The Banking-Commerce Controversy Revisited

Mr. Chairman, members of the Subcommittee, I am delighted to appear before you this morning to discuss—in accordance with your request—the specific features of the Administration's proposals to modify the current restrictions on the ability of commercial banks to affiliate with both securities firms and commercial entities. Because it is more controversial and because it has more far-reaching implications, I shall concentrate much of my prepared statement on the so-called banking-commerce question.

I should say at the outset that while I do have some differences of view with the Treasury on a few specific points—including the banking and commerce question—I enthusiastically applaud the efforts of Secretary

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Brady and his associates at the Treasury to put before the Congress and the nation a truly comprehensive approach to reforming and modernizing the banking and financial system in the United States. Unless this task is successfully completed—and completed soon—I fear we face renewed and more intense stress in our financial system, with all of its implications for strains in the economy at large and a further deterioration in the international competitive position of U.S. financial institutions. Thus, I very much share the view of the Treasury and the President that these issues are a high priority on the national agenda for 1991, and I support the thrust of the great bulk of the approach suggested by the Treasury.

In part I welcomed this invitation to appear before the Subcommittee because it provided me with an opportunity to take a step back and reconsider my personal views on whether the separation of banking and commerce should be continued. In preparing this statement I have gone to considerable lengths to give the benefit of the doubt to the arguments for permitting commercial firms to control banks. But the more I analyze the issue,

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Basic reform of the system is needed and needed badly. At the very least, we should put those reforms in place and permit them to run their course before we

Statement by E Gerald Corrigan, President of the Federal Reserve Bank of New York, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, April 11, 1991

give any further consideration to permitting commercial firms to own and control banking institutions having access to the public safety net.

This statement is organized and presented in eight sections as follows:

The text of this statement is obviously very lengthy. I apologize for that, but its length reflects the fact that the mixing of banking and commerce raises many very substantive questions, some of which are quite subtle. Concern about these issues is reflected in the wide-spread present-dav prescriptions against such combinations in the international community as well as in a long-standing Anglo-American caution about such arrangements that reaches back some three hundred years.

The bottom line of the statement is, however, quite clear. I remain opposed to combinations of commercial and banking organizations.

The bottom line of the statement is, however, quite clear. I remain opposed to combinations of commercial and banking organizations because (1) when firewalls are needed most, they will not work; (2) it is inevitable that at least parts of the supervisory system—if not the safety net—will be extended to commercial owners of banks; (3) the risks of concentration of economic resources and power are great; and (4) the potential benefits that might grow out of banking-commercial combinations strike me as remote at best and illusory at worst, at least under present circumstances.

Definition of terms

One of the immediate problems that must be confronted in the debate on banking-commerce is the need for a consistent definition of terms within which the debate can be framed. The crucial issue is not whether a manufacturing firm or a retail firm may own or control a company that engages in financial services or even whether an industrial company directly engages in the provision of financial services. Rather, the core question—in the context of other problems associated with banking-commercial combinations—is whether such a business entity should be permitted to own and control financial institutions that, in turn, have direct or indirect access to the federal safety net associated with banking institutions.

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It follows, therefore, that we must have a clear conception of what we mean by the terms "control" and "safety net." The dictionary definition of "control" is a useful starting point in that it stipulates that control means the "power or authority to guide or manage." But even that definition is only a starting point because we all know that in the day-to-day world of corporate affairs it is not always easy to pinpoint the circumstances in which financial or other arrangements produce the result of "control." Fortunately, however, there is a long-established body of banking law and administrative rulings that helps clarify that ambiguity. That history tells us that control is *presumed to exist* when ownership exceeds 24.9 percent and that control *may exist* when ownership is far less than 24.9 percent. Control is presumed not to exist when ownership is less than 4.9 percent. These parameters strike me as a very reasonable range within which the debate can be framed.

The definition of the safety net is rather straightforward, even though the precise application of that definition to particular cases can be difficult. For these purposes, a financial firm may be said to have access to the safety net if it, directly or indirectly, has deposit insurance, has access to the discount window of the central bank, has access to the account and payment services of the central bank, and is subject to official supervision. The ambiguity that can arise in the application of this definition centers on two main points: first, whether the distinction between direct versus indirect access to the safety net matters; second, whether concerns about access to the safety net apply equally to all of its components or whether one or more elements, such as deposit insurance and access to the discount window, take on special significance in particular applications of the definition.

While the specifics may vary from country to country, the *de facto* presence of an official safety net for banks is universal. The mere presence of a safety net implies something of a covenant between those institutions that are the beneficiaries of the safety net and the society at large. Under the terms of that covenant, the affected institutions agree to conduct their affairs in a safe and impartial manner. As a part of that covenant, such institutions are subject to official regulation, the burden and costs of which are accepted in exchange for the privileges and protections afforded by the safety net. Looked at in this light, one of the key problems facing banking and other financial institutions is that technology and other forces have fundamentally altered the historic balance between the burdens of regulation and the protections and privileges afforded by the safety net. We see this quite vividly in the diminished value of the banking franchise.

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All of this brings into sharp focus the question why all nations have a safety net and regulated financial institutions in the first place. In other words, why don't we simply treat banks and other financial institutions the same way we treat gas stations and furniture stores? The fundamental answer to that question lies in the essential functions that banking institutions perform. That is, in the context of market economies, the tasks of mobilizing savings, channeling those savings into the most productive uses, and providing the means through which payment is made are seen as having such unique economic and fiduciary importance as to justify both regulation and the safety net. For example, since these institutions can perform these functions only with someone else's money, and because the risks inherent in the performance of these functions are so obvious, all nations take at least some steps to protect depositors and investors and to regulate some aspects of the credit origination process.

In the context of market economies, the tasks of mobilizing savings, channeling those savings into the most productive uses, and providing the means through which payment is made are seen as having such unique economic and fiduciary importance as to justify both regulation and the safety net.

But such protections, important as they are, cannot fully explain the nature of the safety net arrangements in this country, to say nothing of arrangements in other countries that often go farther in protecting financial institutions and their customers than is the case in the United States. The missing link is, of course, what central bankers and others call "systemic risk." By systemic risk I mean the clear and present danger that problems in financial institutions can quickly be transmitted to other institutions or markets, thereby inflicting damage on those other institutions, their customers, and ultimately the economy at large. More than anything else, it is the systemic risk phenomenon associated with banking and financial institutions that makes them different from gas stations and furniture stores. It is this factor—more than any other—that constitutes the fundamental rationale for the safety net arrangements that have evolved in this and other countries.

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Looked at in this light, it seems to me very clear that a society should care, and care a lot, about who it is that controls financial institutions that have access to the safety net. By the same token, I would concede that those public policy concerns are not similarly present in a situation in which an auto manufacturing company or a retailer has a financial subsidiary, so long as neither the auto company nor anyone else has any illusions that it or the financial subsidiary has access to the safety net. Admittedly, I can imagine circumstances in which the sudden and uncontrolled failure of a major financial subsidiary of a manufacturing company could pose significant problems for financial markets and financial institutions more generally. Similarly, I must also admit that the competitive presence of financial subsidiaries of commercial firms—even when operating wholly outside the safety net—has been a factor in undermining the value of the franchise of banks. This may be especially true when the terms of credit or other transactions with the financial subsidiary are heavily subsidized by the parent company.

All of that notwithstanding, the banking-commerce question does not stand or fall on whether commercial firms can provide financial services; it does not even stand or fall on the presence or absence of the Bank Holding Company Act. The key question is whether we, as a society, should care about who owns and controls banking institutions that have access to the safety net and the terms and conditions—if any—under which such arrangements should be permitted.

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International experience

Impressions to the contrary, examples in other major countries in which commercial firms control banking firms (recognizing that in most countries banking and securities firms are one and the same) are *very much* the exception rather than the rule. In fact, I am not aware of a single example in which such a pattern of ownership would apply to a major banking institution, and I can think of only a limited number of cases in which it would apply at all, even though there may very well be some examples that I am not acquainted with.

Having said that, I will quickly state that (1) there are cases abroad in which banks own large stakes in commercial firms; (2) there are many countries in which banks have greater flexibility in the scope of their relationships with commercial firms than is the case in the United States; and (3) there are countries where, as a general matter, ownership interests in banks *and* corporations generally are not as widely distributed as is the typical case in the United States. But commercial control of banking institutions having access to the safety net is by far the exception, not the rule, even though in a number of countries, including the United Kingdom and Germany, the absence of commercial control of banks occurs by practice and tradition rather than as a matter of strict legal prohibition.

While on this subject of statutory arrangements abroad, I find it interesting that within the very recent past we have had two important countries—Italy and Mexico—that have had experience with commercial and banking combinations, and have enacted sweeping new legislation strictly precluding commercial firms from controlling banks in the future. In the case of Italy, ownership of banks in excess of 5 percent is subject to approval by the Bank of Italy, and in no case can a single owner's holdings exceed an absolute ceiling of 15 percent. Mexico's new law limits ownership to 5 percent, with an absolute ceiling of 10 percent.

The point of this, of course, is that if the United States were to authorize commercial firms to control banking institutions having access to the safety net, we would be alone among the major countries of the world in permitting such arrangements. Perhaps being alone in that regard should not bother us. But on the other hand, perhaps experience around so much of the rest of the world is telling us something.

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A brief history of banking and commerce

Those who favor permitting banking-commercial combinations here in the United States often point out that over the broad sweep of the financial history of the United States we have had noteworthy examples of commingling banking and commercial activities. However, such examples are the exception, not the rule. Moreover, the full history of banking in the Anglo-American tradition seems quite clearly to point to a public policy bias against such combinations.

The history of the banking-commerce issue over most of the eighteenth and nineteenth centuries must be viewed in the context of prevailing legal and business practices. For example, for most of that period, the corporate form was in a state of evolution as a natural outgrowth of the early and more mature stages of the Industrial Revolution. Thus, most corporations were chartered by some political jurisdiction to perform specified functions. Partly for that reason, much of the earlier debate about the banking-commerce issue did not center squarely on the issue of who should be allowed to own banks. Rather, it centered on the extent

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to which the charter of banking corporations would permit such an institution to engage in a broad range of activities, including activities that in today's terminology would fit squarely on the "commercial" side of the ledger.

While there surely were examples in which banking and commercial activities were authorized in the same business entity, there is ample evidence that such combinations were viewed with concern as a matter of broad public policy. For example, when the Bank of England was chartered by the British Parliament in 1694, the chartering act contained a clear prohibition against the bank engaging in commerce. Specifically, the act provided:

> And to the intent that their Majesties' subjects may not be oppressed by the said corporation by their monopolizing or engrossing any sort of goods, wares or merchandise, be it further declared ... that the said corporation ... shall not at any time ... deal or trade ... in the buying or selling of any goods, wares or merchandise whatsoever.

Almost one hundred years later, Alexander Hamilton drafted the chartering legislation of the Bank of the United States, which was enacted on February 25, 1791. Hamilton's model for the Bank of the United States was influenced importantly by the charter of the Bank of England, and it contained similar restrictions. Specifically, Section 7, Article X reads:

> The said corporation ... shall not be at liberty to purchase any public debt whatsoever; nor shall it directly or indirectly deal or trade in any thing, except bills of exchange, gold or silver bullion, or in the sale of goods really and truly pledged for money lent and not redeemed in due time; or of goods which shall be the produce of its lands.

Moreover, Section 8 states:

> And be it further enacted, that if the said corporation, or any person or persons for or to the use of the same, shall deal or trade in buying or selling any goods, wares, merchandise, or commodities whatsoever, contrary to the provisions of this act, all and every person and persons, by whom any order or direction for so dealing or trading shall have been given, and all and every person and persons who shall have been concerned as parties or agents therein, shall forfeit and lose treble the value of the goods, wares, merchandises, and commodities, in which such dealings and trade shall have been.

In drafting the charters of each Bank of the United States, Congress was sensitive to issues relating to ownership of banks. No individual or partnership could own more than 4 percent of the shares of the First Bank. No individual, company, or corporation could hold more than 0.875 percent of the shares of the Second Bank.

In the period immediately after the chartering of the Banks of the United States, there were some cases in which banking and commercial entities or activities were commingled. Yet, in a number of states and in the charter of the Second Bank of the United States enacted in 1816, the stipulations against such combinations of activities were retained.

Concerns about commingling banking and commercial activities were again recognized in the National Banking Act of 1864, which stipulated that nationally chartered banks would be limited to exercising "such incidental powers as shall be necessary to carry on the business of banking." Interpreting this phrase narrowly, the courts subsequently ruled that it would be "ultra vires" (beyond the proper scope or in excess of legal authority) for a bank to carry on a mining, manufacturing, or trading business; to engage in the buying or selling of cattle; or to operate a railway.

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While the issues associated with the commingling of banking and commercial activities were very much a part of banking history in the last two centuries, it was not until this century that the question of commercial ownership of banks was joined. The ownership issue began to surface in the legislative debate surrounding the enactment of the Clayton Act. However, it was not until the late 1930s that the debate in today's terms really took shape. In that time frame, the Federal Reserve Board, among others, began to call for legislation that would curb the growing practice of commercial firms owning banks—a trend that was (perhaps ironically) taking hold in part to save banks from the repercussions of the depression.

The efforts that began in the late 1930s culminated with the passage of the Bank Holding Company Act of 1956. The 1956 act's major restrictions applied only to companies controlling two or more banks. However, in response to the subsequent growing importance and scope of the one-bank holding companies, the 1970 amendments to the act closed the so-called one-bank loophole, although a similar loophole for so-called unitary thrifts was left in place and remains to this date.

Much of the legislative debate about the 1970 amendments to the act centered on the distinction between corporate "conglomerates" and "congeneric" corporations. The result of the conglomerate/congeneric debate was the adoption of a limited congeneric proposal—bank holding companies could engage in activities "closely related to banking." Companies engaged in a broader range of activities had a ten-year temporary grandfather period to divest themselves of either their banks or their impermissible nonbanking activities.

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To summarize briefly, for the greater part of this nation's existence, the fact that commercial firms did not own and control banks, with some exceptions, was the generally accepted state of affairs. Beginning in the 1930s, commercial firms began to acquire smaller banks. This growing tendency was dealt with in federal legislation in 1933, 1965, and 1970, but the matter was not fully laid to rest. Now that we are at a watershed in terms of the structure of our financial system, we once again have an opportunity to get it right.

The arguments for combining banking and commerce

While contemporary experience around much of the industrial world and the history of banking in the Anglo-American tradition would, taken by themselves, seem to constitute sufficient grounds to go slowly in moving toward permitting commercial firms to control banks, neither that history nor those global practices constitute necessary or sufficient reason to reject banking-commercial combinations out of hand.

Indeed, in a market economy—especially one such as the United States that is so deeply rooted in the tradition of freedom and entrepreneurial enterprise—there is a strong philosophical bias toward permitting any institution the right to go into any business, including banking. On the other hand, the very essence of public policy has its roots in the central proposition that the common good can dictate circumstances in which individual prerogatives must be limited. It was precisely this line of reasoning that led Adam Smith to the conclusion that banking had to be regulated when, in *The Wealth of Nations*, he wrote:

> Such regulations may, no doubt, be considered as in some respect a violation of natural liberty. But those exertions of the natural liberty of a few individuals, which might endanger the security of the whole society, are, and ought to be, restrained by the laws of all governments; of the most free, as well as of the most despotical. The obligation of building party walls, in order to prevent the communication of fire, is a violation of natural liberty, exactly of the same kind with the regulations of the banking trade which are here proposed.

Against this background I, for one, do not feel apologetic in taking the position that the case *for* permitting commercial firms to control banking institutions should be based on some affirmative public policy reasons to take this step. In those circumstances, I think it only reasonable to ask: first, why would commercials firms want to control banking institutions; second, what public policy ends would be served by such arrangements; and third, how credible are the safeguards against abuse, recognizing that even the most ardent of the proponents accept the fact that such safeguards are necessary?

I, for one, do not feel apologetic in taking the position that the case *for* permitting commercial firms to control banking institutions should be based on some affirmative public policy reasons to take this step.

As to the first of these questions, namely, why would commercial firms want to control banking organizations, I can see several possibilities: First, the commercial firm may conclude that the rate of return on such investments is greater than is available on alternative investments. Second, the commercial firm may conclude that such investments provide a vehicle to diversify its cash flow and/or its profits. Third, the commercial firm may see synergies between its basic business and one or more aspects of the banking business. Fourth, the commercial firm may see advantages in having indirect access to one or more elements of the safety net. While it is never stated, I must confess that I wonder at times if another motivation for such combinations might not be a desire on the part of some firms to further leverage their own capital position.

In considering the question why commercial concerns might wish to make investments in banks, it is important to keep in mind that any commercial firm can make sizable passive investments in one or more banking institutions under existing laws and regulations. Similarly, such passive investments could easily provide major elements of income diversification. On the other hand, if control is sought or achieved, or if the investment is motivated by perceived synergies or by a desire to gain indirect access to the safety net, then it must follow that concerns about conflicts of interest, unfair competition, concentration, and the extension of the safety net *must* be present, even if differences of opinion exist as to the nature and depth of those concerns.

If control is sought or achieved, or if the investment is motivated by perceived synergies or by a desire to gain indirect access to the safety net, then it must follow that concerns about conflicts of interest, unfair competition, concentration, and the extension of the safety net *must* be present.

Indeed, to my knowledge, all of the proponents of blending banking and commerce recognize that the potential for such problems is present when control of the bank exists. However, in the face of those concerns, the argument is made that allowing such combinations will provide important public benefits that—given appropriate safeguards and firewalls—will more than compensate for the risks. The most important public benefit that is cited in this regard is that such arrangements would provide a needed source of fresh capital to the banking system or to individual banks. It is also suggested—though not as forcefully—that commercial ownership of banking organizations will provide, presumably through synergies, greater innovations and efficiencies that will lower costs for financial services to their end users. Finally, it is suggested—drawing on the experience in countries like Germany and Japan—that close linkages between banks and commercial firms will promote greater economic stability.

Regardless of how much weight one puts on the potential benefits associated with permitting commercial firms to control banks, virtually everyone acknowledges that such arrangements must be accompanied by strong regulatory safeguards to protect against potential abuse. While the list of existing or suggested safeguards or firewalls is long, in generic terms they fall into three major categories: first, limits on which banks can be acquired by which commercial firms; second, various firewalls that limit transactions and/or interaction between the bank and its commercial owner; and third, various arrangements whereby the authorities can force a commercial owner of a bank to take certain actions—including divestiture—in the event the bank is in jeopardy.

In considering the merits of any or all firewalls, it is important to keep several things in mind: First, firewalls by their nature must limit synergies. Thus, the higher and thicker the firewall, the less the synergy. Indeed, if the firewalls are fail-safe, the synergies must all but disappear. Second, firewalls by their nature seem inconsistent with the essence of control. If, to use the dictionary definition, the "power or authority to guide or manage" is present, it is very hard to conceive of conditions in which firewalls can be said to be fail-safe. Third, the acid test of firewalls arises in the context of adversity either to the banking institution itself, a cross-stream affiliate, or the parent. That is, in the face of serious problems, is it reasonable to conclude, based on experience, that the marketplace—here and abroad—will distinguish one entity from another within the framework of a business conglomerate with common ownership of the component parts? Unless one can be quite sure of that result, the obvious danger is that in times of stress, firewalls become walls of fire!

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The risks associated with combining banking and commerce

From a public policy perspective there are three sets of risks associated with permitting commercial firms to control banks. The first is the historic concern about conflicts of interest, unfair competition, and concentration. The second is the contagion risk—or the dangers that problems in one part of an overall entity cannot, in market terms, be contained and isolated from other parts of the firm. The third set of risks are those surrounding the potential extension of the safety net—or at least parts of it—to the firms that control the banking organizations.

I do not believe it is necessary to elaborate in any detail on the nature of the risks regarding conflicts, unfair competition, or excessive concentration that can grow out of situations in which commercial firms control banks. The nature of those potential sources of risk has been recognized for centuries.

While those sources of potential concern have been widely recognized, it should be stressed that they arise because they constitute a threat to what I like to call the impartiality of the credit decision-making process. As such, they go right to the heart of one of the most important functions of banking institutions in a market economy.

It should also be stressed that in the contemporary world of high-speed, high-complexity finance, practices that cross the line between potential problems and actual problems can be very difficult to detect until it is too late. This is especially true if the entity that controls the banking organization is not itself subject to direct official supervision or oversight. This is an important point since I suspect that none of the advocates of commerce and banking combinations would favor the extension of the kind of direct and continuing supervi-

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sion of bank holding companies we now have to commercial owners of banking institutions. Indeed, the nature of government involvement in business that would seem to grow out of such arrangements would in itself seem contrary to the role of government in a market economy.

The second set of risks associated with banking and commercial combinations—namely the so-called contagion risks—pose even more difficult problems. By contagion risks I mean, of course, the danger that problems in any one part of a business will adversely affect other parts of the business despite firewalls and/or legal separations between particular business units within the company as a whole.

The contagion problem is, of course, multifaceted. That is, the concern does not simply center on the relatively narrow question of what happens if the banking entity itself gets into trouble. In fact, the contagion problem can be more difficult to cope with in a situation in which adversity at the level of the parent impairs the well-being of the bank.

In any of these circumstances, the important question relates to how the marketplace and how the owners and managers of such institutions react to adversity. That is, faced with adversity, do the owners and managers walk away from troubled affiliates or do they conclude that reputational and other considerations require that they make efforts to stabilize the troubled affiliate in order to protect the well-being and the reputation of the entity as a whole? Similarly, and even more important, what does experience tell us about the manner in which the marketplace reacts to these circumstances? That is, in the face of serious problems in one part of a financial entity, does the marketplace continue to deal with the other parts of the entity on a business-as-usual basis or do market participants shy away from the affiliated companies as well as the troubled entity?

On both of these points it seems to me that the evidence is overwhelming that firewalls and corporate separateness do not stand up well in the face of adversity and that the contagion risks are very real indeed. It is noteworthy in this regard that in a recent ruling regarding the relationship between Credit Suisse and Credit-Suisse First Boston, the Swiss Federal Supreme Court squarely acknowledged the existence of the contagion problem even in the face of legal separateness.

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Specifically, the court said:

> The Drexel affair has shown that isolating a company that was in itself solvent could not protect it from a loss of repute. Since the insolvency of one member of a banking and financial group leads to a loss of confidence in the other members, the Federal Banking Commission is justified in requiring evidence that sufficient own funds [capital] are available within the group as a whole.

This ruling by the Swiss Federal Supreme Court is important not only because it seems to be a common sense affirmation of what experience suggests, but also because it tends to reflect the widespread view outside

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of the United States that banking and financial firms are a single entity. This is important because even if we in the United States can convince ourselves that firewalls and legal separations can be made to stick in any circumstances, it will accomplish little if the international financial community does not accept that view. This is particularly true in a context in which all major U.S. financial firms—and therefore the well-being of the financial system at large—are highly dependent on foreign counterparties for a wide range of activities—including funding.

As I look at experience in the United States and around the world, it seems clear to me that Walter Wriston had it exactly right when, a number of years ago, he said:

> For example, it is inconceivable that any major bank would walk away from any subsidiary of its

holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way.

The realities of the contagion problem give rise to the third set of risks associated with banking and commerce combinations, and those risks include, of course, the dangers that such combinations bring with them the likelihood that at least some parts of the safety net will be extended to the commercial owner of banking institutions, especially in times of stress.

It seems clear to me that the mere fact of permitting commercial firms to own and control banking organizations carries with it at least the implicit transfer of some elements of the safety net to such firms.

However, fully aside from situations involving severe financial strains, it seems clear to me that the mere fact of permitting commercial firms to own and control banking organizations carries with it at least the implicit transfer of some elements of the safety net to such firms, if in no other way than through the official sanction of the particular combination in question. For example, I assume that even the proponents of merging banking and commerce would agree that the acquisition of a bank by a commercial company would be subject to some sort of official approval process. I assume they would also agree that a part of that application process would have to focus on the financial strength of the acquiring firm as well as the regulatory and managerial firewalls that they agree should be constructed. I assume they would further agree that some such applications would be approved while others would be denied and that some form of ongoing monitoring would be necessary. In making this point, I should emphasize that commercial firms wishing to own banks undoubtedly will not be limited to a few "blue chip" companies. To the contrary, the list of *potential* acquirers will include all comers—something I am convinced we should be especially sensitive to in this era in which the fate of seemingly very strong companies can fall on difficult times so very quickly and irreversibly.

Therein, of course, lies the dilemma. That is, even the official act of approving an application of a commercial firm to acquire a bank seems to carry with it the extension of at least some elements of official oversight to the acquiring firm in a manner that brings with it—at least by implication—an official blessing of the transaction and the relationship. As I see it, this subtle but certain extension of an element of the safety net is not something we should take lightly since we must be prepared to live with its consequences in foul weather as well as in fair.

When the potential sources of risk associated with commercial ownership of banks are considered, there can be honest differences of judgment about how great and how clear and present those dangers may be. That is why these risks and potential risks must, in the end, be carefully weighed and balanced against the potential benefits of banking and commercial combinations. That is the task of the next section of this statement.

Balancing the risks and the benefits

It is clear to me that in current circumstances the weight of the arguments against permitting commercial firms to own and control banking institutions is very powerful on a number of counts. While any one of these factors seems to me persuasive, it is the cumulative weight of all the arguments that is truly compelling:

First, when firewalls are needed the most, they will not work. This is important not only in its own right but also because, as mentioned earlier, every serious proposal to permit commercial firms to own banks depends—either implicitly or explicitly—on the premise that firewalls are fail-safe and will stand up in the face of stress. Not only is that premise inconsistent with experience, but it also seems to me to be an outright contradiction since the concept of control is incompatible with the concept of fail-safe firewalls. To put it differently, control seems inescapably to entail responsibility. To make matters worse, the very instant that synergies are stipulated—either explicitly or implicitly—the contradiction becomes glaring. If the firewalls are fail-safe, the synergies must disappear, and if the synergies disappear, the central economic argument that public benefits will flow from such combinations is rendered moot.

If the firewalls are fail-safe, the synergies must disappear, and if the synergies disappear, the central economic argument that public benefits will flow from such combinations is rendered moot.

I am not suggesting that separately capitalized subsidiaries and firewalls (or, better stated, Chinese walls) may not serve a useful public policy purpose. To the contrary, such arrangements can be a very big help in minimizing problems of potential conflict of interest and unfair competition. They can also be very helpful in facilitating a sensible system of functional supervision. But it would be a serious mistake to conclude or to assume that firewalls can protect against the contagion problem.

The marketplace views these banking and financial entities as a whole; indeed, that is how these firms typically are managed, and in many cases their integrated nature is a feature of their advertising. To believe things would somehow be different with commercial ownership of such firms seems to me to strain common sense and experience to the limit. Therefore, if we have commercial ownership, there will be an entirely new dimension to the contagion problem—namely, the implication for the banking entity should there be serious problems

It is worth pondering what would have occurred in 1980 had Chrysler owned a family of banking institutions having access to the safety net. Similarly, what might have happened if Texaco were in a similar position at the time of the Penzoil litigation?

with the parent. For example, it is worth pondering what would have occurred in 1980 had Chrysler owned a family of banking institutions having access to the safety net. Similarly, what might have happened if Texaco were in a similar position at the time of the Penzoil litigation? It is also worth keeping in mind that the corporate landscape is currently littered with dozens of "fallen angels," many of which might well have owned banks in happier times. Finally, it is also worth noting that if we go back twenty-five or thirty years we can find examples of commercial companies that were seen as financially invincible—and thus strong candidates to own banks—that are today a mere shadow of their earlier profile, if that.

In short, I draw very little comfort from the track record of firewalls, especially their reliability in times of stress. Given that the invincibility of firewalls would be even more important in the case of commercial ownership of banking institutions, the risks associated with such arrangements seem to me entirely too great.

Second, it is inevitable that at least parts of the supervisory system—if not the safety net—will be extended to commercial owners of banks. Partly because it would be so very imprudent to rely on firewalls, permitting commercial firms to control banks would, of necessity, entail at least some elements of the regulatory and supervisory apparatus being extended to the commercial owners of banks. The application process itself guarantees that result, as does even the most subtle imposition of a source-of-strength doctrine. Similarly, with all or most of the capital of the bank downstreamed from the parent, the supervisor would have to look to the

Permitting commercial firms to control banks would, of necessity, entail at least some elements of the regulatory and supervisory apparatus being extended to the commercial owners of banks.

parent to see what lies behind that capital. More generally, the enforcement of firewalls—even those governing transactions flows—would have to entail at least some interaction between the supervisor and the parent. At a minimum, all of this will complicate the already difficult moral hazard problem. At worst, it could entail a greatly expanded role for the government in the affairs of corporate America—a result that I suspect few would welcome.

But the even larger question is whether, in the face of adversity, such combinations might result in the de facto extension of other aspects of the safety net to the owner of the bank. As I said earlier, the mere fact of official sanction of some such combinations and the denial of others seems to carry with it some elements of that risk. How much further that risk might be extended in the face of serious problems is hard to judge, but it seems clear to me that the best way to avoid that risk is to avoid creating the preconditions under which it could arise.

If we were to permit commercial firms to control banks, it is clear that the potential dangers in terms of concentration of economic resources and economic power—with all of the potential implications for compromising the impartiality of the credit decision-making process—could be serious indeed.

Third, the risks of concentration of economic resources and power are great. That is, if we were to permit commercial firms to control banks, it is clear that the potential dangers in terms of concentration of economic resources and economic power—with all of the potential implications for compromising the impartiality of the credit decision-making process—could be serious indeed. Since this is as much a social and political issue as it is an economic issue, I tend to shy away from placing too much emphasis on this factor Even though I choose to do that in recognition of the official position I hold, I would be less than candid if I did not acknowledge that I, too, worry about the broad socioeconomic—and perhaps even political—implications of these arrangements that have been raised by Henry Kaufman and others

The potential benefits that might grow out of banking-commercial combinations strike me as remote at best and illusory at worst, at least under present circumstances.

It is important to keep in mind that while these concerns may seem remote today, once we start down the very slippery slope of combining banking and commerce we will, in practical terms, have already passed the point of no return Turning back will not be easy or cheap

Finally, the potential benefits that might grow out of banking-commercial combinations strike me as remote at best and illusory at worst, at least under present circumstances The one possible exception to this is the source-of-capital argument, which is discussed further below However, that issue aside for the moment, the two other economic arguments (that is, the efficiency argument and the economic stability argument) just do not strike me as very convincing For one thing, both depend on synergies that, as outlined earlier, collide head-on with the firewall problem But even if we fully ignore the firewall issue, it seems a major leap to conclude that commercial-banking conglomerates would, in fact, yield sizable efficiencies Indeed, the history of conglomerates generally is, at best, checkered Again, the financial capital issue aside, the two most obvious sources of such gains in efficiency that are not inherently objectionable would seem to lie in the areas of technology and managerial expertise However, if better or different technology or management is needed, it can be acquired directly

With regard to the economic stability argument, it must be acknowledged that in Germany and Japan in particular, there are closer relationships between banking and industry than is the case in the United States And it must also be acknowledged that in recent years the overall economic performance of those two countries has, by many standards, been quite good However, there are also other countries where banking-commercial relationships are very close but economic performance has been mixed or worse What that suggests, of course, is that economic performance is much more a function of the fundamentals of macroeconomic policy than it is a function of national preferences as to industrial structure

Moreover, even if we were to grant that there is some marginal net benefit to economic performance growing out of these arrangements, the question remains whether there may not be costs—either economic or social—growing out of such arrangements that would outweigh the potential benefit That is probably more a political question than an economic one, so I must leave it to others to consider the possible trade-offs involved

There is one final aspect of this issue, and it relates to the motivations for commercial ownership of banks If the motivation is either a desire to gain access to the safety net or large-scale synergies, the problems are obvious If it is diversification of income, it is clear that there are all kinds of ways commercial firms can diversify their income, including owning financial subsidiaries that unambiguously do not have access to the safety net Finally, if the returns in banking are so superior to returns available on alternate investments, then it is clear that capital would flow to banking quite freely and naturally with no need for the capital resources of industrial firms to augment traditional sources of capital

However, as we all know very well, the current situation in banking is not one in which relative returns command that lofty position in the eyes of investors Indeed, the pattern of price-earnings ratios of even the most successful banking organizations over recent years tells us that in unmistakable terms Thus, the strains in the banking system and the associated pressures on the financial position of the deposit insurance fund are the major factors that give rise to the suggestion that permitting commercial firms to own banks is desirable on public policy grounds, in that such arrangements will provide the needed fresh capital to the banking industry

It is by no means clear to me that the banking *system* is materially short of capital. The problem may well be too much capital chasing too few *good* loans.

While this argument deserves careful attention under current circumstances, I find it unpersuasive For one thing, as I have said on earlier occasions, it is by no means clear to me that the banking *system* is materially short of capital The problem may well be too much capital chasing too few *good* loans Beyond that, there is ample room for commercial firms to make passive investments in banking institutions even under existing rules. Finally, in a market economy, capital is attracted by profits and returns. If an industry cannot compete—especially because of outdated laws and regulations—it will not, and should not, attract capital. On the other hand, if the unnecessary and outdated structural impediments to profitability are removed, capital should flow quite naturally. At the very least, this says to me that before we as a nation take the essentially irreversible step of permitting commercial firms to own and control banking firms, we ought to put in place the kind of basic reforms the Treasury and others have suggested and see what happens. I, for one, have little doubt that where capital is needed and can serve its purpose, it will be available from conventional sources. As a part of that process, and as I have said on earlier occasions, I would not be allergic at all to providing some greater flexibility regarding commercial firms' ownership stakes in banks and vice versa, so long as the control issue is not breached or threatened.

I would not be allergic at all to providing some greater flexibility regarding commercial firms' ownership stakes in banks and vice versa, so long as the control issue is not breached or threatened.

To summarize, the position I have taken on the banking-commerce question is that, given the obvious risks, the case for permitting commercial firms to own and control banking institutions should rest on some compelling and affirmative public policy reason. In the current circumstances, I simply do not see compelling public policy reasons to follow that course of action. Thus, under present and foreseeable circumstances, I remain opposed to such combinations.

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Combinations of banking and securities firms

While I am strongly opposed to combinations of banking and commercial firms, I have been, and remain, in favor of authorizing combinations of banking and securities firms—given, of course, appropriate corporate structure and safeguards. The reasons that I favor such combinations are in many ways the mirror image of the reasons I am against banking-commercial combinations. Those factors include the following.

Unlike banking and commerce, combinations of banking and securities firms are the rule, not the exception, throughout the industrial world.

First, unlike banking and commerce, combinations of banking and securities firms are the rule, not the exception, throughout the industrial world. In fact, as things stand now, only Japan and the United States do not permit such combinations. Moreover, in a number of important countries, securities activities take place directly in the bank and not in an affiliated company.

Combinations of banking and securities companies strike me as wholly in keeping with the spirit of congeneric financial corporations. Indeed, even within the narrowly defined limits of Glass-Steagall, banks are actively engaged in a wide range of securities activities.

Second, combinations of banking and securities companies strike me as wholly in keeping with the spirit of congeneric financial corporations. Indeed, even within the narrowly defined limits of Glass-Steagall, banks are actively engaged in a wide range of securities activities. More recently, and reflecting the thrust of competitive and technological developments, banks and securities companies alike have aggressively been moving into each other's traditional lines of business here and abroad. Banking organizations now have securities affiliates here and abroad, and securities companies now have banks here and abroad. Moreover, there is now a wide range of specific activities in which banking organizations and securities firms compete directly. Examples include foreign exchange, writing and brokering of interest rate and currency swaps, underwriting and trading in a wide range of Eurocurrency debt and equity instruments, underwriting and dealing in a wide range of governmental securities, here and abroad, underwriting or private placement of commercial paper, and, on a limited scale, underwriting of debt and equity securities here in the United States. Obviously, none of these close parallels in business activities are to be found among banking and commercial firms.

Third, bank holding companies—including such companies that own securities subsidiaries—are and should be subject to official supervision at the level of the holding company. They are also subject to functional supervision at the level of the bank or securities affiliate of the holding company. This means that the official supervisory process does not have to reach into a new segment of corporate America, as would be the case with banking and commercial combinations.

More important, it also means that problems at the level of the parent that might adversely affect the bank should be easier to detect and remedy. Indeed, the mere presence of officially promulgated capital standards, consolidated reporting requirements, and periodic inspections at the level of the holding company provides some greater assurance against contagion problems coming from any direction. I might add in this regard that the principle of consolidated supervision of banking institutions is the norm throughout the industrial world. This principle is the basic line of reasoning that lies behind the ruling of the Swiss court in the Credit Suisse case that was cited earlier.

Fourth, because *some* elements of the safety net—in this case, official supervision and regulation—apply to the holding company owners of banks, it does not follow that all other elements of the safety net need or should apply to the holding company or to its nonbank subsidiaries. This is surely the case with deposit insurance. On the other hand, in Japan and the United Kingdom, securities firms that are not affiliated with banks do have account relationships with the central bank, and in Japan such firms also have access to the discount window at the Bank of Japan.

While I am under no illusion about firewalls—especially their ability to deal with the contagion problems—I do believe that so-called Chinese walls can play a very useful role in guarding against conflicts of interest and unfair competition.

Fifth, while there is something to be said for the so-called limited universal bank model, I believe that securities activities (with some exceptions) of banking firms should be conducted in a separately capitalized subsidiary of the holding company, and that the banking activities of securities firms should be organized similarly. While I am under no illusion about firewalls—especially their ability to deal with the contagion problems—I do believe that so-called Chinese walls can play a very useful role in guarding against conflicts of interest and unfair competition. Such arrangements have, for example, worked well over the years in relationships between trust departments of banks and the bank as a whole. It is also true, as noted earlier, that separately capitalized entities can also facilitate functional supervision. However, functional supervision is not good enough. We also need consolidated supervision at the level of the holding company.

Thus, combinations of banking and securities firms should be permitted as long as appropriate supervisory standards and policies are in place. However, such arrangements can give rise to one major practical problem: there will be a handful of securities firms owned by commercial companies that would not be allowed to own insured depository institutions. That is, securities firms that are not controlled by commercial firms would be free to own insured depositories but those controlled by commercial firms would not. This may seem arbitrary, but it is a natural outgrowth of the argument against the direct or indirect control of banking firms by commercial entities. This would not, of course, preclude commercial companies from owning and controlling financial subsidiaries, as is now the case. But it would put a halt to such firms owning and controlling banking institutions with access to all elements of the safety net.

Prompt and comprehensive reform of the banking and financial system is long overdue. Therefore, I would urge the Congress to move as promptly as possible toward the enactment of broad-based progressive legislation this year.

Summary

The long-term implications as to how the United States should best reform and restructure its banking and financial system cannot be anticipated with precision. That, inevitably, points to the case for care and caution in the process. The need for caution is at the heart of the reasons that I oppose banking and commercial combinations in the present circumstances.

However, the need for caution cannot be allowed to result in paralysis. Prompt and comprehensive reform of the banking and financial system is long overdue. Therefore, I would urge the Congress to move as promptly as possible toward the enactment of broad-based progressive legislation this year. Few items on today's national agenda strike me as having greater importance, and even fewer will have greater importance for the long-term well-being of not just the banking and financial system but also the economy at large.