OF FIREWALLS AND SUBSIDIARIES: THE RIGHT STUFF FOR EXPANDED BANK ACTIVITIES

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Summary

The extent and structure of non-banking activities for commercial banks has been a long-standing policy concern for the United States. Recently, three alternative models for the undertaking of non-traditional activities -- the universal bank, the separate subsidiary of the holding company, and the operating subsidiary of the bank -- have come to the fore. After reviewing the history of activity restrictions on banks and providing an analytical framework for considering the appropriate structure, we conclude that the "op-sub" approach has modest advantages, but that even it carries substantial risks and requires vigorous monitoring and enforcement.

I. Introduction

The proper structure for the corporate organization of banking that would accompany the expansion of permissible activities has been a topic of active policy debate in the United States throughout the 1990s. The Treasury has twice brought forth reports that have envisioned wider powers and structures for banks as part of a program of "financial modernization." The Congress has actively considered the issue but has thus far failed to pass any enabling legislation. The Federal Reserve and the Office of the Comptroller of the Currency ("OCC") have proposed different structures for expanded banks, and the OCC is actively pursuing its view of the appropriate structure. In both the Federal Reserve’s and OCC’s proposal, "firewalls" separating banks from affiliates and subsidiaries play an important role.

This issue is an important one for the financial sector. Partly it is one of the efficient delivery of financial services; partly it is one of assuring the safety and soundness of traditional commercial banks and of avoiding a repetition of the drain on federal deposit insurance funds that occurred in the 1980s as a consequence of the debacle of thousands of insolvent savings and loan associations and commercial banks; and partly it is one of traditional American concerns about bigness, and concentration of power, particularly in financial institutions.

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1 Unless otherwise indicated, by "banks" we mean commercial banks; but the general ideas developed in this paper apply to depository institutions more generally.


4 I.e., restrictions on transactions and information flows; see the discussion in Section II.B below.

5 For a recent review of some of the issues, see The New American Universal Bank, 110 HARV. L. REV. 1310 (1997).
This paper provides an analysis of alternative organizational structures with respect to the issue of how favorable they are in achieving the efficiency and risk diversification benefits of activity expansion, while limiting the risks of insolvency and transmission of whatever net subsidy initially accrues to banks. There are, of course, other important criteria on which differential corporate organization can and should be evaluated, including the possible effects on concentration in banking and other industries, on the capital costs of banks, and on the regulatory structure itself, in shifting authority among the several banking agencies. As a consequence, the evaluation developed here is incomplete, but nevertheless a useful step toward the development of a more complete evaluation.

As will be seen, we find that the "operating subsidiary" ("op-sub") approach favored by the OCC provides some modest net advantages that are not found in the other two potential approaches -- the "universal bank," found in some European countries; and the "holding company subsidiary" approach favored by the Federal Reserve. Even the op-sub structure, however, carries some risks and requires appropriate structuring and enforcement.

The remainder of the paper proceeds as follows: In Section II we review the history of limitations on bank activities, the development of corporate structure and firewalls, and address the question of why banks are treated differently. Section III provides an analytical framework for considering alternative organizational structures for expanded bank activities. Section IV then examines and evaluates the three main structural alternatives in light of this analytical structure. Section V provides a brief conclusion.

II. A Brief History of Banking Organization and Firewalls

Most enterprises in the U.S. are relatively free to engage in a wide range of activities and to employ a variety of organizational structures for those activities. They can choose to be conglomerates or to maintain a narrow focus; they can choose to consolidate all of their activities within one ownership structure or to establish subsidiaries and/or holding companies. By comparison, banks are tightly constrained.

Banks are different. Their corporate charters and federal and state legislation limit them to a restricted set of activities. There are also legally-mandated organizational structures for engaging in other activities. In this Section, we briefly review the development of activity restrictions in banking and the firewalls associated with them.

A. Activity Restrictions

As a general matter, within a bank itself, the ownership of stock in non-financial firms (e.g., a hardware store, a textile manufacturing, a computer software company) has been severely limited, and control of such commercial firms prohibited. Some financial activities (e.g., securities and insurance underwriting) have been substantially constrained. Subsidiaries of a bank have somewhat greater scope for undertaking financial activities, and bank holding companies, through nonbank subsidiaries, provide even wider latitude for financial, and some nonfinancial, activities. As indicated below, the organizational

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6 If nonbanking activities conducted in the bank itself or through subsidiaries are a preferred organizational arrangement, regulatory authority over some substantial portion of banking assets is likely to shift from the Federal Reserve to the OCC.

7 We realize that these statements are overly broad. On the one hand, state and federal regulations (e.g., environmental, work place safety, corporate governance, etc.) have broad application and restrict enterprises from wholly unfettered actions. On the other, we address here only activity and organizational structure restrictions of banks; we do not address geographic restrictions on branch banking and holding companies that historically have been a part of the general pattern of constraints on banks. As compared with the limitations on banks, most enterprises have considerably greater freedom and flexibility.

8 This section draws on Bernard Shull, Banking and Commerce in the United States, 18 J. BANKING & FIN. 255 (1994).
constraints that, until recently, confined most permissible “non-traditional” activities to holding company affiliates have been partly the result of historical accident.9

Until 1863 the chartering and regulation of banks was almost entirely the responsibility of the states.10 In the late eighteenth and early nineteenth centuries, prior to general incorporation laws, banks as well as other private enterprises that provided public services were granted limited-purpose corporate charters through special acts of the individual state legislatures. The limited-purpose charters were narrowly focused on what even then were viewed as the traditional activities of banks -- lending, issuing notes that would circulate as currency, and taking deposits. In many charters and in state laws, it was made clear that banks were not to deal in merchandise; real estate ownership was frequently restricted. This narrow focus established a dichotomy between banking and "commerce."11

With the passage, in many states, of "free banking" laws beginning in the late 1830s, bank charters became considerably easier to obtain through application to an administrative agency, rather than by special legislative act. The new laws, however, retained the limited purpose charter, even as general incorporation laws, permitting corporations to engage in any lawful activity, were also being enacted by states.12

When the Federal government entered widespread bank chartering with the passage of the National Banking Acts of 1863-64, the bank power clause of New York’s Free Banking Act served as the model.13 National banks were permitted to make loans on “personal security,” which was taken to imply that they could not make mortgage loans. In litigation it was determined that they could not, in general, invest in real estate; that they could accept corporate stock as collateral and as payment for debt, but could not deal in or purchase stock as an investment; that they could not, under any circumstances, become a partner in a business in which they could incur unlimited liability; and that it was beyond their power to engage in the operation of a business, even if it had been acquired in satisfaction of a debt. The national banking system thus continued the distinctive legal treatment of commercial banks in restricting their activities.

By the late nineteenth century large national banks in New York and Chicago had begun to undertake investment banking activities in their bond departments. Though the Comptroller apparently issued no regulation, faced by adverse court decisions he interpreted the National Banking Act to preclude some of the investment banking activity undertaken directly.14 Around 1902, he began to inform national

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9 We recognize that the concept of non-traditional activity is time specific. In the 1920s, consumer loans were a non-traditional activity, as were term loans into the 1950s and residential mortgage loans into the 1960s.

10 The exceptions were the chartering of the Bank of North America by the Continental Congress in 1781, and the federal chartering of the First Bank of the United States (1791-1811) and the Second Bank of the United States (1816-1836).

11 There were, nevertheless, banks that were involved in construction and other commercial activities. States granted banking powers to companies to build canals, railroads and turnpikes. Some states required banks to invest in public works. Many banks, moreover, were named for the commercial interests they principally accommodated such as farmers, mechanics, traders manufacturers, lumberman. Bank charters were sometimes obtained by owners of industrial or commercial firms as a source of financing.

12 Though it is not the focus of this paper, it is an interesting question to ask why the states were prepared to ease the restrictions on corporations generally but retained the limited purpose charter that applied to banks. We address the latter issue in Section II-C below.

13 In addition to the powers specified as "the business of banking," national banks were also authorized "to exercise...all such incidental powers as shall be necessary to carry on the business...." For reviews of early court decisions interpreting "incidental powers," see Powers of National banks to Acquire Various Kinds of Property, 33 HARV. L. REV. 718 (1920); and Edward L. Symons, The Business of Banking in Historical Perspective, 51 GEORGE WASH. L. REV. 676, 701-719 (1983).

banks that they were not permitted to hold corporate stock. Some banks responded by organizing securities affiliates. Principally owned pro rata by bank stockholders and controlled by bank management, the affiliates were state-chartered firms with general powers that permitted almost any kind of activity.

State banks were hampered in the mid and late 1860s by a prohibitive tax on state bank notes; but they revived in the 1870s and 1880s through deposit banking. Along with trust companies and unincorporated banks, they confronted national banks as relatively unregulated competitors.

The Federal Reserve Act of 1913 did provide for a moderate expansion of national banking powers by permitting real estate loans, time and savings deposits, trust services and foreign branches. The Act did not materially disturb the security affiliates of national banks or state banking powers. In 1927 the McFadden Act gave national banks explicit authority to buy and sell marketable debt obligations. The Comptroller ruled that national banks could underwrite all debt securities and that their affiliates could underwrite both debt and equities. This arrangement was demolished by the Banking Act of 1933. The Glass-Steagall provisions of the Act revoked the powers that had been granted by the McFadden Act and mandated the divorce of commercial banking and investment banking. Passed in the wake of the stock market crash of 1929, the failures of thousands of banks during those same years, and the slide of the U.S. economy into the worst depression of its history, the Act was motivated by Congress’ perceptions that some commercial banks' securities activities had helped fuel the stock market speculation of the late 1920s prior to the crash; that some banks had abused their fiduciary responsibilities toward their customers through improper securities activities; and that the failures of some banks in the early 1930s was related to their securities activities. Also, Senator Carter Glass, a principal author of the Act, believed that a proper and stable banking system required that banks be restricted to short-term lending.

Many affiliates surrendered their charters and liquidated their assets. In some cases, affiliates separated from parent banks and continued as independent organization; e.g. First Boston Corporation

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15 See Bernard Shull, A Note on the Role of the Comptroller in the Organization of Early Bank Affiliates, Working Paper 95-15, Department of Economics, Hunter College (1995). See also OFFICE OF THE COMPTROLLER OF THE CURRENCY, ANNUAL REPORT 35-36 (1915) for references to letters sent by the Comptroller to a national bank, including one at least as early as 1903, drawing attention to a Court decision stating that "(t)he power to purchase or deal in stock of another corporation is not expressly conferred upon national banks, nor is it an act which may be exercised as incidental to the powers expressly conferred."

16 George Baker, Chairman of the Board of First National Bank of New York, testified in 1913 that his bank's affiliate, First Security Company, was organized "(f)or doing business that was not specially authorized by the banking act. We held some securities that in the early days were considered perfectly proper, but under some later decisions of the courts the holding of bank stock or other stock was prohibited; at any rate the comptroller prohibited it." HEARINGS BEFORE THE COMMITTEE TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT, Part 20 1424, 1432 (1913).

17 Realty, insurance, and mortgage company affiliates were also acquired and frequently had their main offices in the same building as the bank; see PEACH, supra note 14, at 51-52.

18 See George F. Barnett, State Banks and Trust Companies Since the Passage of the National Bank Act, NATIONAL MONETARY COMMISSION, 61st Cong., 3rd sess., Doc. 659, 12-14, 34 (1911).

19 The relevant Sections are 16, 20, 21 and 32. Sec. 16 limits bank dealing and underwriting to specified types of securities; obligations of the United States and general obligations of states and political subdivisions. Sec. 20 prohibits banks from having affiliates principally engaged in dealing in securities. Federal Reserve interpretation of Section 20 has permitted holding company affiliates to underwrite otherwise impermissible securities. Sec. 21 prohibits firms dealing in securities from accepting deposits. Sec. 32 prohibits interlocks of directors and officers of securities firms and banks. The overseas investment banking operations of U.S. banks were not affected by the Act, nor did it apply to state-chartered non-members.

20 For a recent (negative) review of the evidence supporting these claims, see GEORGE F. BENSTON, THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE GLASS-STEAGALL ACT REVISITED AND RECONSIDERED (1990). Regardless of the actual validity of the Congress's perceptions at the time, the vehemence of Congressional sentiment is indicated by an unusual feature of the Act: It permitted no "grandfathering" of incumbents' activities.
from First National Bank of Boston. Private investment banks had to choose between accepting deposits and dealing in securities; J.P. Morgan split into Morgan Guaranty and Morgan Stanley, along the lines required by the Act.

While some commercial banks continued to deal in securities to the limited extent permitted by the 1933 Act, for roughly 50 years thereafter there was little involvement in the securities business. Beginning in the early 1980s, however, banks began again to expand their securities operations, primarily through the bank holding company mechanism.

Bank holding companies have traditionally provided an alternative avenue for the expansion of commercial banks into new activities. Prior to 1933, they were not restricted by federal law. The Banking Act of 1933 imposed limited restrictions involving registration with the Federal Reserve. Companies that owned banks could and did find ways to avoid them. By 1954, only 18 of the 114 bank holding companies identified by the Federal Reserve had registered.

The essentially unrestricted growth of bank holding companies was terminated with the Bank Holding Company Act of 1956 ("BHCA"). The Act was motivated by Congress's desire both to prevent the spread of interstate operations by holding companies and the expansion of bank holding companies into "nonbanking" activities through affiliates. Bank holding companies were defined as organizations that controlled two or more banks. The Act prohibited bank holding company control of almost all nonbanking firms. Under its provisions, activities were to be "of a financial, fiduciary, or insurance nature" and "so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto" (emphasis added). The Federal Reserve Board narrowly interpreted the term "the business of banking" to mean a relationship between the customers of specific banks and their nonbanking affiliates.

A number of large commercial and industrial firms, such as W.R. Grace, R.H. Macy and Corn Products Refining, continued to own a small bank, so as to accommodate employees. Until the mid-1960s, however, the one-bank company remained, for the most part, a small firm, controlling a small bank in a unit banking state.

Commercial banks began to broaden their activities in the early 1960s, with the help of interpretations by the Comptroller of the Currency of the "incidental powers" clause of the National Banking Act. The new or expanded activities permitted by the Comptroller included data processing services, insurance agency and travel agency services, mutual funds, and revenue bonds underwriting. Many of the Comptroller's decisions were challenged in litigation.

In the late 1960s, however, banks found that, by reorganizing into one-bank holding companies, they could affiliate with almost any kind of nonbanking firm without legal challenge. By 1969, many of the largest banks had done so.

The realization that the 1956 Act had left a large loophole with respect to non-bank activities, and growing political concern about the growth of conglomerate enterprises and conglomerate mergers during

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21 Corporations owning more than 50 percent of the stock of one or more Federal Reserve member bank were required to apply to the Federal Reserve to secure permits to vote their stock.


23 Transamerica had become symbolic of the holding company device for combining banking and other kinds of businesses. In 1954, in addition to controlling banks in five western states, its nonbanking subsidiaries included insurance companies (Occidental Life and others), real estate and oil development companies, a fish packing company, and a metal fabricating company; see Control of Bank Holding Companies, HEARINGS BEFORE THE SUBCOMMITTEE ON BANKING OF THE SENATE COMMITTEE ON BANKING AND COMMERCE, 84th Cong., 1st sess. 52, 62-63 (1955). Passage of the Bank Holding Company Act of 1956 was a victory for the Federal Reserve that had, to that point, been unsuccessful in restricting the growth of Transamerica. Transamerica decided to withdraw from banking. It spun off all but one of its banks to the newly established Firstamerica Corporation in order to retain control of its nonbanking subsidiaries.

24 Id., 121.


the 1960s, led to the 1970 Amendments to the BHCA.\(^{27}\) The Act extended its prohibitions to one-bank holding companies and added new anti-tying restrictions.\(^{28}\)

Sec. 4(c)(8) of the 1970 Amendments also liberalized activity restrictions. In the phrase "so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto," the term "the business of" was eliminated to make clear that the new nonbanking activity should be related to banking in general and not to the business of specific institutions.\(^{29}\) With that phrase removed, the new legislation authorized the Federal Reserve Board simply to permit activities it had determined are "so closely related to banking or managing or controlling banks as to be a proper incident thereto."\(^{30}\) The "proper incident" phrase established a "net public benefits" test that requires the Federal Reserve to weight the benefits of the new activity on increased competition, efficiency, and convenience against any costs of increased concentration, less competition, and diminished bank soundness. The Federal Reserve’s determinations under the Act since its existence have been widely reported.

Over the last two decades, additional legal and market changes have also had an impact on activity expansion by banks. Savings and loan associations ("S&Ls"), like commercial banks, have been treated distinctively by Congress since the early 1930s. Federal chartering and regulation of S&Ls first appeared in the Home Owners Loan Act of 1933, and S&Ls were provided with deposit insurance by the National Housing Act of 1934. The Congress’s intention was to salvage the traditional mutual S&Ls so as to promote housing finance. S&Ls remained unregulated by the Federal Reserve’s Regulation Q (which restricted the interest rates that could be paid on deposits), the Glass-Steagall Act, the McFadden Act, and the BHCA.

The first S&L holding company (Great Western Financial Corporation) was organized in 1955 by Lehman Brothers, a securities firm. Legislation in 1959 limited such holding companies to no more than one insured S&L. The S&L Holding Company Act of 1968 permitted unitary S&L holding companies meeting a "thriftiness" test (a minimum percentage of assets in mortgages and other specified securities) to engage through other subsidiaries in any activity. Thus, through a holding company, Sears, Roebuck & Co. could own a retail enterprise and also own insurance, securities, and real estate development companies as well as an S&L. Such activities were effectively combined with "banking" when S&Ls became commercial bank-like institutions in the early 1980s with Federal authority to provide checkable deposits and make commercial loans.

A direct incursion into banking by nonbanking firms was made possible by the creation of "nonbank banks." A redefinition of the term "bank" in the BHCA Amendments of 1970 had opened another "loophole." Banks, under the 1970 legislation, were redefined as institutions that provided demand deposits and made commercial loans.\(^{31}\) Beginning in 1980, large conglomerates, securities and

\(^{27}\) The attempt in 1969 by a non-bank firm (Leaseco) and its owner (Saul Steinberg) to mount a hostile takeover of Chemical Bank motivated the banking community to overcome their reluctance to see new activities restrictions placed on one-bank holding companies and to seek the anti-takeover protections that the extension of the BHCA to one-bank holding companies would afford.


\(^{30}\) There is a curious dichotomy between the activities in which individual owners of a bank engage and what the corporate, holding company owner of a bank can do. Individual owners can also own and control any other legitimate enterprise, including a hardware store or an insurance company; such multiple-firm ownership has not been uncommon in smaller towns.

\(^{31}\) In 1933, holding company restrictions were imposed only on firms owning a Federal Reserve member bank. The Bank Holding Company Act of 1956 redefined "bank" to include "any national banking association or any state bank, savings bank or trust company." In 1966, to avoid covering savings banks, industrial banks and non-deposit trust companies, Congress changed the definition to cover only institutions that accepted demand deposits. In 1970, to avoid including trust companies that accepted demand deposits but did not make commercial loans, notably Boston
insurance firms began exploiting the "loophole" by acquiring banks that refrained either from commercial lending or demand deposits. By the mid-1980s, General Electric, J.C. Penney, Gulf +Western, ITT, Prudential Bache, Merrill Lynch, and others owned such banks.\footnote{See \textit{U.S. DEPARTMENT OF THE TREASURY 1991, supra} note 2 at XVIII-21 ff.}

Congress closed the loophole with passage of the Competitive Equality Banking Act of 1987. The Act again changed the definition of "bank" in the BHCA so that all institutions with deposit insurance were included. With over a hundred of these non-bank banks already in existence, Congress grandfathered the existing ones and placed a ceiling on their future growth.

Sharp-eyed lawyers and bank regulators also found loopholes in the Glass-Steagall Act that allowed banks (albeit with some awkwardness and inconvenience in structure) to engage in wider arrays of securities activities. The FDIC recognized that the Glass-Steagall Act did not apply to affiliates of nonmember insured banks. By the early 1990s, roughly half the states had authorized affiliates of such banks to deal in securities beyond the limits established by Federal law and regulation.\footnote{\textit{Id.} at XVIII-16.}

Federal Reserve Board interpretation of the Glass-Steagall Act and Section 4(c)(8) of the Bank Holding Company Act in the late 1980s provided holding companies with authority, albeit limited, to deal in and underwrite a wide variety of securities. In recent years, it has repeatedly expanded the scope of operations for Section 20 subsidiaries.

Throughout recent years, the definition of "control" has been a regulatory focal point. In general, "control" of a firm in an impermissible business is prohibited.\footnote{Whether or not control exists is determined through diverse regulatory standards for different classes of bank and banking organizations. In general, under the Bank Holding Company Act, there is a rebuttable presumption that ownership of a 5 to 25 percent share constitutes control and a conclusive presumption for over 25 percent. In 1986, the Federal Reserve permitted Sumitomo, a bank holding company, to invest in 24.9 percent of the partners' capital stock in Goldman Sachs; see \textit{Federal Reserve Board, Press Release, Announcing Approval of Sumitomo Investment in Goldman Sachs} (Nov. 19, 1986).} But limited equity investments (e.g., in the form of equity kickers) are generally permitted. Exceptions to general prohibitions and limits are made for investments in publicly-favored areas: e.g., through small business investment companies, for low cost housing, and for community redevelopment.\footnote{\textit{See} Susan J. Macaulay, \textit{The Aggregation of Equity Investments by Banks and Bank Holding Companies}, 107 \textit{BANKING L. J.} 510, 513 ff. (1990).}

As is evident from this review of activity restrictions in banking, the development of the bank holding company as a vehicle for activity expansion was partly accidental, as has been the dominant role of the Federal Reserve as the regulator of new activities. They occurred as a result of unforeseen exploitation of the one-bank holding company loophole in the late 1960s and a Congressional decision to plug the loophole by expanding, with limitations, bank holding company powers. Choosing the bank holding company as the principal mechanism for bank diversification also elevated the Federal Reserve, which had been the only Federal regulator of holding companies since 1933, to a dominant supervisory position.

In 1996, however, the OCC proposed and then put into effect a substantial loosening of the restrictions on permitted activities that banks could conduct in direct operating subsidiaries (the OCC's revisions to 12 C.F.R. Part 5). This action has generated widespread comment and debate among bank regulators as to the appropriate organizational structure for non-traditional activities.\footnote{\textit{See for example} Eugene A. Ludwig, \textit{Testimony}, \textit{HEARINGS BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES}, Committee on Banking and Financial Services, U.S. House of Representatives, 105th Cong., 1st sess. (March 5, 1997); Alan Greenspan, \textit{Statement}, \textit{HEARINGS BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT}, Committee on Banking and Financial Services, U.S. House of Representatives, 105th Cong., 1st sess. (February 13, 1997); and Ricki Helfer, \textit{Testimony on Financial Modernization}, \textit{HEARINGS BEFORE THE
IV will analyze the key issues of that debate.

B. The Development of Firewalls

Firewalls are restrictions that separate the traditional bank from the activities of its affiliates and subsidiaries. They typically entail limits on financial transactions and on information flows. They are intended to augment the legal concept of corporate separateness.

When national banks first established affiliates in the early twentieth century, firewalls were apparently an unknown concept. In Congressional testimony, the Comptroller of the Currency took the position that the "(s)ecurity companies are corporations...with which I have nothing to do....They are not under my jurisdiction in any way, shape, or form..." When national banks first established affiliates in the early twentieth century, firewalls were apparently an unknown concept. In Congressional testimony, the Comptroller of the Currency took the position that the "(s)ecurity companies are corporations...with which I have nothing to do....They are not under my jurisdiction in any way, shape, or form..."

The Banking Act of 1933, however, added Section 23A to the Federal Reserve Act, imposing limitations on inter-affiliate transactions. The Bank Holding Company Act of 1956 superimposed Section 6, prohibiting nearly all inter-affiliate transactions. Amendments in 1966 repealed Section 6, making Section 23A again binding. Amendments in 1982 substantially liberalized transactions among affiliated banks. Section 23B was added in 1991, requiring that inter-affiliate transactions be on an arms-length basis (12 U.S.C. 371-1).

The Federal Reserve’s decision in the late 1980s to permit new securities powers for bank holding companies through Section 20 affiliates was accompanied by a special set of firewalls. In January 1997 the Federal Reserve proposed a substantial loosening of them.

In stake-out investments, the Federal Reserve has also established special firewalls. For example, in approving the Sumitomo investment in Goldman-Sachs, the Federal Reserve forbade Sumitomo from having directors on the boards of any of Goldman’s affiliates; prohibited Sumitomo from acquiring any stock in Goldman's affiliates; and prohibited both companies from soliciting business for one another. It mandated that their business affairs be arms-length and on a nonexclusive basis and that Sumitomo waive its rights under New York law to select Goldman's general partners and to vote for or direct other policies.

For many years, questions have been raised about the effectiveness of firewalls by both regulators and bankers. The consensus is that firewalls may work reasonably well in good times, but may well break down in bad; i.e., they are unlikely to work in extremis when, in fact, they are most needed. In an often cited statement, Walter Wriston, the former Chairman of Citicorp remarked that "it is inconceivable that any major bank would walk away from any subsidiary of its holding company."

In reviewing recent events in 1990, including the collapse of Drexel Burnham Lambert, Alan Greenspan, Chairman of the Federal Reserve Board, told Congress that he had "serious questions about the ability of firewalls to

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37 For a review of the 28 current firewalls established by the Federal Reserve for Section 20 subsidiaries, and its proposed liberalization, see Federal Reserve Board, Press Release, Review of Restrictions in the Board's Section 20 Orders (January 9, 1997).

38 See HEARINGS, Part 19, supra note 16, at 1407.

39 See Greenspan, supra note 36; and U.S. GENERAL ACCOUNTING OFFICE, BANK INSIDER ACTIVITIES (March 1994). Initially, Citicorp, Bankers Trust and J.P.Morgan were given authority to underwrite and deal in commercial paper, 1-4 family mortgage-backed securities and municipal revenue bonds (i.e., "bank-ineligible" securities) in separate subsidiaries ("Section 20" subsidiaries), so long as the subsidiaries were "not engaged principally" in the business; all types of debt and equity securities were permitted in 1989. See Citicorp/J.P. Morgan/Bankers Trust, Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities, 73 FED. RES. BULL. 473 (1987); and J.P. Morgan et al., Order Conditionally Approving Applications to Engage to a Limited Extent in Underwriting and Dealing in Certain Securities, 75 FED. RES. BULL. 192 (1989).

40 See Federal Reserve Board, supra note 37.

insulate one unit of a holding company from the funding problems of another. More recently, Ricki Helfer, Chairman of the FDIC, in commenting on Sections 23A and 23B, observed that "these firewalls are not impenetrable...of course, in times of stress firewalls tend to weaken, and transgressions have occurred both within and outside the reach of the regulators....pressure can be exerted on a bank from its holding company as well as from subsidiaries." While such anecdotal evidence is illuminating, to the best of our knowledge there has been no systematic empirical analysis on the extent to which firewalls are effective, in good times and bad.

Beyond the question of their effectiveness, firewalls raise a serious anomaly. They are generally accepted as a way of isolating deposit-insured banks from risks in their nonbanking activities and of preventing the transmission of subsidy to nonbank subsidiaries. However, complete isolation of banks, as apparently was effective while Section 6 of the Bank Holding Company Act was in force, undermines the public purpose behind activity expansion; i.e., to permit banks to realize the advantages of economies and diversification. In Chairman Greenspan’s words, "(I)t is clear that high thick firewalls reduce synergies and raise costs for financial institutions....If they raise costs and are not effective, we must question why we are imposing these kinds of firewalls at all...." A thorough analysis of specific firewalls that would maximize net benefits is beyond the scope of this paper. But it is a subject that merits attention.

C. Why Have Banks Been Differentially Treated?

Why have banks and their corporate owners been so tightly restrained? Equivalently, why are banks treated differently from most other enterprises? We offer five primary reasons, of historical relevance, for this special treatment.

First, the American polity has had a long history of antagonism toward the size, power, and influence of financial institutions, especially of banks (as well as of government itself). That banks were originally government-sanctioned enterprises with “monopoly” attributes has augmented this traditional antagonism. Restricting the extent of banks' activities has clearly been one way of restricting their size, power, and influence.

Second, though the American polity is rarely comfortable with the insolvency and bankruptcy of any sizable enterprise (primarily because of the perceived consequent loss of jobs), the insolvency of banks creates special concerns with respect to the holders of banks' primary liabilities -- deposits. Bank deposits are a significant fraction of many households' wealth; this is especially true for households that are less financially sophisticated. The loss of even a fraction of these deposits is a traumatic event. The expansion of a bank's activities beyond those of its traditional expertise may create greater risks of its insolvency and thus of losses by depositors -- either because of incompetence by the bank in the undertaking of the new activities, or because the expanded activities give the bank's owners greater opportunities to favor themselves at the expense of the depositors.

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42 Alan Greenspan, Statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 76 FED. RES. BULL. 731 (1990).
43 Helfer, supra note 36, 62, 67 ff.
44 Violations of Sections 23A and 23B for the years 1990 and 1991 are reviewed in a study of bank insider activity in GENERAL ACCOUNTING OFFICE, supra note 39; for a discussion of data deficiencies in this area, see Ibid., pp. 59-63. In response to a request for data from one of the federal banking agencies while the authors were preparing this paper, a legal compliance official responded that information on the number of violations of sections 23A and 23B "is not publicly available." When asked whether such data are collected, he stated: "That information is not publicly available."
45 Greenspan, supra note 42.
46 Our ordering of these reasons is not an indication of their relative importance.
47 Restricting the geographic scope and spread of their offices (branches) -- intra-state and interstate -- has been a second method of restricting their size.
48 But diversification can also lead to a smoothing of income flows and thereby a reduced likelihood of insolvency.
49 I.e., it may give the owners greater opportunities to "loot" the bank and thus cause its insolvency.
Third, and related to the second, the maturities (durat ions) of bank assets and liabilities, with assets typically less liquid and of longer maturity than deposit liabilities, particularly deposits withdrawable on demand, leave banks prone to runs. Depositors who are either ill-informed or well-informed about the condition of their banks may fear for the safety of their deposits; even for banks in good condition, well-informed depositors may decide that the ill-informed fears of others will cause the premature and inefficient closure of their bank, thereby endangering the safety and/or liquidity of their deposits).\textsuperscript{50} Runs by depositors on one bank may be contagious and lead to runs on others. Again, the expansion of a bank's activities may increase the likelihood of its insolvency.

Fourth, banks have been an important source of credit to the rest of the U.S. economy. Though the twentieth century has seen a substantial waning of banks' aggregate role as supplier of credit, political memories linger.\textsuperscript{51} Further, banks have retained a special role as lenders to small and medium-size businesses.\textsuperscript{52} The expansion of a bank's activities beyond the traditional ones then raises two fears: (a) that its consequent increased likelihood of insolvency will deprive its borrowers of future streams of credit; and/or (b) that the bank will favor the financing of its own (new) activities at the expense of its traditional loan customers.\textsuperscript{53}

Fifth, public concerns about banks' insolvencies make banks recipients of favorable treatment by government: e.g., in the provision of government-backed deposit insurance; access to the payments system; and access to the Federal Reserve as a provider of short-term adjustment credit and as a lender of last resort in exigent circumstances. The expansion into non-traditional activities may give banks the opportunity to extend to the new activities any net subsidy implied by this special treatment. In turn, the spread of the subsidy will give banks an unfair advantage vis-a-vis their non-bank rivals in these non-traditional areas, as well as encouraging the inefficient expansion of banks into these areas.

This paper does not evaluate the validity and relative importance of these reasons for special treatment.\textsuperscript{54} Nevertheless, they have clearly been important in shaping the history of restrictions on

\textsuperscript{50} For theoretical elaborations of this point, see Douglas W. Diamond and Philip H. Dybvig, Bank runs, Deposit Insurance, and Liquidity, 91 J. POL. ECON. 401 (1983); and Andrew Postlewaite and Xavier Vives, Bank Runs as an Equilibrium Phenomenon, 95 J. POL. ECON. 485 (1987).

\textsuperscript{51} For documentation of this decline, see ROBERT E. LITAN, WHAT SHOULD BANKS DO? (1987); and FRANKLIN R. EDWARDS, THE NEW FINANCE: REGULATION AND FINANCIAL STABILITY (1996).


\textsuperscript{53} Both of these fears assume a deficiency in competition in banking markets and/or that new entry will not occur or will not occur sufficiently to take up the slack.

\textsuperscript{54} For arguments that it is primarily banks' role as providers of deposits and banks' inherently illiquid structure that justify special (safety and soundness) treatment, which in turn justifies special concern about a bank's activities and their structure, see LAWRENCE J. WHITE, THE S&L DEBACLE:PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION (1991); and Lawrence J. White, The Proper Structure of Universal Banking: "Examinability and Supervisability," in UNIVERSAL BANKING: FINANCIAL SYSTEM DESIGN RECONSIDERED 682 (Anthony Saunders and Ingo Walter eds., 1996). For historical evidence that activity restrictions emerged from apprehensions about the expansion by banks, "affiliated" with the government, into nonbanking markets, see Bernard Shull, The
expansions of banks into non-traditional activities.

III. An Analytical Framework for Evaluating Expanded Banking

An evaluation of the public policy wisdom of permitting banks to expand into non-traditional activities and of the appropriate structure for such expansion requires an analytical framework. In this Section, we will provide a framework that focuses on the potential financial sector benefits and costs of expanded banking. Though we do not attempt specific quantification of these costs and benefits, we believe that the framework helps clarify them. In the following Section we will employ this specification to analyze the various organizational options that have been proposed.

A. The Potential Benefits

1. Synergies/economies of scope. The combination of some non-traditional activities with banking should, in principle, permit the combined organization to enjoy efficiencies from the combination that are not available when the activities are provided separately. The sources of these efficiencies could be the sharing of joint and common facilities, personnel, knowledge, brand name, etc. For example, the bank might be able to market other products and services to its customers more efficiently; or its production of, say, insurance services could efficiently use the financial expertise found elsewhere in the bank.

2. Diversification/stabilization. If the new activities have income streams that are not perfectly correlated with the bank's income stream from its existing activities, the combination of the new activities with the bank will reduce unsystematic risk and provide an income stream that has less variance relative to its mean than was true for the bank alone. Other things being equal, this smoothing should reduce the likelihood of bankruptcy/insolvency of the combined organization. Because the insolvency of a bank has substantial real costs (as well as psychic/political costs), this reduction in likelihood would be an important benefit.

B. The Potential Costs

The discussion in Section II-C listed the reasons why banks in the U.S. have not been allowed to engage in non-traditional activities. From that list we focus on two that have been prominent in the recent discussion of bank expansion: concerns about the increased risks of insolvency of banks, and concerns that any public subsidy that is provided to banks will unfairly and inefficiently be spread to their non-traditional activities.

1. Insolvency. The addition of non-traditional activities may increase, rather than decrease, the likelihood of a bank's insolvency. This increase could arise from two sources. First, the bank's management may simply blunder in its investments and operation of the non-traditional activity. Unlike the textbook description of portfolio diversification (e.g., the purchase and passive ownership of the shares of a large number of other enterprises), a bank's entry into non-traditional activities may involve the ownership and operation of a few specific activities. If the bank management's judgment about its

Separation of Banking and Commerce: Origin, Development, and Implications for Antitrust, 28 ANTITRUST BULL. 225 (1983); and Shull, supra note 8.

55 The ability of any specific bank to take advantage of the potential efficiencies is likely to be an idiosyncratic phenomenon that is related to the capabilities of that bank's management and the scale of the bank and of the non-traditional activities.

56 If the costs of bankruptcy/insolvency were absent or very small to begin with, the benefits of income smoothing could be gained by the owners' investing separately in a bank and in a firm that conducted the other activities; i.e., this aspect of a conglomerate firm would have little value to the owners (unless the costs of insolvency were high).

57 This covers the second and third reasons discussed in Section II-C.

58 This covers the fifth reason discussed in Section II-C.
capabilities in operating the non-traditional activities are wrong and the losses are sizable, the bank's solvency may be at risk. This danger is heightened by the fact that banks in the U.S. currently operate with capital (net worth) levels that, while high by comparison to recent experience, are low compared with most other enterprises in the U.S.

Second, the bank's owners/managers may use non-traditional activities to benefit themselves at the expense of the solvency of the bank. In essence, they might use the non-traditional activity to "loot" the bank. This could arise, for example, if the non-traditional activity's losses are due to the underpricing of its services to the owners/managers.\(^{59}\)

These scenarios of heightened risks of insolvency presuppose inadequate monitoring on the part of safety-and-soundness regulators whose primary responsibility is to prevent such bank insolvencies. This inadequacy in monitoring might be due to the regulators' unfamiliarity with the non-traditional activity. This is an important issue to which we will return below.

2. Extending the subsidy. If banks receive (net) special privileges or subsidies and if these subsidies can be extended to the bank's operation of a non-traditional activity, then banks will enjoy an "unfair" advantage vis-a-vis their non-bank rivals in the operation of the non-traditional activity. Further, the extension of the subsidy is likely to encourage the bank inefficiently to produce too much of the non-traditional good or service.

It is clear that banks have special and valuable privileges that are not afforded other enterprises in the U.S. Their deposit liabilities are insured by the FDIC and effectively backed by the full faith and credit of the U.S. Treasury; they have access to the payments system; and they have access to Federal Reserve credit. These privileges have value, constituting the "gross subsidy."

But banks also have special costs. They pay premiums for deposit insurance; they must maintain non-interest bearing reserves at the Federal Reserve; and they bear non-trivial costs of satisfying regulatory requirements, ranging from safety-and-soundness to disclosure to "community reinvestment" obligations under the Community Reinvestment Act of 1977. These costs need to be subtracted from the gross subsidy, to compute the net subsidy.

Recently published estimates of gross and net subsidies, based principally on one or more of the elements indicated above, have suggested that, under current regulatory procedures, and at current bank capitalization levels, the net subsidy for most banks is either close to zero or negative.\(^{60}\) These estimates are quite sensitive, however, to assumptions about the levels of bank capital, the variance of the bank's investments, and the level of losses to which the deposit insurer is exposed, as well as the elements included as subsidy and cost. It is generally accepted that in the late 1980s and early 1990s, when bank capital levels were lower and the FDIC was experiencing sizable losses in its handling of insolvent banks, the net subsidy levels were positive for many banks. This was yet more true with respect to hundreds of savings and loan associations in the 1980s. Moreover, the expectation of assistance in difficult periods, particularly for large banking organizations, even if not completely certain under the Federal Deposit Insurance Corporation Improvements Act of 1991 ("FDICIA"), has a value that is not included in such net

\(^{59}\) At the limit, all of the non-traditional activity's goods or services could be given to the owners/managers for free; this would be the equivalent of concessional loans to the owners/managers.

\(^{60}\) See Gary Whalen, *Bank Organizational Form and the Risks of Expanded Activities*, Economics Working paper 97-1, Office of the Comptroller of the Currency (1997); and gary Whalen, *The Competitive Implications of Safety Net-Related Subsidies*, Economics Working Paper 97-9, Office of the Comptroller of the Currency (1997). In the latter paper Whalen provides a review of recent subsidy studies. Whalen's own estimates of the benefits focus entirely on deposit insurance, using an option-pricing model; see also Helfer, *supra* note 36. Accepting an estimate of about 10 basis points for the gross subsidy, Chairman Helfer concluded that the costs associated with regulation were more than three times as great -- about 33 basis points. Federal Reserve Board Chairman Alan Greenspan has argued that there is a "sovereign credit subsidy" implicit in the safety net, and it seems likely that the Federal Reserve has also made estimates, but thus far none have been made public. *See* Greenspan, *supra* note 36, at 4; and Alan Greenspan, *Statement*, HEARINGS BEFORE THE COMMITTEE ON BANKING AND FINANCIAL SERVICES, U.S. House of Representatives, 105th Cong., 1st sess. (May 22, 1997).
subsidy calculations. Consequently, we remain agnostic as to the current and prospective levels of net subsidy for banks.

One further point should be made, however, with respect to net subsidy and new activities. An important question concerns activity at the margin: Does a bank's expansion into a non-traditional activity generate additional gross subsidy and additional regulatory costs for it? What is the marginal net subsidy attached to the new activity? The answer will indicate whether a bank has an undue incentive (and an undue advantage) to undertake a non-traditional activity, and perhaps increase the likelihood of success in its rivalry with non-activity expanding banks. We believe that insufficient attention has been given to the marginal net subsidy. With respect to its values, we also remain agnostic, though the marginal focus will be useful in our consideration of the alternative structures for expanded banking.

It is to that analysis that we now turn.

**IV. The Pluses and Minuses of the Three Alternative Structures**

In this section we will examine the pluses and minuses of three alternative structures for expanded banking: (a) the universal bank, in which the non-traditional activity is consolidated within the same corporate entity as the bank; (b) the holding company affiliate, in which the bank is in one subsidiary of a holding company and the non-traditional activity is in another subsidiary of the holding company; and (c) the operating subsidiary (op-sub), in which the non-traditional activity is located in a subsidiary of the bank. Figure 1 provides a diagrammatic representation of the three alternative structures.

Before proceeding with the discussion, however, we wish to make an important distinction among non-traditional activities: those that are "examinable and supervisable" and those that are not. By "examinable and supervisable," we mean an activity that bank regulators believe can be regulated in a manner consistent with their notions of safety and soundness; i.e., they can examine it, they can determine whether the bank is undertaking it competently, they can set appropriate capital requirements, they can set appropriate risk-based deposit insurance premiums for it, etc. Note that this distinction is not one of "not risky" versus "risky." Almost all traditional bank assets and activities involve risk, but bankers and bank regulators are generally comfortable with the management of that risk. Instead, it is one of bank regulators' comprehension of an activity, its risks, what sound management of that activity would look like, etc.

This distinction is, we believe, important for the problems of insolvency and (marginal) extension-of-subsidy on which we will focus. If an activity is examinable and supervisable in the sense that we have described, then it should be no more likely to bring on the insolvency of a bank than would a traditional bank activity. Similarly, if an activity is regularly examined and supervised, is subject to adequate capital, and has appropriate risk-based deposit insurance premiums, the level of net subsidy should be quite low or non-existent. Conversely, an activity that is not examinable and supervisible may embody large but hidden risks that could threaten a bank's insolvency; and hidden risks may well mean a large net subsidy for the activity.

Since we are not bank regulators ourselves, we do not take a position as to what specific assets...
and activities would fall into the one category or the other; we will leave that up to the experts: the bank regulators.  

If our distinction is valid and meaningful, then it is primarily the non-traditional activities that are not examinable and supervisable that should be the focus of concern with respect to insolvency and extension-of-subsidy problems. Accordingly, unless otherwise indicated, it is these types of activities that will occupy our attention for the remainder of this Section.

A. The Universal Bank

In the pure universal bank, neither subsidiaries, affiliates or holding companies, are required by law or regulation (although a bank could use them for managerial convenience or efficiencies). Instead, both traditional banking and the non-traditional activity can be conducted in a thoroughly integrated manner within the bank. Neither the legal concept of corporate separateness nor legal/regulatory firewalls separate any one type of banking activity from any other. This organizational structure allows the bank to maximize the synergies between traditional and non-traditional activity and to gain the maximum amount of smoothing from the combined income flows. But it effectively extends the existing safety net and any subsidies to new markets and an expanding portion of the economy and poses the greatest risk that losses from new activities will cause the insolvency of the bank. As a result, it also poses the greatest threat of regulatory expansion. On the other hand, as discussed below, the undesirable incentives to support one segment of the organization at the expense of another, which can arise in the case of holding company affiliates and op-subs because of the possibility of differential ownership interests and leverage, does not arise in the case of the universal bank.

B. The Holding Company Affiliate

In this organizational structure, the separation of the bank from its new activity affiliates is likely to reduce any synergies that would accrue to a universal bank. Economies of scope and the smoothing of income flows that occur as a consequence of diversification are, for the most part, likely to benefit the owners of the holding company; the efficiency of the bank itself, and its income flows, and thus its risks of insolvency from the variance of its income stream alone, will not be directly affected. If bank regulators can successfully mandate that the holding company, including its non-bank subsidiaries, be a "source of strength" for the bank so that when the bank incurs losses and its capital is reduced, the holding company downstreams capital funds, the bank will directly benefit from the holding company’s gain in efficiency and the income smoothing effect. There have been Federal court decisions hostile to the Federal Reserve's source-of-strength doctrine. However, the FDICIA requires holding companies to guarantee that an undercapitalized depository institution it controls will comply with any capital restoration plan otherwise acceptable to a Federal bank regulatory agency.

On the other hand, losses incurred in the new activities will directly threaten the solvency of the
The effectiveness of "corporate separateness" and firewall restrictions. This effectiveness surely can, and of fewer benefits but probably fewer direct risks to the bank.

subsidiaries, and as a result of differential leverage as well.

result of differential ownership interests by those controlling the holding company in the bank and in other financial transactions, as required by Section 23B, is crucial for the prevention of any marginal net subsidy payment of excessively large dividends to the holding company. Insistence on arms-length terms in and services from an affiliate. It can also be weakened by the direct "looting" of its assets through the owners/manager) on concessional terms (relative to the risks) to an affiliate and over-payment for goods as a result of affiliation in a variety of ways, including loans (dictated by its holding company which assets are stripped from the bank. If firewalls are not effective, a bank can be weakened financially one another's problems.

Firewall restrictions are necessary to ensure that the affiliates are not the indirect route through which assets are stripped from the bank. If firewalls are not effective, a bank can be weakened financially as a result of affiliation in a variety of ways, including loans (dictated by its holding company owners/manager) on concessional terms (relative to the risks) to an affiliate and over-payment for goods and services from an affiliate. It can also be weakened by the direct "looting" of its assets through the payment of excessively large dividends to the holding company. Insistence on arms-length terms in financial transactions, as required by Section 23B, is crucial for the prevention of any marginal net subsidy transfers through concessional transactions. Incentives to weaken or sacrifice the bank may develop as a result of differential ownership interests by those controlling the holding company in the bank and in other subsidiaries, and as a result of differential leverage as well.

In sum, as compared with the universal bank, the holding company structure offers the prospects of fewer benefits but probably fewer direct risks to the bank. The reduction in risk depends on the effectiveness of "corporate separateness" and firewall restrictions. This effectiveness surely can, and


68 Even with a simple ownership structure that has no holding company, there must be restrictions on the bank's transactions with (e.g., loans to, purchases from) its owner(s), so as to prevent this indirect form of "looting."

69 Whalen, Bank organizational Form..., supra note 60 at 16-19, argues that transmission of problems from nonbank affiliates to banks have been rare but that there may be differences between potential and realized insulation as perceived by the market. The problem was found to be more serious by Anthony Cornyn, Gerald Hanweck, Stephen Rhoades, and John Rose, An Analysis of the Concept of Corporate Separateness in BHC Regulation from an Economic Perspective, PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION, Fed. Res. Bank of Chicago (1986).

70 The monitoring of concessional transactions must be concerned not only with, say, loans to the bank's affiliates within the holding company but also to the customers of or suppliers to the affiliates. since such concessional terms might still indirectly favor the affiliates. And, of course, such monitoring is necessary for concessional transactions vis-a-vis the suppliers/customers of the bank's owner(s), even in the absence of a holding company.

71 See Franklin R. Edwards, Banks and Securities Activities: Legal and Economic Perspectives on the Glass-Steagall Act, in THE DEREGULATION OF THE BANKING AND SECURITIES INDUSTRIES 273, 286-87 (Lawrence G. Goldberg and Lawrence J. White eds., 1979); and Walter, supra note 67, at 29 ff. When the stock of affiliates are not owned ratably by the stockholders who own the bank holding company, as would be the case if, for example, the holding company owned 100 percent of a nonbank affiliate and 30 percent of its bank affiliate, obvious conflicts would result if the nonbank affiliate got into trouble. Different leverage structures for the bank and its affiliates can create similar conflicts of interest.

72 It is worth noting that, despite the absence of restrictions on the nature of affiliates for unitary thrift holding companies, the S&Ls that were part of diversified holding companies were not significant sources of the losses of the S&L debacle of the 1980s. Also, commercial banks have been able to conduct investment banking activities abroad, through holding company affiliates, that do not appear to have created problems for their domestic banks.
probably has, changed with both experience and legislation; but it remains currently uncertain in the absence of persuasive empirical studies.

C. The Operating Subsidiary

In this structure the non-traditional activity is located in a subsidiary of the bank. Under current OCC requirements, the bank's net investment position in the subsidiary, typically the net worth of the subsidiary, cannot be counted as an asset of the bank and thus does not contribute to the capital of the bank.\(^{73}\)

Again, the organizational separation of the subsidiary from the bank may reduce the synergies available, as compared to the universal bank. But the smoothing of aggregate income flows from diversification occurs more directly than in the holding company structure, since the op-sub's income is "trapped" beneath the bank and can be upstreamed only through the bank.\(^{74}\) Diversification that results in the op-sub's income swelling when the bank is running losses, would result in a natural and beneficial upstreaming.

On the other hand, losses in the subsidiary should not directly affect the bank as long as the regulatory accounting treatment of the bank's investment in the op-sub insulates the latter from the former. As was true for the holding company affiliate structure, in the event of the bankruptcy of the op-sub, the bank is affected only if (a) the creditors can pierce the corporate veil; (b) the bank's reputational capital is damaged; (c) the bank is a creditor to the op-sub; and/or (d) the bank's owners attempt to prevent the bankruptcy of the op-sub by transferring some of the bank's assets to the op-sub.

Again, points (c) and (d) highlight the need for firewalls. Bank owners that have a separate ownership stake in the op-sub might have an incentive to strip assets out of the bank in support of their investment.\(^{75}\) This could be accomplished through concessional transactions between the op-sub and the bank's owners. In the absence of such separate ownership stakes, however, the firewalls probably do not need to be as "thick" as would be true for transactions with an affiliate, because the op-sub cannot be the direct vehicle for the stripping of assets out of the bank (since any financial gains for the op-sub must flow back through the bank before reaching the owners).\(^{76}\)

As in the case of the bank holding company organization, firewalls remain necessary to prevent the marginal transfer of any net subsidy from the bank to the activities of the op-sub. As before, this could be accomplished through concessional terms on transactions between the bank and the op-sub.

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\(^{73}\) Only a bank with excess capital could create such a subsidiary, since the downstreaming of funds from the bank to the subsidiary would cause, for regulatory reporting purposes, those funds to disappear from the assets of the bank. In this sense, the creation of the op-sub would have the same regulatory-financial consequences for the bank as would the divesting of the funds up to a holding company and then to an affiliate. Thus, the regulatory accounting treatment of an op-sub for nontraditional activities would be different from, and harsher than the accounting treatment of a subsidiary for traditional activities in which that latter subsidiary's net worth would be counted as an asset of the bank. In the latter case, the subsidiary is examinable and supervisable by regulatory agencies, and needs to be examined and supervised by them.

\(^{74}\) To the extent that the owners of the bank establish their own ownership position in the op-sub, they could upstream a fraction of the op-sub's income without going through the bank; see Edwards, supra note 67. At the limit, all of the op-sub's income could be upstreamed directly to the bank's owners, and the bank would receive no income-smoothing benefit; the effect would be the equivalent of the holding company structure.

\(^{75}\) If the stock of an op-sub is not owned pro rata by the stockholders of the bank, such that a relatively small portion of the op-sub's equity were owned by the bank and a substantial portion owned independently by a subgroup of owners who control the bank (i.e., the officers and directors), management incentives similar to those in the holding company case can develop. The worst situation for the bank would be where the bank’s officers and directors own a substantial portion of the stock of the subsidiary, but little or none of the stock of the bank.

\(^{76}\) Monitoring is still necessary to prevent indirect asset stripping via the op-sub. This could happen if the bank provides loans to the op-sub, which in turn provides concessional transactions to the bank's owners (or the owners' customers/suppliers). And, of course, the normal levels of examination/supervision should apply to the transactions of the bank vis-a-vis the op-sub, to prevent bank management blunders, etc.
In sum, because the op-sub is "trapped" below the bank, the op-sub structure offers some modest regulatory advantages relative to the holding company structure: Depending on the distribution of ownership interests, the op-sub's income will naturally flow up to the bank at times when the bank needs it; a "source of strength" doctrine is not needed. And, in the absence of a separate ownership position in the op-sub by the bank's owners, the firewalls need not be as thick, since it is more difficult for the bank's owners to use the op-sub to strip assets out of the bank.

D. A Summing Up

As compared with the universal bank structure, both the holding company structure and the op-sub structure offer reduced potential benefits but also reduced potential costs. In a regulatory landscape involving over 9,000 banks (and somewhat less than 2000 thrifts and thousands of credit unions), the general dangers of placing non-traditional activities (that are not examinable and supervisable) immediately within the bank seem substantial.

Between the latter two, the op-sub structure slightly dominates, because of its superior smoothing properties and its need for thinner firewalls.\textsuperscript{77} In both cases, the capital structure of the holding company and its affiliates, and banks and their subsidiaries may create serious problems to the extent that firewalls are not impenetrable.

On the basis of the factors considered, the op-sub structure seems to provide the marginally superior tradeoff.

V. Conclusion

The choice of appropriate banking structure for a world of expanded banks and banking is not an easy one. As this paper has demonstrated, however, both the holding company affiliate arrangement and the operating subsidiary structure appear to be a safer than the universal bank for non-traditional activities that are not examinable and supervisable by bank regulators. The operating-subsidiary structure, on the basis of the efficiency, diversification, insolvency risk, and transfer of any marginal safety-net subsides appear to offer modest advantages relative to the holding company structure. Accordingly, the op-sub structure as an alternative seems a prudent policy course for U.S. banking regulation.

It is worth noting, finally, that after the complex construction of new risk-adjusted capital requirements over the last decade, there seems to be nothing in current law or regulation that directly addresses the problem of perverse incentives created by differential capital structures among affiliates and subsidiaries. If, in the United States, we are committed to placing a growing number of new activities in separately incorporated affiliates, rather than in the bank itself, consideration needs to be given to regulations that minimize such incentives and not simply to rely on firewalls that aim to frustrate them. Clearly one of the lessons of the last two decades is that where incentives exist, circumventions will be found.

\textsuperscript{77} Note that this analysis implies that it is preferable for the bank to own the hardware store than for the hardware store to own the bank. We do not mean to imply by this observation that banks should be allowed to buy hardware stores but that hardware stores should not be allowed to buy banks. Instead, in a world of expanded banking, a hardware store's purchase (or chartering) of a bank should then be followed by a corporate restructuring that places the hardware store operations as a subsidiary of the bank.
Figure 1: The Three Alternative Bank Structures

The Universal Bank

+--------+
¦ Owners ¦
+--------+

| Bank |
+------+
| Non-traditional activity |
+-------------------+

The Holding Company

+--------+
¦ Owners ¦
+--------+

| Holding company |
+-------------------+

| Bank |
+------+
| Non-traditional activity |
+-------------------+

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