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Administrative Office
c/o Professor George Kaufman
Loyola University of Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
TEL (312) 915-7075
FAX (312) 915-8508

Statement No. 138

For information contact:

Richard Herring
215-898-5613

George Kaufman
312-915-7075

Peter Wallison
202-955-8515

Statement of the Shadow Financial Regulatory Committee

on

RESTRICTIONS ON BANKING-COMMERCE AFFILIATIONS

May 5, 1997

Current law generally prohibits commercial banks from owning or being owned by non-bank enterprises. In particular, the Bank Holding Company Act allows banks to be affiliated only with businesses "closely related to banking". For a corporation to own a bank, it must first divest itself of all activities that do not meet this affiliation test.

Congress and the Administration have been considering proposals to lift or modify the banking ownership and affiliation restrictions, but so far have not reached agreement on any particular plan. Failure to reach agreement on this issue almost surely will prevent adoption of any meaningful financial modernization proposal during this session of Congress. For this reason, many observers believe that a compromise or gradual approach may be necessary. One such proposal has been offered by Congresswoman Marge Roukema, who has suggested that no more than 25 percent of the business of any consolidated entity be derived from operations that are not "closely related to banking".

The Shadow Financial Regulatory Committee believes that advocates on both sides of this debate have exaggerated the risks and the benefits of relaxing restrictions on combinations of banking and commerce.

Claimed Risks

Advocates of strict separation between banking and commerce have pointed to three dangers: (1) that banks owning or affiliated with commercial enterprises will bias their lending; (2) that banks owning commercial entities will be exposed to excessive risks; and (3) that lifting the restrictions will lead to an undue concentration of economic and political power.

Current law and regulation already address the potential concern about conflicts of interest by requiring all bank loans to bank affiliates or subsidiaries to be made on arms-length conditions, to be fully collateralized, and to be subject to legal limits. (No loan to a related entity can exceed 10 percent of the bank's capital, nor can all loans to related entities exceed a total of 20 percent of bank capital). Any relaxation of the prevailing restrictions on banking and commerce should retain these safeguards.

The concern that banks could take excessive risks by owning or affiliating with commercial entities can be directly addressed by requiring such activities to be capitalized separately from the bank's regulatory capital. In fact, the Office of the Comptroller of the Currency has embodied this approach in its recent rule allowing banks to own operating subsidiaries engaged in financial activities, which the Committee has applauded (Statement Nos. 121 and 136, issued on May 22, 1995 and December 9, 1996, respectively). The rule requires banks to deduct any investments in their subsidiaries from their regulatory capital. By the same token, any investments by bank holding companies automatically accomplish the same degree of insulation of the bank from risks in non-banking affiliates because the capital of the bank holding company is not counted by regulators as capital of the bank. The provisions aimed at preventing conflicts of interest also would limit banks' risk exposure from ownership or affiliation with commercial entities.

Fears about excessive concentration of power have both an economic and political dimension. Apart from generally unwarranted concerns about tying of banking and commercial products, marriages between a bank and a commercial company pose no competitive concerns because concentration in each market will remain unchanged. Moreover, the antitrust enforcement agencies already have ample means for preventing mergers that produce

anti-competitive increases in market concentration. Tying becomes an anticompetitive concern only in rare instances where the firm has market power in one of the product markets and can extend its dominance into the market for another product by tying purchases of both products. But this well-established legal rule -- which the antitrust agencies also have a long tradition of policing -- should be of little relevance to marriages between banks and commercial companies, since the banking industry is unconcentrated and faces increasingly stiff competition from a wide variety non-bank providers of financial services.

The political concentration argument rests on the fear that lifting the banking-commerce restrictions would permit the economy to be controlled by a handful of large conglomerates mixing banking and commerce which are able to exercise an undue degree of influence over the political process. A related fear is that large foreign conglomerates which purchase US banks may be enabled to accomplish the same ends.

Considerable evidence suggests, to the contrary, that the U.S. political process is more influenced by trade associations and special interest groups (consisting of thousands of like-minded individuals and/or small businesses in certain lines of commerce) than by large corporations. The savings and loan disaster of the 1980s is instructive in this regard. The S&L industry was not dominated by a handful of large firms nor has the industry been highly concentrated, yet it was highly successful in influencing the political process to delay the necessary closure of insolvent institutions at a taxpayer cost in excess of $130 billion. Moreover, these fears assume that large banks and commercial enterprises would, in fact, seek to combine. Based on current experience with unit thrift holding companies which permit combinations of deposit-taking and commerce and past experience with bank holding companies before the Bank Holding Company of 1956 prohibited banks from owing or being owned by non-bank enterprises, we regard this assumption as doubtful.

Claimed Benefits

Although advocates of the status quo appear to have exaggerated the dangers of lifting the banking-commerce restrictions, it is important not to expect dramatic benefits from doing so, at least in the short run. These combinations have been permitted in the thrift industry for unit thrift

holding companies. Yet two of the largest marriages between commercial companies and thrifts have already resulted in divorce: both Ford Motor Company and Sears have sold their thrifts, suggesting that the hoped-for "synergies" or "economies of scope" were elusive or were outweighed by the difficulties of combining two disparate corporate cultures, sets of business expertise, and incentive systems. Similarly, very few sizeable banking/commercial conglomerates operated in the era before they were prohibited by the Bank Holding Company Act.

In virtually no other sector of the economy has the government dictated which kinds of corporations can own or be owned by other corporations. There are good reasons for this. In a dynamic market economy, where technology and a variety of other factors are constantly changing the boundaries of markets and competitive advantages, it is unwise for the government to interfere with the quest of private actors to develop organizational forms that will facilitate the most efficient allocation of resources (unless those combinations threaten to reduce competition).

It is time for policy makers to apply the same presumption to the banking industry. This is especially true at a time when rapid advances in technology are blurring the distinctions between banking and information/telecommunications businesses.

It is the Committee's policy that members abstain from voting on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Robert Litan abstained from voting on this statement.