United States since the birth of the republic, and they remain mixed today. The key questions therefore are: Should banking and commerce be permitted to continue to mix? If so, how should they be permitted to mix, and what regulation, if any, is required when they do mix? These are the questions for which this paper attempts to frame answers.

The Relevance of History

In some discussions of whether banking and commerce should mix, it is asserted that there exists a long tradition of separation between banking and commerce and that this tradition should continue to guide future policy (Volcker 1986; Corrigan 1987). But whatever this tradition says about the activities in which banks can engage directly, it says little about who can own a bank, or the activities in which the affiliate of a bank may engage.[1] Throughout American history, owners of banks have engaged in all types of business activities, including those that would not be permitted for banks themselves. Existing restrictions on what the owner of a bank may do are of relatively recent vintage. Indeed, as a Federal Reserve Board staff study has pointed out, it was not until 1956, when the Bank Holding Company Act prohibited nonbanking corporations from owning two or more commercial banks, that "the basic principle of separation of banking and commerce was established" (Savage 1978, p. 46). And

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[1]For a fuller discussion of the issues in this section, see Huertas (1986a).

since 1956, this principle has been applied only to some owners of some banks.

In particular, the law has always permitted individuals to own controlling interests in both a bank and a commercial firm, and throughout American history individuals have simultaneously owned and in many cases managed both a bank and a commercial firm.[2] In the 19th century, for example, Moses Taylor was the chief executive and principal shareholder of National City Bank (the forerunner of Citibank) as well as the chief executive and principal shareholder of a trading company, a gas utility, and an iron and steel company.

Such individual control over banks and commercial firms continues today. For example, Joe L. Allbritton is chief executive and owns a controlling interest in Riggs National Corporation, the parent holding company for Riggs National Bank, the largest commercial bank in the District of Columbia. He also owns a controlling interest in five television stations. Another example is Sam Walton, the chairman, chief executive, and leading shareholder of Wal-Mart Department Stores. He also is the chairman, chief executive, and leading shareholder of Northwest Arkansas Bancshares, a bank holding company headquartered in Bentonville, Arkansas.

Similarly, the law has always permitted nonbank corporations to own some type of bank. Until 1956, any nonbank corporation could own any number of commercial banks.[3] Until 1970, any nonbank corporation could own a single commercial bank. Until 1969, any nonthrift corporation could own any number of thrifts. And any nonbank corporation remains able to own a single thrift.

[2]One exception to this statement consists of the restrictions contained in the Glass-Steagall Act passed in 1933. Section 20 of the act prohibits individuals owning more than 50 percent of a member bank from owning more than 50 percent of an entity that is principally engaged in the underwriting and distribution of securities. Section 32 of the act prohibits an individual from simultaneously serving as an officer, director, or employee of a member bank and an entity that is primarily engaged in the underwriting and distribution of securities. The definitions of "primarily," "principally," and "securities" for the purposes of these sections are a matter of some dispute, but whatever their precise meaning, they are evidently consistent with an individual having a controlling influence over an investment bank, a member bank, and the bank holding company owning that member bank. One example of such an individual is Ira J. Kaufman, who is the chairman and chief executive of Exchange National Bank of Chicago, the chairman and chief executive of its parent holding company, Exchange International Corporation, and the chairman and chief executive of Rodman and Renshaw Capital Group, Inc., an investment bank that underwrites and deals in corporate debt and equity securities ineligible for underwriting directly by member banks.

[3]The National Bank Act of 1864 prohibited a national bank from owning stock in other corporations, but it did not prohibit a nonbank corporation from owning a national bank.

In 1970, moreover, Congress created a class of commercial banks that could be owned by anybody (Felsenfeld 1985). It did so by redefining the term "bank" for the purposes of the Bank Holding Company Act to be an institution that makes commercial loans *and* accepts deposits payable on demand. Commercial banks that fulfilled one condition but not the other could be owned by any other corporation.

In sum, the law has always allowed some form of corporate affiliation between banks and commercial enterprises.

In practice, corporate affiliation between banks and commercial firms has a long tradition in the United States, dating back to at least 1799 when the Bank of the Manhattan Company was formed as a subsidiary of a company chartered to supply New York City with fresh water. Since then, commercial banks have at various times been affiliated with or owned by insurance companies, shipping companies, department stores, and manufacturers. Thrift institutions have been affiliated with or owned by retailers, insurance companies, securities firms, real estate developers, and electric utilities. And so-called nonbank banks are currently owned by a wide variety of commercial enterprises, including securities firms, insurance companies, and retailers.

Thus, the affiliation of banking and commerce has deep roots in American history. Individuals owning banks have at the same time owned commercial enterprises. Corporations owning banks have at the same time engaged in commerce or owned commercial enterprises. Thus, if history offers any guide to the question of whether banks should be affiliated with such firms, it points in the direction of allowing such affiliations.

The Benefits of Allowing Banking and Commerce to Mix

Competition among suppliers benefits customers in terms of lower prices and greater convenience, and it benefits society by boosting productivity and, ultimately, output. Free entry is the best way to promote competition, and allowing banking organizations to enter commerce, and commercial firms to enter banking, is certainly pro-competitive.

The benefits of allowing such free entry are primarily twofold. First, it would eliminate any market power that the current system of financial regulation may confer on financial firms. Second, free entry would allow financial firms to develop more comprehensive

financial services that may offer improvements in convenience and/or reductions in price.[4]

A trend toward allowing freer competition in financial services is already under way, and it has produced positive benefits. The customer now pays lower prices for financial services, receives higher rates of return on his savings, and is offered a greater choice among financial services. Subsidies from one group of customers to another have been reduced; the prices that customers pay are more in line with the cost that financial firms incur in producing the service. Financial firms have also been forced to become more efficient, to bring costs into line with the lower prices that customers pay (Bailey 1986). In sum, freer entry has made financial firms more competitive.

Entry into financial services is still not completely free, however. Restrictions on who may own a bank and on the activities in which the affiliates of banks may engage mean there still are significant barriers to entry into investment banking, insurance, and local deposit banking markets. These barriers raise the prices that customers pay for financial services. Specifically, limits on entry into investment banking tend to raise the underwriting fees that issuers must pay to float new securities (Silber 1979; Pugel and White 1985). Limits on entry into insurance raise the premiums that customers pay (Joskow 1973; Consumer Federation of America 1987). Limits on entry into local deposit banking markets raise loan rates and service fees and lower deposit rates, all to the detriment of banks' customers, especially small businesses and consumers who have few financing alternatives (Heggestad 1979).

Removing regulatory barriers to entry is the best way to ensure that markets will be competitive, that costs and profits will not be excessive, and that prices will be kept to a minimum. If anyone can legally enter the industry, no firm can exercise market power for very long unless there are natural barriers to entry (Bailey and Baumol 1984). And in financial services there do not appear to be any significant natural barriers to entry.

A second benefit to consumers of financial services would come from firms' passing along economies of scope to customers. Economies of scope arise when a factor needed to produce one product can be used at little or no additional cost to produce another. This means that a firm that produces the two products jointly can do so more cheaply than two independent firms that produce the two products

[4]Free entry would also allow financial firms to respond to market forces and to diversify their income, and this would potentially enhance the safety of financial instruments, including deposits, that they issue.

separately. Customers therefore get a lower price on one or both of the two products, and firms that produce the products jointly tend to gain market share at the expense of firms that produce the products separately (Panzar and Willig 1981).

Financial services are particularly likely to be characterized by economies of scope, for information is a key factor in the production of financial services. Consulting information does not destroy it; the information remains intact and can be used to support other products. For example, many of the same data needed to grant a mortgage can be used to sell homeowner's insurance. The firm that offers both services need collect the information only once and can pass the resultant cost savings along to the consumer. In addition, the seller of the mortgage knows that the customer is a likely candidate for insurance, so that marketing expense can be much reduced. This saving can also be passed along to the consumer.[5]

In sum, allowing banking and commerce to mix would enhance economic efficiency. Benefits of economies of scope would be passed along to customers for financial services in the form of lower fees or higher rates of return on financial assets, such as deposits or securities, that customers purchase from or through financial firms. Because no financial firm would be protected from competition, no financial firm or group of firms would be able to earn excessive profits or incur unnecessary costs. Customers would be able to purchase the widest possible variety of financial services at the lowest possible price. Customers would decide for themselves, rather than have regulators decide for them, whether they were better served by specialized or by diversified financial firms.

Should Banking and Commerce Mix?

Restrictions on the affiliation between banking and commerce should be imposed only if such affiliations clearly threaten to impose costs on society that outweigh the benefits outlined above of allowing banking and commerce to mix. Opponents of allowing such mixing claim there is a clear threat. They allege that allowing banking and commerce to mix would make society undemocratic, the financial system unfair, the payments system unstable, and deposits unsafe. How clear and present are these dangers?

[5]A case in point is Metropolitan Life's recent decision to originate mortgages, homeowner's insurance, and mortgage insurance through its real estate brokerage subsidiary, Century 21.

A Democratic Society

It is often claimed that allowing banking and commerce to mix would lead to an undue concentration of resources. The concern here is not about market power but about the size of firms themselves. The contention is that free entry would produce firms of great size, and that this would produce great evil, for it would confer on a firm or group of firms an undue influence over the political process.

This argument has great populist appeal and is practically as old as the republic itself. It can be traced back at least to Andrew Jackson's "war" in the 1830s against the Second Bank of the United States, and elements of the argument were already present in the debates concerning the chartering of the nation's first banks during the late 18th and early 19th centuries (Hammond 1957, pp. 144–71; Schwartz 1947).

It is instructive to note that in the bank war of the 1830s, great numbers won out over great size, and that generally remains the rule in politics today. Fears that free entry into financial services would result in excessive political power seem overdrawn. Free entry may produce financial supermarkets, but no one financial supermarket will necessarily have political power. There will be many financial supermarkets, and each may have some political influence. To the extent that they will have such influence, however, it is likely to result from their acting as a group, much as members of trade associations now do.

In fact, allowing free entry into financial services is likely to reduce the concentration of political power that currently rests in specialized firms and their trade associations. Any law that restricts entry confers wealth on the people owning the entities that are protected from competition, and this tends to create a constituency in favor of the law (Stigler 1971). The current system of financial regulation is no exception. Regulation protects specialized financial firms from competition and increases their profit-making potential. Consequently, specialized firms have the incentive to reinvest some of the excess profits generated by regulation to lobby for a continuation of the very system of regulation that generates those excess profits. In this sense, excessive political power is far more likely to result from restricting entry, rather than from allowing entry, into financial services.

A Fair Financial System

How fair should the financial system be, and to whom should it be fair—to competitors or to customers? Much of the debate about financial regulation has been phrased in terms of fairness to competitors, creating a "level playing field" so that what is right for one firm is

right for another. But many regulatory regimes might meet such a standard. The relevant question is, Which of these regimes is fairest to customers and to society as a whole?

By the standard of fairness to customers, it is hard to do better than allowing free entry into financial services. Allowing anyone to own a bank and allowing a bank's nonbank affiliates to engage in any type of activity affords customers the widest choice among financial services plus the prospect of paying lower prices for the financial services they do decide to buy. Some observers, however, contend that allowing free entry would inevitably lead to grave abuses involving conflicts of interest or to an undue concentration of market power in the hands of a few large financial firms, and that these adverse effects would outweigh the positive benefits of greater choice and lower cost resulting from free entry.

Conflicts of interest are universal, and so, therefore, is the possibility of abuse. In particular, all of the potential conflicts of interest that allowing free entry into financial services would allegedly create already exist within financial firms today. Is more competition within financial services likely to increase or reduce the possibility that abuses will arise?

In general, more competition reduces the possibility for abuse. It gives the customer more options and therefore makes him less vulnerable to the actions of any one vendor. The firm that provides many services must be careful in providing each, lest poor performance in one area lead the customer to take all of his business elsewhere (Peltzman 1979).

In particular, allowing free entry into financial services practically eliminates the possibility of abusive tie-ins. Tying is economically harmful only if a company has market power in at least one of the two products that are tied together.[6] Since free entry is the best way to minimize the market power that any firm may have, allowing free entry into financial services would help prevent abusive tie-ins and promote the beneficial bundling of banking and nonbanking services.

Free entry would also help prevent financial firms from amassing monopoly power, that is, from obtaining an undue concentration of economic resources.[7] Free entry into financial services does not mean

[6]Tie-ins that are economically harmful are generally also illegal. See, for example, Jefferson Parish Hospital District No. 2 et al. v. Hyde 104 S.Ct. 1551 (1984).

[7]Indeed, barriers to entry are a precondition for market power. High concentration ratios are meaningful indicators of market power only if there exist barriers to entry into the relevant market. Conversely, if there are high barriers to entry to the relevant market, even extremely low concentration ratios are consistent with the possession of market power by firms in the market (Landes and Posner 1981).

that one firm will be permitted to become a financial supermarket, but that any firm will have the opportunity to do so. Consequently, free entry into financial services is likely to produce many financial supermarkets, none of which has monopoly power.[8]

Free entry, however, would force all financial firms to become more efficient. In other words, some specialist firms might have to reduce their prices (and costs) or improve the quality of their services, much as the vegetable store must offer fresher produce to compete with the supermarket. This is a more strenuous and perhaps less profitable world than many specialist firms enjoy today, and that prospect undoubtedly motivates many of them to oppose allowing free entry into financial services.

A Stable Payments System

Opponents of mixing banking and commerce cite risk to the payments system as a primary reason to restrict affiliations between banks and commercial enterprises (Volcker 1986; Corrigan 1987). But the stability of the payments system has nothing to do with who owns a bank or whether a bank does or does not have nonbank affiliates. Consequently, controls on who may own a bank or on the activities in which a bank's nonbank affiliates may engage are not required to assure stability in the payments system. If reforms in the payments system are needed, they concern changes in the way payments are settled.[9]

The payments system consists principally of two large electronic payments networks, FedWire and CHIPS (Clearing House Interbank Payments System). FedWire is the principal component of the domestic payments system; CHIPS is the principal component of the international dollar payments system. In terms of value, these two systems together process over 85 percent of all payments made in the United States each day.

Essentially the payments system is nothing more than a switching mechanism that routes funds from one bank to another. Risk in the payments system arises because banks extend credit to one another during the payment process. Controlling risk in the payment system

[8]Free entry into financial services is unlikely to eliminate specialized, single-service financial firms. Indeed, as long as entry is free, specialized firms will retain the potential to skim the cream off any market that financial supermarkets show any sign of successfully monopolizing. Thus, financial firms may grow to a greater size as a result of freer entry into financial services, but no financial firm is likely to have any more market power than it does now. In fact, each financial firm is likely to have a good deal less.

[9]For a fuller discussion of the issues in this section, see Huertas (1986b).

therefore amounts to ensuring that banks adequately control the credit they grant to each other during the process.

Risk to the stability of the payments system is systemic risk. Such risk exists because the failure of one participant to settle its obligation to the payments system could lead other participants to be unable to settle and so lead to an interruption in the payments process.

There is no systemic risk on FedWire. FedWire cannot collapse because the Federal Reserve guarantees all payments made over FedWire. Thus, if a bank fails, no other bank is affected. The system remains intact and stable, like the telephone network does when a single phone is disconnected.

The only party at risk on FedWire is the Federal Reserve or, more exactly, the Treasury, in that any losses sustained by the Federal Reserve as a result of its guarantee of payments made over FedWire would merely serve to reduce the Fed's net contribution to the Treasury. Thus, risk on FedWire should be compared to the risk that government expenditures and receipts may not come in at their budgeted levels and that the agency responsible for the shortfall may come under increased congressional scrutiny and/or executive branch supervision. But why should the Fed take this risk? Should the Fed guarantee payments over FedWire or even operate a payments system at all?

Some degree of systemic risk exists on CHIPS. CHIPS could collapse if one of its participating banks were to fail, but this systemic risk has nothing at all to do with the degree to which participants on CHIPS are or are not affiliated with nonbank enterprises.

On CHIPS the receiving bank is exposed to the sending bank for the net amount of payments due from the sending bank. Thus, the receiving bank is exposed to any risk that may be posed to the sending bank by its nonbank affiliates. The receiving bank controls for this risk, as well as all other risks that may be posed by the sending bank, by setting a limit on the net amount of payments that it agrees to receive from the sending bank (the bilateral credit limit). In addition, the system sets a limit on the total amount that any one bank can owe to all other banks on the system (net debit sender cap) that is equal to a fraction of the sum of the bilateral credit limits that the other banks in the system set for that bank. In this way receiving banks provide an independent assessment of the risk posed by sending banks, including any risk that may arise as a result of the sending bank's having nonbank affiliates.

The systemic risk on CHIPS arises solely from the provisional nature of the net settlement procedure used. Payments over CHIPS are not final when made, but contingent upon settlement at the end

of the day. If one bank cannot settle, then others may not be able to settle either, and the payments involving one or more banks on the system may have to be deferred via a system delete or system unwind. Such procedures have never had to be invoked, and the system of bilateral credit limits and net debit sender caps makes it unlikely that they ever will. Nonetheless, there is a remote possibility that CHIPS could collapse, and to remove this possibility the members of CHIPS are currently considering the adoption of "settlement finality." Under settlement finality all payments made over CHIPS would be final as far as the sending and receiving banks are concerned. In the event that a bank with a net debit to the system fails, other participants on CHIPS would have to make good the failed bank's payment to the system so that settlement could occur.[10] In that case, the failure of one bank would not impair the ability to settle payments made on CHIPS. CHIPS would remain intact and stable.

In sum, risk to the stability of the payments system is not a reason to restrict who may own a bank or to limit the activities in which a bank's nonbank affiliates may engage. FedWire is inherently stable, and changes in the way CHIPS is settled will make CHIPS stable. Restricting who may own a bank or restricting the activities in which a bank's affiliate may engage will not affect the stability of FedWire or CHIPS. Consequently, allowing the mixture of banking and commerce is perfectly consistent with maintaining the stability of the payments system.

Safe Deposits

One of the primary objectives of financial regulation is to enhance the safety of consumer deposits. But federal deposit insurance does this completely. Deposit insurance protects consumer deposits from all risk, including any risk that may arise as a result of a bank's affiliation with nonbank enterprises.[11] Consequently, allowing or prohibiting the mixture of banking and commerce has no effect on the safety of consumer deposits as far as consumers are concerned. Any risk to a bank that may arise from a bank's affiliation with non-

[10]Adoption of such a rule requires the resolution of a number of issues, and these are currently under discussion among the members of the clearinghouse. The issues include fixing the rule by which the amount owed to the system by the failed bank would be apportioned among the other participants as well as establishing some provision to ensure the liquidity of the settlement (so that the banks obligated to cover the position of the failed bank could make available the necessary funds promptly enough for settlement to occur).

[11]It should be noted that an individual can insure a truly staggering amount of deposits. By depositing $100,000 in each of the nation's 14,000 banks a consumer or corporation could obtain up to $1.4 billion in FDIC-insured deposits.

bank enterprises is a risk borne by the deposit insurance fund and the bank's uninsured depositors and creditors.

That leads to the question of deposit insurance reform. Much of the debate about how to reform financial regulation centers around the question: In what activities should an institution that issues federally insured deposits be permitted to engage, either directly or through affiliates? Much of the debate about how to reform the deposit insurance system centers around the question: Is the financial guarantee provided by deposit insurance worth more or less than the premium paid to the deposit insurance agency? Are these two questions related, and if so, what light does this shed on the question of mixing banking and commerce?[12]

Deposit insurance is a financial guarantee given to insured deposits. The price of this guarantee is the premium paid to the deposit insurance agency; in the case of FDIC insurance, it is one-twelfth of 1 percent of the bank's domestic deposits.[13] The value of the guarantee is equivalent to the value of a put option on the stock of the bank. This value depends on whether regulators allow such a put option to go "in the money"—that is, on whether they allow banks to operate with negative net worth. If regulators do not—if banks are promptly reorganized or recapitalized if and when they become insolvent—the value of the guarantee given by deposit insurance is zero, and consequently less than the positive premium paid for it. If the value of deposit insurance is less than the premium paid for it, deposit insurance cannot be said to subsidize banks or to induce banks to take excessive risk, either directly or indirectly, through their affiliation with nonbank enterprises.

Promptly reorganizing or recapitalizing banks if and when they become insolvent, is precisely what bank regulators are supposed to do. If there is a problem in the deposit insurance system, it has arisen for two reasons. One is that regulators have permitted banks to operate with negative net worth. The other reason is that regulators on occasion have resolved bank failures so as to protect uninsured depositors and creditors of the bank and, in some instances, so as to protect creditors of the parent holding company as well. Such ex post extensions of insurance to liabilities that are de jure uninsured have led some observers to contend that investors regard these uninsured liabilities to be de facto or ex ante insured. As a consequence, these

[12]For a fuller discussion of the issues in this section, see Huertas and Strauber (1986a).
[13]Note that only the first $100,000 of a depositor's domestic deposits are insured. Since the premium is due on all domestic deposits, the premium rate relative to insured deposits is higher for banks that fund with uninsured domestic deposits.

same observers assert, the value of the guarantee given by deposit insurance exceeds the premium paid for it, so that deposit insurance is alleged to subsidize banks and to induce banks to take excessive risk.

Regardless of whether such assertions are true or false (and there is evidence to suggest that they are false [Huertas and Strauber 1986c]), the source of the alleged problem *is not deposit insurance* per se, but bank failure determination and resolution policies. Consequently, the key to reforming deposit insurance is to reform the way in which bank failures are determined and resolved. Banks should be promptly reorganized or recapitalized when they become insolvent, and bank failures should be resolved in a manner that does not protect the creditors of the bank's parent holding company or of its nonbank affiliates.

Such reforms in policies for resolving bank failures would solve the problems facing the deposit insurance system. Separating banking and commerce does not. Thus, deposit insurance cannot be cited as a reason to prevent the affiliation of banking and commerce.[14]

In sum, the public would benefit from allowing free entry into financial services. Customers would benefit in terms of greater convenience and lower cost. The stability of the payments system would be unaffected. Consumer deposits would remain safe. The potential for abuses caused by conflicts of interest would be reduced, as would the potential for firms or groups of firms to amass excessive political power.

These results hold regardless of the type of nonbank firm that would affiliate itself with a bank or own a bank. Consequently, there is no reason to restrict who may own a bank or to limit the activities

[14]The objection that deposit insurance gives firms affiliated with banks an unfair advantage over other firms is also no reason to prevent affiliation between banking and commerce. As long as any firm can own a bank, deposit insurance would be an advantage open to all, and therefore no competitive advantage at all. Moreover, if banks are *promptly reorganized or recapitalized when they become insolvent*, deposit insurance is not an advantage to anyone, in the sense that there would be no subsidy from deposit insurance. Thus, deposit insurance could not be used by anybody to subsidize entry into anything.

Similarly, there is the notion that allowing the affiliation of banking and commerce would somehow aggravate the "too big to fail" problem. But this is not the case. The issue of whether a firm is too big to fail does not depend on whether that firm is a bank. At various times automobile companies (Chrysler), defense contractors (Lockheed), and securities firms (Bache) have been considered too big to fail. Moreover, it is possible to solve the problem as it may apply to banks, first by resolving all bank failures in a manner that does not protect the creditors of a bank's parent or nonbank affiliates, and second, *by promptly reorganizing or recapitalizing* banks when they become insolvent. Such steps are possible even for very large banking organizations. For details on how this can be done, see Huertas and Strauber (1986a).

in which a bank's nonbank affiliates may engage. Banking and commerce should be allowed to mix.

What Should Banks Do?

If banking and commerce should be permitted to mix, is there any rationale for limiting what a bank can do? What should constitute "banking," or what should banks be permitted to do directly?

If there is a rationale for limiting the activities of banks, it must be based on distinctions between banks and other firms. Perhaps the most important such distinction is that a different closure rule applies to banks. Unlike other firms, banks do not declare bankruptcy; indeed, the bankruptcy code does not apply to banks. Instead, the chartering agencies are responsible for monitoring the solvency of banks and for ensuring that banks that become insolvent are promptly reorganized or recapitalized.[15] And as noted above, if the chartering agency is able to reorganize or recapitalize a bank at the point where its net worth is equal to zero, the deposits of the bank will be safe.

This suggests that what a bank should be permitted to do should depend on how easy it is to monitor the solvency of the bank. That in turn depends on whether others, in addition to the chartering agency, monitor the bank. Currently, the chartering agencies share responsibility for monitoring the solvency of the bank with uninsured depositors and general creditors. If these investors expect they will be exposed to loss in the event the bank fails, then they will monitor the solvency of the bank. In particular, no uninsured creditor will lend funds to a bank he considers to be insolvent, and banks that are close to insolvency will find it increasingly difficult to fund their activities with uninsured liabilities. Consequently, uninsured creditors could give an early warning to regulators as to when a bank is becoming insolvent.[16] Thus, if a bank largely funds itself through

[15]Other distinctions between banks and nonbank firms, such as deposit insurance and access to the discount window, are really part and parcel of the different closure rule applied to banks. Deposit insurance is in effect a performance bond given to small, and presumably unsophisticated, depositors that chartering agencies will reorganize or recapitalize banks whose net worth has been exhausted. The small depositor therefore need not be concerned that the chartering agency will fail to close a bank that has become insolvent. Access to the discount window is supposed to prevent a bank that is solvent but temporarily illiquid from failing. Nonbank firms, however, can fail solely because they are illiquid (that is, cannot refund maturing liabilities).

[16]Uninsured depositors will provide such an early warning by reducing the volume of funds they are willing to place with the bank and/or by raising the rate of return they demand on their deposits. They will exert such discipline if they expect to be exposed to the possibility of loss (of principal and/or liquidity) in the event the bank should fail. And regulators can reinforce such expectations by resolving the bank failures that do occur in a manner that exposes uninsured depositors and general creditors to loss.

uninsured liabilities, there is little need to define what the bank can or cannot do. That can be left for the market to determine. In effect, the bank will have to confine itself to activities that yield returns sufficiently high and sufficiently stable to ensure the degree of safety desired by depositors.

A similar result would hold if the bank issued subordinated debt. Holders of such debt would monitor the condition of the bank, for they would bear the first portion of any loss the bank incurred after its equity was exhausted. To protect themselves, investors in subordinated debt would build in covenants allowing them a greater say in the bank's affairs when the net worth of the bank declined to zero or close to zero. Thus, subordinated debt would make it easier for the chartering agency to determine when the bank was close to insolvency, and it would also provide a cushion of additional protection to deposits, thereby making deposits safer.

Moreover, if such subordinated debt were required to be convertible into equity when the net worth of the bank reached zero (or some small positive amount), it could provide for an automatic recapitalization of the bank in the event the bank "failed" (that is, in the event its equity capital were exhausted).[17] In effect, mandatory convertible subordinated debt would provide a parachute that would ensure a soft landing for the payments system and deposit insurance funds. The covenants on the debt that trigger the mandatory conversion into equity would be the ripcord.

With such a safeguard in place, there would be no need to restrict the activities in which a bank could engage. Once again, that could be left for the market to determine. Banks that engaged in overly risky activities would find themselves unable to issue subordinated debt at reasonable rates. And if banks were required to fund a certain percentage of their assets with subordinated debt, they could not expand unless they could issue additional subordinated debt.

If a bank does not issue subordinated debt, and if it funds itself exclusively through insured deposits, then the chartering agency will be the only entity responsible for monitoring the solvency of the

[17]See, for example, Benston et al. (1986, pp. 192–95). Such subordinated debt could be issued either to outside investors or to the bank's parent holding company. In the latter case, the market discipline exerted on the bank would be indirect, through discipline exerted by debt holders of the holding company. Since dividends and interest from the bank to the holding company would service the holding company debt, and assuming there would continue to be minimum equity requirements and dividend restrictions on the subsidiary bank, the mandatory conversion of subordinated debt into equity in the bank could jeopardize the ability of the bank to pay dividends to the holding company and of the holding company to service its debt. This would induce investors in the holding company's debt to monitor the condition of subsidiary banks.

bank. To this end, the chartering agency has various tools at its disposal, including periodic reporting requirements and on-site examinations. Are restrictions on the activities in which a bank may engage also required?

Strictly speaking, such restrictions are not necessary if the chartering agency can monitor the solvency of banks under its supervision so that banks can be promptly reorganized or recapitalized when they become insolvent. If current reporting and examination techniques are insufficient, they could be improved through on-line reporting, statistical analysis, more frequent examinations, and a greater emphasis during examinations on detecting fraud (which remains the primary cause of bank failures). Another method would involve allowing the chartering agency to take over the administration of the bank through a conservatorship if the bank's capital fell below a minimal positive level (say 1 percent of assets), or if the bank had to borrow some multiple of its capital from the discount window over an extended period of time.

Thus, tightly defining what a bank can do directly does not seem necessary, particularly for banks that issue subordinated debt or derive a large proportion of their funding from uninsured liabilities. In such banks, the uninsured creditors can be expected to keep a sharp eye on the solvency of the bank and to refuse to fund any bank they believe to be insolvent or close to being insolvent. In such cases, regulators can take their cue from the market as to when a bank becomes insolvent and needs to be reorganized or recapitalized.

In sum, what banks should do, or what should constitute "banking," does not appear to be susceptible to easy definition. Perhaps the best that can be said is that it does not much matter what banks are permitted to do as long as the activities themselves are lawful and banks are promptly reorganized or recapitalized when they become insolvent.

How Should Banking and Commerce Be Allowed to Mix?

If banking and commerce do mix, should the owner be required to conduct all activities within the bank itself, or should the owner be free to structure the corporation in any manner he chooses, provided the entity that issues deposits is regulated as a bank? The analysis of the previous section suggests that all activities could be conducted within the bank itself, and the private banks of the 19th century and today's universal banks are examples of this.

There is, however, no reason to require that all activities be conducted within the bank itself. As long as the condition of the bank can be monitored and banks that become insolvent are promptly recapitalized or reorganized, any corporation should be free to own a bank; a bank's nonbank affiliates or subsidiaries should be able to engage in any activity whatsoever; and the owner of the bank should be free to decide which activities to conduct within the bank and which activities to conduct in nonbank affiliates or subsidiaries.

If some activities are conducted outside the bank, what restrictions should be imposed on transactions between the bank and its nonbank affiliates? Strictly speaking, no such restrictions are necessary if the bank funds itself largely through uninsured deposits or if it issues subordinated debt. In such cases, the uninsured depositors or creditors would monitor all the risk to which the bank might be exposed, including any risk that might result from its affiliation with nonbank enterprises. It could be left to the market to determine what restrictions, if any, are appropriate, and, over time, banks and investors would develop various sets of covenants regarding transactions with affiliates that would protect depositors and/or subordinated debtors, much as covenants in debt issued by nonbanks protect bondholders.

Thus, if restrictions on interaffiliate transactions are needed, they are required only to the extent that the bank funds itself with insured deposits and only to facilitate regulators' ability to monitor the solvency of the bank. However, overly restrictive limitations on interaffiliate transactions, by limiting the ability of banking organizations to serve their customers effectively, could actually increase the likelihood that the bank will become insolvent. Thus, in designing restrictions on interaffiliate transactions, a balance must be struck between ease of monitoring and ease of conducting business.[18]

Where should that balance be struck? One approach is to err on the side of safety, to impose restrictions that would enable the bank regulator to confine its monitoring activity to the bank itself and to ensure that the deposits of a bank with affiliates are at least as safe as the deposits of a bank without affiliates. The following represents one set (and not necessarily the only set) of restrictions on interaffiliate transactions that would fulfill these criteria:

[18]Volcker (1986) asserts that restrictions should completely insulate all banks from all risk that might be assumed by nonbank affiliates. Strictly speaking, this standard implies that the equity as well as the deposits of the bank should be protected, and that it is more important to protect deposits completely from the risks assumed by nonbank affiliates than to protect deposits against risks, such as credit risk, that are directly assumed by the bank itself. For a fuller discussion of this and the other issues in this section, see Huertas (1986c).

1. Impose limits on dividends from the bank to the parent, such as those imposed on national banks. Coupled with the requirement that all banks, regardless of parentage, maintain minimum capital, this would prevent a bank from upstreaming an excessive amount of resources to its parent. It would also give depositors and general creditors what amounts to a first lien on the assets of the bank.
2. Impose a requirement that all extensions of credit by a bank to its parent or affiliates be fully and adequately collateralized.[19] This restriction removes the need for the bank regulator to monitor the condition of the affiliate to which the bank may extend credit, and it would actually make credits extended to affiliates considerably safer than credits extended to nonbank affiliates.
3. Impose a requirement that all other transactions between a bank and its parent or affiliates be conducted on an arm's-length basis, that is, on terms that are at least as favorable to the bank as those that would prevail in comparable transactions between the bank and unaffiliated third parties. This restriction would make it impossible for the parent or nonbank affiliates to siphon off an excessive amount of resources from the bank. But it would leave the parent and the nonbank affiliates free to transact with the bank on terms that do not harm the bank or that plainly favor the bank. Again, such a restriction removes the need for the bank regulator to monitor the condition of the nonbank affiliates.
4. Impose a requirement that a bank's parent and its nonbank affiliates explicitly state to investors that their liabilities are not deposits and are not covered by federal deposit insurance. This restriction would go beyond full disclosure to require that banking organizations give investors fair warning they are not buying a deposit when they buy a security issued by a bank's parent or its nonbank affiliates. This extra precaution would act to preserve the reputation of the bank should either its parent or nonbank affiliates get into trouble.

Together, these four restrictions confine the bank regulator's monitoring task to the bank itself, and they would more than adequately protect the deposits issued by a bank with affiliates, in the sense that they would make those deposits at least as safe as the deposits issued

[19]An exception to the collateralization requirement could be made in the case of intraday overdrafts by affiliates of their accounts on the bank. On CHIPS the risk to the sending bank of such overdrafts is monitored by the receiving bank, and on FedWire the overdraft limit of the bank itself vis-à-vis the Fed may be a more efficient monitoring mechanism than the collateralization of the overdrafts.

by a bank without any affiliates at all. In fact, under such restrictions the deposits of a bank with affiliates would likely be a good deal safer than the deposits of a bank without affiliates because the bank with affiliates could potentially draw on a "hidden reserve"—the resources of those affiliates.

Aside from these four restrictions, no further restrictions on a bank's relationship with its parent or nonbank affiliates are necessary. In particular, no further restrictions need be placed on cross marketing or on operating the bank and its nonbank affiliates in tandem with one another. No requirements need be imposed on the capital that the parent holding company must maintain. All that is required is that the above restrictions be enforced. And as noted above, even these restrictions are not necessary if the bank issues subordinated debt or if the bank funds itself largely through uninsured liabilities.

Conclusion

Regardless of what banks should be permitted to do, anyone should be permitted to own a bank, and banks should be permitted to affiliate themselves with any type of nonbank enterprise. Affiliations between banking and commerce have been common throughout American history, and they continue today. They are beneficial and fair to customers. They do not jeopardize the safety of consumer deposits or threaten the stability of the payments system. Consequently, banking and commerce should be permitted to mix.

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EXPANDING BANKING POWERS: THE PRESENT DEBATE

Robert A. Eisenbeis

The paper by Thomas Huertas on commingling banking and commerce is useful because it raises a number of interesting and important issues relevant to the present debate over expanded powers for banking organizations—issues that are on the minds of both policy makers and those in the financial services industry.

The paper has several key sections. The first is a history section that attempts to answer the question posed in the title of the paper "*Can Banking and Commerce Mix?*" Not surprisingly, the conclusion is yes. More important, however, is the fact that the conclusion follows logically from the historical review that indicates these activities always have been mixed.

Huertas's analysis debunks the notion found elsewhere that there has been a traditional separation between banking and commerce.[1] The evidence shows there have never been restrictions on individuals owning or having substantial interests in banks and nonbanking firms. Moreover, throughout the 19th century, there were numerous instances of corporate affiliations between banks and a wide range of commercial enterprises, including public utilities, water companies, railroads, chemical companies, and other nonfinancial and financial firms. The paper documents and illustrates quite well the various kinds of affiliations that existed.

The present separation between banking and commerce is very recent, dating back to the Bank Holding Company Act of 1956.[2] That act broke up the Transamerica Corporation and prohibited any firm

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[1]See, for example, Corrigan (1987), Volcker (1986), and Fein (1986).

[2]The principal exception, as Huertas points out, is the prohibition of the combining of investment and commercial banking in the 1933 Glass-Steagall Act.

owning two or more banks from owning companies other than those whose business was closely related to banking. The subsequent rise of one-bank holding companies, which were not subject to the activity prohibitions in the 1956 act and thus free to acquire commercial affiliates, caused great congressional concern during 1968–69 and culminated in passage of the 1970 amendments to the Bank Holding Company act of 1956.[3] The 1970 amendments prohibited any company owning a bank that both accepted demand deposits and made commercial loans from engaging in any financial or commercial activity that was not "so closely related to banking . . . as to be a proper incident thereto." The interesting question following from Huertas's analysis is why there has never been similar concern about the commingling of banking and commerce through individual ownership that seems to have accompanied corporate ownership of banking and commercial firms.

A small quibble is possible with one portion of this history section. In discussing the 1970 amendments, Huertas suggests that, by revising the definition of a bank, Congress purposefully created a class of banks that could be owned by any individual or corporation outside of the activity restrictions of the act. Review of the legislative history of the 1966 and 1970 amendments to the 1956 Bank Holding Company Act suggests a different interpretation.[4] The original 1956 act defined a bank so as to include both savings banks and nondeposit trust companies. Experience with the act suggested that this definition was too broad. The 1966 amendments modified that definition so as to exclude savings banks and trust companies by defining a bank to be any company that accepted demand deposits. The Senate report on this change indicated that the intent of the act was to limit undue concentration and control of bank credit and to prevent abuses of bank subsidiaries by bank holding companies to the benefit of nonbank subsidiaries. It further stated that this purpose could be achieved without extending the act to savings banks.[5] Natter (1983) indicates that even with the revision, coverage was too broad, so further modifications were made in the 1970 amendments. Fischer (1986, p. 159) notes that the Senate report explained:

> The definition of "bank" adopted by Congress in 1966 was designed to include commercial banks and exclude those institutions not engaged in commercial banking, since the purpose of the act was to restrain undue concentration of commercial banking resources

[3]See Fischer (1986).

[4]This discussion is based on Natter (1983) and Fischer (1986).

[5]Senate Report No. 89-1179, 89th Congress, 2d sess., 1966.

> and to prevent possible abuses related to the control of commercial credit. However, the Federal Reserve Board has noted that this definition may be too broad and may include institutions which are not in fact engaged in the business of commercial banking in that they do not make commercial loans. The committee, accordingly, adopted a provision which would exclude institutions that are not engaged in the business of making commercial loans.

Given this history, it is unlikely that Congress was attempting to open up bank ownership to nonbanking organizations. Rather, Congress apparently intended to exclude from coverage of the act institutions like the Boston Safe Deposit Corporation that were not primarily engaged in commercial banking.[6] In making such refinements, Congress unintentionally opened the possibility for commingling commerce and insured deposit taking.

In the second main section of his paper, Huertas shifts his attention to a general discussion of the benefits of permitting the commingling of banking and commerce. The conclusion that positive social benefits would result is rooted in a theoretical discussion of the benefits of increased competition and the preservation of free entry into markets. The only empirical evidence cited suggests that some of the markets that banking organizations would be most likely to enter if permitted (for example, insurance and investment banking) have been characterized by abnormally high profits and prices. Presumably, prices would fall and abnormal profits would disappear if bank entry were permitted. There is no evidence cited, however, on the actual experience in those nonbanking markets in which banking organizations have been permitted under existing provisions of the Bank Holding Company Act.[7]

Turning from the theoretical discussion to the present debate over whether banking and commerce should be permitted to mix, Huertas suggests that restrictions could be justified only if the social costs exceed the benefits. He examines four common arguments about why these social costs might be high. Net social costs might result because free entry might (1) lead to bigness and the abuse of political power, (2) lead to inequities in the functioning of markets, (3) pose a threat to the safety of the payments system, or (4) adversely affect the safety of bank deposits.

With respect to the issues of fairness, which include the first two sources of social costs mentioned, Huertas correctly points out that

[6]Boston Safe was subsequently acquired by American Express and became an entry vehicle for American Express into the deposit taking business in the U.S.

[7]For reviews of this evidence see Fischer (1986) or Federal Reserve Board (1978).

much of the present concern with fairness is from the perspective of competitors and not customers. He argues, and I agree, that the focus should be on fairness to customers more than competitors.[8] One of the best ways to ensure fairness is through increased competition and free entry. Interestingly, however, much of the existing financial legislation enacted to promote fairness to competitors does so by imposing differential costs and handicapping certain institutions relative to others. Such regulation promotes inequity and unfairness to achieve redistributions of resources and wealth and allocations of credit different from what an unfettered market would offer.[9]

With respect to the safety and soundness considerations that might arise from commingling banking and commerce, the third and fourth sources of social costs discussed, Huertas breaks down the issues into two broad categories: those pertaining to the implications for the payments system and those related to the protection of customer deposits. In the payments system area, he notes that the bulk of the dollar volume of payments is large and flows through CHIPS (the Clearing House Interbank Payments System) and FedWire.

FedWire is essentially a riskless system from the customers' perspective because once a transaction enters the system, the Federal Reserve guarantees that payment will be received, even if the initiator of the transaction defaults. There are some very interesting questions here that are worthy of further consideration. These concern the appropriateness of the Fed assuming the credit risk in such cases without charging for that risk. Should the federal government even operate a payments system at all?

In the case of CHIPS, Huertas argues that because of the provisional way that transactions are settled, funds received may be reversed if the sender defaults. This policy makes the system vulnerable to systemic risk. Huertas suggests that adoption of "settlement finality"

[8]We already have general statutes in the form of the Robinson-Patman Act that prevent predatory and unfair competitive practices.

[9]In contrast, antidiscrimination laws and regulations attempt to ensure that all customers have access to financial services based on their economic capabilities and are not denied access on the basis of race, creed, etc. One should be careful to distinguish between these types of consumer regulations and those designed to promote credit allocation. Regulation Q ceilings, for example, were neither fair to consumers nor fair to competitors. See Kane (1981). During the Cato Institute's February 1987 conference, it was pointed out repeatedly that most financial regulation has been anticompetitive and designed to reallocate market shares rather than to promote competition. Attempts to promote competition appear to be almost an afterthought in the bank merger and bank holding company acts, which require that proposed mergers and acquisitions pass muster under the antitrust laws of the country. But these requirements are an attempt to correct the anticompetitive consequences of restrictive branching laws and home office protection provisions in state law.

would deal with that problem, but he does not discuss how likely this is to come about or whether finality of settlement should be required for CHIPS to continue operation. Huertas asserts, but does not discuss, that activities engaged in by system participants do not affect the risks facing these two major payments systems. Here, his analysis is incomplete and needs further development to be convincing.

In the case of protecting customer deposits, Huertas argues that federal deposit insurance has accomplished this end because any risks arising from the commingling of banking and commerce would be borne by the federal deposit insurance agencies. He suggests, consistent with both Benston (1987) and Kaufman (1988), that the principal risks arising from expanding the activities permitted to banking organizations result from failure of the insurance agencies to close institutions when their economic net worth goes to zero, and this closure risk exists independent of the activities banks are permitted to pursue. I agree with this argument completely.[10] The key to protecting the insurance agencies from losses due to activity risks are accurate monitoring and prompt closure policies.[11] In fact, with accurate monitoring and prompt closure policies, there is no need to be concerned about the mix of banking and nonbanking activities engaged in by insured entities from a risk perspective.

In the third major section of his paper, having established that banking and commerce have never truly been separated and that the risk associated with these activities should not be of major concern, Huertas addresses the question of how banking and commerce should be mixed. This section is divided into two parts. The first focuses on the activities that should be permitted to banks, and the second deals with the restrictions that should be placed on the activities of the corporate owners of banks (bank holding companies).

If one accepts, as I do, that prompt closure policies can protect the deposit insurance fund, then the principal reason for limiting banking activities rests on the ease of monitoring the activity. The innovation in the first part of this section lies in Huertas' pointing out that effective monitoring depends not only on the capabilities of the regulators (the lack of which might be used as an excuse for limiting activities) but also on the incentives that other agents, such as debt holders and uninsured depositors, have to monitor the bank.[12] He

[10]See Benston et al. (1986, pp. 103–06).

[11]Adoption of current value accounting is a key element in accurate monitoring by either the regulators or the market.

[12]Kaufman (1988) points out that in periods before federal deposit insurance, banks were required by market forces to maintain substantially higher levels of capital than at present.

suggests that these incentives would be enhanced by requiring all banks to maintain a minimum proportion of their liabilities in subordinated debt that would be converted into equity when net worth reached zero. Huertas fails, however, to present a more complete discussion of this interesting recommendation.[13]

The next part of this section investigates restrictions on the activities of corporate owners of banks that choose to conduct activities outside of commercial bank subsidiaries. The goal of these restrictions presumably is to limit risk shifting between an insured bank and a nonbank parent or affiliate. Again, the main issues pertain to the ease of monitoring transactions and risk shifting. Regulation is justified if it facilitates monitoring and, I would add, settlement of claims in the event of default. Huertas does not address either how the regulations are justifiable or the more important issue of what closure policies should be used for banks in a holding company system.[14] Should, for example, the agencies close a bank holding company or require a recapitalization when its net worth falls to zero, even if its subsidiary banks are solvent? More generally, whose capital and what uninsured claims support the bank and protect the insurance fund? Only the bank's, or all the resources of the holding company? Can one really separate subsidiary banks from risk taking in the rest of the organization, and would properly designed closure policies stimulate market discipline and enhance monitoring? These are only a few of the questions that arise from this interesting paper.

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[13]This role of uninsured creditors in monitoring and the possibility of requiring the issuance of subordinated debt has been suggested recently in Benston et al. (1986).

[14]The FDIC has already had to face some of these issues in its restructuring of Continental and First Oklahoma. Here the FDIC did make claims on the resources of the parent company and affiliates in resolving the problems.

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