

SECURITIES UNITS OF BANKING
CONGLOMERATES:
SHOULD THEIR LOCATION BE REGULATED?

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The separation between commercial and investment banking has been a distinctive feature of the U.S. financial system for decades. In 1933, reacting to the wave of bank failures that followed the Great Depression, Congress passed the Glass-Steagall Act separating the two industries. For more than 30 years, firms on both sides seemed to lack the incentive (or the ability) to explore some of the gray areas of that regulation. Since the 1960s, however, commercial banks and securities firms have tried to expand their activities into each other's strongholds. These attempts have contributed to a gradual erosion of the barriers separating them.

Currently, the federal agencies charged with regulating and supervising commercial banks, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve System (Fed), all agree on easing the barriers separating the two industries, provided that securities activities are housed in a separately capitalized unit of the banking conglomerate. They have, however, argued for different regulations on the location of the securities unit in the conglomerate. The OCC and the FDIC have manifested their preference for a regulation that allows banks to choose between the bank parent model and the holding company model. The Fed has expressed its preference for a regulation requiring the holding company model.

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The difference in the regulatory agencies' proposals has brought increased prominence to the debate on the more general question of whether the location of the securities unit in a banking conglomerate should be subject to regulation. This debate has focused on two issues: one related to the economic implications of the different locations for securities units, the other related to how that location would affect the portion of the banking industry that each agency oversees. This paper reviews the arguments as to whether the location of the securities unit in a banking conglomerate should be subject to regulation. This review is complemented with evidence on the regulations and on the predominant banking conglomerate models in some other countries and in the United States before the Glass-Steagall era.

Commercial Banks in the Securities Business

In the debate over repealing the Glass-Steagall Act, it is usually conjectured that combining commercial banking with investment banking enhances the bank-firm relationship, generates economies of scope, creates conflicts of interest, and poses problems to the safety and soundness of banks (see Santos 1997). It is also conjectured that these effects vary with the location of the securities unit in the banking conglomerate.

Potential Benefits and Costs of Combination

The modern banking literature relies on information frictions to explain the existence of financial intermediaries (see Freixas and Rochet 1997). Firms usually have information about their investment opportunities that is not readily available to outsiders. In this case, delegating certain functions to a financial intermediary reduces the costs of financial intermediation because it avoids the duplication of such functions as gathering relevant information before making the funding decision and monitoring borrowers' actions once they receive the funds to undertake their investment projects. Under these circumstances, it is believed that a bank that also offers securities services can develop a "wider" and "longer" relationship with firms than can a specialized bank.

Increasing the number of contact points between a bank and a firm makes it easier for the bank to gather information about that firm and to use it in a wider set of transactions. For example, it will be relatively simple for a bank to study a firm with which it has a lending relationship for the purpose of underwriting its securities. The expected duration of the bank-firm relationship is also important. Young firms generally obtain funding from banks, but as they mature,

they often switch to capital markets, a move that in turn requires underwriting services. Unlike a specialized bank, an institution that offers both lending and securities services can fulfill the firm's funding needs throughout its existence. In sum, there seem to be important information advantages associated with offering commercial and investment banking services jointly. Empirical research on these issues confirms that the enhancement of the bank-firm relationship is a source of benefits in terms of both cost and availability of funding (Petersen and Rajan 1994; Berger and Udell 1995).

Another potential advantage of combining commercial banking with securities activities is economies of scope. Several reasons are frequently given as to why that combination may be the source of scope economies in the supply of financial services, such as the banks' ability to use their networks of branches to distribute additional products at a low marginal cost. Economies of scope could also arise on the consumption side. Because of lower search and monitoring costs, a consumer might find it advantageous to acquire a bundle of services from a single bank instead of shopping around for individual deals. Thus, from a theoretical point of view, there seem to exist some important sources of scope economies. From an empirical point of view, however, the debate over the importance of these economies remains unsettled. Research on U.S. banks finds little evidence of scope economies in production, but research on banks in Japan and in some European countries finds evidence of such economies (see Mudur 1992, Forestieri 1993).

When the Glass-Steagall Act legally separated commercial banking from investment banking in 1933, backers of the legislation claimed that they were heading off serious conflicts of interest and threats to the safety and soundness of the banking industry. These arguments continue to be invoked by those who favor maintaining that separation.

Conflicts of interest associated with the combination of commercial and investment banking are said to arise for several reasons, such as the bank's opportunity to impose tie-in deals by coercing borrowers to buy its securities services or have their credit rationed.¹ The critical issue regarding any potential conflict of interest, however, is not its existence per se but whether the parties have incentives and opportunities to exploit it. Working against banks' incentives is the possible impact of such behavior on their reputation, and working against their opportunities is the competition in financial markets and consumers'

¹For a discussion of other conflicts of interest, see Saunders (1985), Kelly (1985), and Benston (1990).

expected behavior. For example, if firms perceive that they may be forced into tie-in deals, they can protect themselves by maintaining relationships with several banks. Despite the existence of potential conflicts of interest associated with the combination of commercial and investment banking, empirical research on the period before Glass-Steagall failed to find evidence that banks systematically exploited these conflicts (Kroszner and Rajan 1994; Ang and Richardson 1994; Puri 1994, 1996).

The other most frequently cited justification for not allowing commercial banks to offer securities services is based on the argument that these are risky services which could threaten the safety and soundness of banks. Empirical research, however, appears to disprove the idea that securities activities are highly risky for banks. Research on banks' securities activities prior to Glass-Steagall finds no evidence that these activities were responsible for the bank failures that occurred at the time (White 1986). Studies of the potential risks to existing banks and bank holding companies (BHCs) from offering securities services appear to indicate that such activities give banks some potential, though rather limited, diversification gains (see Brewer, Fortier, and Pavel 1989).

Alternative Conglomerate Models

The potential benefits and costs of allowing banking conglomerates to provide securities services depend to a large extent on their freedom to integrate such services with their current businesses. This integration is greatly influenced by the conglomerate model that the organization is allowed to adopt. In a deregulated system, there are several models that banks could adopt to integrate commercial banking with securities activities. The most common are the universal banking model, the bank parent model, and the holding company model.

In the universal banking model both commercial banking and securities activities are conducted within a single corporate entity. Resources can be shared among the organization's various departments with maximum flexibility, permitting a complete integration of the activities at the lowest cost. In the bank parent model, the securities business is undertaken by a subsidiary of the bank. There is a legal separation between the bank and the securities unit. This imposes some operational separateness between the activities conducted by the two units and, because of limited liability, it confines the bank's loss to its investment in the subsidiary in the event that the securities unit should fail. Finally, in the holding company model, a holding company owns both the bank and the securities subsidiary. As in the bank parent model, there is a legal separation between the two units.

The critical difference between these two models, however, is that in the latter the securities subsidiary's capital is owned by the holding company while in the former it is owned by the bank itself. Therefore, in the holding company set-up the relationship between the bank and the securities subsidiary is only indirect, while in the bank parent set-up it is direct.

International Evidence on Banking Conglomerate Models

International evidence on the conglomerate models that banks are allowed to adopt to integrate securities activities with commercial banking, together with the model that predominates in each country, provides important insights on banks' preferences. Table 1 presents that information for several countries.

The table highlights two important facts. First, the vast majority of the countries considered allow banks to offer the securities services in-house or through their subsidiaries. Second, in countries where banking firms have more freedom to choose where to locate the securities unit in the conglomerate, they choose in most cases to locate it in a department of the bank. When they choose to implement corporate separateness, they prefer to offer the securities services through one of their subsidiaries.

In the United States, the regulations on the organizational structures that banks are allowed to adopt in order to offer securities services are quite different from those in force elsewhere. Since Glass-Steagall, banks have been permitted to undertake only a very limited set of securities activities in-house. Over time, that set of activities has been expanded, but with the condition that they are housed in a subsidiary of the holding company that also owns the bank. This is one of the reasons why the holding company model has become so important for the U.S. banks.²

As a final note, two important caveats should be taken into account when considering the evidence presented above. First, factors idiosyncratic to each country may influence banking firms' choice of the location of the securities' unit in the conglomerate. Second, if there are market imperfections, a certain conglomerate model may predominate

²In the United States, banks' securities powers and the organizational models that they are allowed to adopt in order to offer securities services vary with the bank charter. Banks in general are permitted to conduct only a limited set of securities activities in-house. State-chartered member banks can offer some additional securities services if they locate them in a subsidiary of a BHC. National banks and state-chartered nonmember banks are also allowed to offer a broader set of securities services if they locate them in a separate unit, which can be a subsidiary of a BHC or a subsidiary that they own. See the next section for a description of the U.S. regulations.

TABLE 1
PERMISSIBLE CORPORATE ORGANIZATIONAL FORMS^a

Countries	Bank Holding Company Permitted	Directly in the Bank	Securities Activities ^b			Most Frequently Conducted in
			Bank Subsidiary	Bank Holding Company Subsidiary	Bank ^c	
Austria	Yes, but infrequently used	Yes	Yes	Yes	Yes	Bank ^c
Canada	No	No	Yes	No	No	Bank subsidiary
Finland	Yes, but infrequently used	Yes	Yes	Yes	Yes	Bank
Germany	Yes, but infrequently used	Yes	Yes	Yes	Yes	Bank
Greece	No ^d	Yes ^e	Yes	No	No	Bank subsidiary
Ireland	Yes, but infrequently used	Yes	Yes	Yes	No	Bank subsidiary
Italy	Yes, widely used	Yes	Yes	No	No	Bank
Luxembourg	No ^f	Yes	Yes	No	No	Bank
Netherlands	Yes, widely used	Yes	Yes	Yes	Yes	Bank
Portugal	Yes, but infrequently used	Yes	Yes	Yes	Yes	Bank & bank subsidiary

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Spain	Yes, but infrequently used	Yes	Yes	NA	Bank & bank subsidiary ^g
Sweden	No	Yes	Yes	No	Bank
Switzerland	Yes, but infrequently used	Yes	Yes	Yes	Bank
United Kingdom	Yes, but infrequently used	Yes	Yes	Yes	Varies

SOURCE: Barth, Nolle, and Rice (1997).

^aInformation as of January 1997.

^bSecurities activities include underwriting, dealing, and brokering in all kinds of securities and all aspects of mutual funds business.

^cSecurities activities fall under the banking activities provisions of Section 1 of the Austrian Banking Act. Hence, such business may be conducted exclusively by a bank.

^dHolding companies may own the majority of shares in a Greek bank, but there is no specific legal framework referring to such companies.

^eOnly underwriting and custodian services.

^fPure holding companies are permitted to incorporate under Luxembourg law, but the statute of a BHC does not exist. This type of company is not submitted to any prudential control by any authority.

^gPublic debt directly in bank and stock exchange in bank subsidiary.

not because it is the most efficient way to integrate particular activities but because it is, for example, the best organizational structure for extracting rents.

Banks' Securities Activities in the United States

Throughout U.S. history, the conglomerate models that banks have chosen for integrating commercial banking with securities activities have been greatly influenced by regulations, in particular the Glass-Steagall Act.

Before the Glass-Steagall Act

The National Banking Act of 1864 allowed national banks to exercise “all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, . . . and other evidences of debt; by receiving deposits; . . . by loaning money on personal security.” After the enactment of that act, national banks were at a disadvantage with respect to trust companies and state-chartered banks because they could not offer trust services and their ability to offer securities services was very limited.³

The Federal Reserve Act of 1913 reduced that disadvantage by authorizing national banks to offer trust services through an in-house department, but their ability to offer investment banking services directly remained very limited until the enactment of the McFadden Act in 1927. Throughout that period, national banks were not allowed to invest in or deal in stocks. They were, however, allowed to invest in U.S. government obligations, and despite not being explicitly allowed to underwrite and deal in debt securities, other than those of the U.S. government, there is evidence that they did conduct these activities under the “incidental powers” clause. In 1927, with the McFadden Act, national banks were allowed to underwrite and deal in “investment securities” that evidenced the issuing party’s indebtedness and the OCC was given the authority to indicate the securities meeting that definition.

Most national banks entered the securities business by establishing an in-house department. But, as investment banking became more important, particularly in the years following World War I, and as competition from less regulated trust companies and state-chartered banks increased, they sought ways to compete with these institutions on an equal footing. They started developing separately capitalized

³For a detailed analysis of national banks’ securities powers, see Peach (1941). For a discussion of commercial banks’ trust and securities services prior to Glass-Steagall, see White (1984).

securities units. These units were generally chartered under state corporation laws rather than under state banking or trust company laws. As a result, banks could engage in any type of financial service not covered by banking and trust laws, and they could do so without being subject to capital regulation and supervision. In addition, they were free to operate offices throughout their home states and across state lines.

The ability of securities units to operate multiple offices was very attractive to both state and national banks, but particularly to the latter. At that time, state regulations prohibited state banks from branching across state lines and some states even limited intrastate branching. National banks' branching powers began to be defined only in 1927 with the McFadden Act.⁴ They were, however, made identical to those of the local banks in the states in which they were located only in 1933 with the Banking Act.

Securities units were generally operated so as to convey the impression that they were very close to their sponsor banks. Their names resembled these banks' names; their main offices tended to be located in the same building as their sponsors' main offices; they frequently benefited from advertising campaigns by their sponsor banks and received loans from them.⁵

Securities units were legally organized so that their sponsor banks controlled their capital. Banking firms generally chose one of the following three organizational forms to integrate their banks with their securities units. In the most common form, the bank's shareholders received a pro rata interest in the stock of the securities unit. Under this arrangement, the shares of the two entities typically were printed on the same certificate, making it impossible to transfer the shares of one entity without transferring the shares of the other. The second organizational form corresponds to the bank parent model. National banks could not promote this organizational structure because they did not have the power to own stock, but trust companies and state-

⁴The McFadden Act gave national banks the same right as local state banks to branch within the cities in which they were located. Soon after 1927, however, states began allowing state banks to branch beyond their home cities, thus putting national banks at a disadvantage. The Banking Act of 1933 ended this disadvantage. For a discussion of the branching regulations, see Pollard et al. (1988).

⁵Banks were not allowed to lend any single borrower, including their securities units, more than 10 percent of their capital, but on many occasions they went beyond this limit by developing chain units and lending the maximum to each unit. Section 23A of the Banking Act of 1933 closed that loophole by limiting loans to all affiliates to 20 percent of the bank's capital.

chartered banks could do so in some states. The third organizational form corresponds to the holding company model.

The number of national and state banks engaged in the securities business (directly or through separate units) increased steadily from 1923 to the end of the 1920s, at which time it started to decline (Table 2). Throughout the entire 1923–33 period, and particularly at the beginning of the 1920s, there were significantly more state banks offering securities services than national banks. However, because state banks then outnumbered national banks by more than two to one, the proportion of national banks engaged in the securities business was slightly higher than that of state banks.

Two aspects revealed by Table 2 are of particular relevance to the subject of this paper. First, throughout the entire 1923–33 period, there were always more banks (national and state) offering securities services through an in-house department than through a separate unit. With time, however, that difference decreased. Second, the proportion of state banks that chose to offer securities services through an in-house department was always significantly larger than the corresponding proportion of national banks, a difference that may be related to disparities in the securities powers and branching capabilities of these banks.

Table 2 also seems to indicate that the McFadden Act did not significantly affect the organizational structure preferred by banks to integrate banking with securities services. In the case of state banks, this is explained by the fact that the act had no direct influence on their securities and branching powers. The MacFadden Act did, however, increase the incentive for national banks to bring their securities operations into a department inside the bank because, as noted above, it clarified their securities powers and gave them branching capabilities similar to those of the state banks where they were located.⁶ Nonetheless, it is possible that these incentives were not strong enough to compensate national banks for the limitations that they continued to face when offering securities services in-house. For example, unlike state banks, national banks were still not allowed to underwrite and deal in equities in-house. They could, however, offer these services through separate securities units, which also had the advantage of being able to operate across state lines.

An alternative explanation is that banks preferred to offer securities services through separate units because of the advantages associated

⁶Peach (1941) and Mote and Kaufman (1989) argue that the McFadden Act mainly gave national banks legal coverage for the securities activities they were already conducting rather than giving them new securities powers.

TABLE 2
BANKS ENGAGED IN THE SECURITIES BUSINESS DURING THE 1923-33 PERIOD

Year	National Banks				State Banks			
	Engaged in the Securities Business				Engaged in the Securities Business			
	Total ^a	Total ^b	Directly ^c	Through sep. units ^c	Total ^a	Total ^b	Directly ^c	Through sep. units ^c
1923	8,179 (27.7)	95 (1.2)	78 (82.1)	17 (17.9)	21,326 (72.3)	219 (1.0)	210 (95.9)	9 (4.1)
1925	8,048 (28.5)	145 (1.8)	112 (77.2)	33 (22.8)	20,209 (71.5)	268 (1.3)	254 (94.8)	14 (5.2)
1927	7,759 (29.4)	181 (2.3)	121 (66.9)	60 (33.2)	18,657 (70.6)	312 (1.7)	290 (93.0)	22 (7.1)
1929	7,403 (30.1)	235 (3.2)	151 (64.3)	84 (35.7)	17,230 (69.9)	356 (2.1)	308 (86.5)	48 (13.5)
1931	6,368 (31.9)	237 (3.7)	123 (51.9)	114 (48.1)	13,602 (68.1)	288 (2.1)	230 (79.9)	58 (20.1)
1933	5,154 (34.3)	178 (3.5)	102 (57.3)	76 (42.7)	9,861 (65.7)	201 (2.0)	169 (84.1)	32 (15.9)

SOURCES: Board of Governors (1943: 16) for the total number of national and state banks; Peach (1941: 83) for all information on banks involved in the securities business. The total number of state banks includes state-chartered and mutual savings banks. The number of state banks involved in securities activities includes state-chartered banks, savings, and loan and trust companies.
^aFigures in parentheses indicate the percentage of all banks that had a national and a state charter respectively.
^bFigures in parentheses indicate the percentage of banks with the corresponding charter that were engaged in securities business.
^cFigures in parentheses indicate the percentages of banks with the corresponding charter that were engaged in securities business directly and through separate units respectively.

with corporate separateness. A complete explanation of the banks' choices would require, in addition to the number of banks and securities units engaged in securities services, data on the financial services offered by each of them and information on the organizational structure, including the operational separateness, that they adopted to operate the securities unit. Such data, however, are either very limited or nonexistent.⁷

The Glass-Steagall Act

The coincident involvement of banking conglomerates in the securities business with the securities market boom in the 1920s and the coincident wave of bank failures with the stock market collapse in 1929 led many to believe that securities activities were an important cause of the banking industry's collapse. This belief, along with accusations that banks had exploited conflicts of interest related to their securities activities, led to Congressional hearings, which culminated in the enactment of the Glass-Steagall Act.

Despite their influential role in passing the Glass-Steagall Act, the Pecora hearings provided no solid support for concluding either that securities activities were to be blamed for the bank failures or that the abuses revealed in some banks' practices were common to the industry.⁸ Instead, they relied on anecdotal evidence, most of it associated with the practices of two banking conglomerates, the National City Bank of New York and the Chase National Bank, and their securities units, the National City Company and the Chase Securities Corporation respectively.

The Banking Act of 1933 revoked the securities powers granted by the McFadden Act and severely restricted member banks' ability to engage directly in securities activities and to affiliate with entities that were primarily engaged in such activities. Sections 16, 20, 21, and 32 of the Banking Act became known as the Glass-Steagall Act. Section 16 limits national banks' investment banking activities to three areas: acting as agents, limited purchase for their own account of certain securities as defined by OCC regulations, and dealing in some govern-

⁷Two studies of the period before Glass-Steagall produce opposite results on the importance of legal separateness for reducing conflicts of interest. Puri (1996) finds that underwriting securities in-house did not lead to more conflicts of interest than doing so in a separate unit. Kroszner and Rajan (1997) find that underwriting securities in a separate unit was helpful in reducing conflicts of interest.

⁸For an analysis of the events that culminated in the enactment of Glass-Steagall, see Carosso (1970), Perkins (1971), and Benston (1990).

ment securities.⁹ Section 20 prohibits member banks from affiliating with entities that are “principally engaged” in investment banking activities. Section 21 makes it illegal for entities that are engaged in investment banking to accept deposits, except as permitted by Section 16.¹⁰ Finally, Section 32 prohibits interlocking directorates and certain other relationships between member banks and entities that are “principally engaged” in investment banking, except for the limited exemptions allowed by the Fed.¹¹

After the Glass-Steagall Act

The Bank Holding Company Act of 1956 and its subsequent amendments did not impose further restrictions on the permissible securities activities of banking conglomerates. They did, however, close a loophole in the Banking Act of 1933. According to the Banking Act, a BHC could not obtain permission from the Fed to vote the shares of a bank subsidiary unless it agreed to divest itself within five years of any interest in a company that was “engaged principally” in investment banking activities not allowed to banks (Pollard et al. 1988). Thus, as long as BHCs did not vote their bank-subsidary shares, they were not subject to the divestiture requirement. The BHC Act closed this loophole by prohibiting BHCs from owning shares in nonbank corporations other than those engaged in approved banking-related activities.¹² The Fed was given the authority to allow BHCs to engage in nonbanking activities other than those explicitly permitted.¹³

In the decades that followed the enactment of the Glass-Steagall Act, it appears that both commercial and investment banks were willing to accept the separation of the two industries. In the 1960s, however, both sides began attempting to expand their activities into

⁹For a summary of the securities in which national banks are allowed to invest for their own account, see Pollard et al. (1988). Section 16 restrictions were extended to state member banks by 12 USC Section 355.

¹⁰One implication of Section 21 was to extend the prohibitions of Section 16 to state nonmember banks. Note, however, that these banks were free to affiliate with investment banking firms.

¹¹The firewalls introduced by Section 32 to separate a bank from its nonbank affiliates were complemented with the firewalls introduced by Section 23A. This set of firewalls was further extended in 1987 by Section 23B of the Federal Reserve Act (Blair 1994, Walter 1996).

¹²The act created another loophole because it defined a BHC as “any company which directly or indirectly owns, controls, or holds with power to vote, 25 per centum or more of the voting shares of each of two or more banks.” The 1970 Amendment to the BHC Act extended that definition to companies that controlled one bank.

¹³The 1970 Amendment to the BHC Act required these activities to be “closely related to banking” and the benefits from their provision by BHCs to outweigh the expected costs of such provision to the economy.

each other's strongholds. These attempts put pressure on the regulatory agencies to change some of the regulations under their control. The Fed, for example, started allowing BHCs to conduct through their so-called Section 20 subsidiaries some "ineligible" activities, that is, activities prohibited to the banks themselves by Section 16 of the Glass-Steagall Act, such as underwriting commercial paper, municipal revenue bonds, and securities backed by mortgages and consumer receivables. To ensure that these subsidiaries were not "principally engaged" in the securities business and thus met Glass-Steagall's requirements, the Fed limited the revenue generated by "ineligible" activities to 5 percent of the subsidiary's total revenue and imposed a set of firewalls between them and the banks that were part of the same holding company. The revenue limit was then twice increased and it now stands at 25 percent. The set of permissible activities was also expanded to include other activities such as the underwriting of corporate bonds and equities, provided that some more stringent firewalls were set up.¹⁴

Like the Fed, the OCC also expanded national banks' securities powers over the years. It did so under the "incidental powers" clause of the Banking Act of 1864 and on the authority granted by Section 16 of the Glass-Steagall Act. More recently the OCC announced that it would consider national banks' applications to offer a wider range of securities services through their subsidiaries provided that they observe some conditions. They will have to be well capitalized, their equity investment in these subsidiaries may not count toward their capital requirements and their transactions with the subsidiaries will be subject to certain restrictions.

Finally, the FDIC ruled in 1984 that it would allow the banks it oversees, insured nonmember banks, to offer securities services, including underwriting and dealing in corporate securities, through a "bona fide" subsidiary. The subsidiary, however, would have to be distinct and physically separate from the parent bank, and its transactions with that bank would be subject to some restrictions. In 1987, the FDIC amended that regulation, easing the operational separation between the bank and its securities subsidiary (Pollard et al. 1988).¹⁵

The Location of the Securities Unit in the Conglomerate

This section discusses the potential impact of different locations of the securities unit in a banking conglomerate. It starts with an outline

¹⁴For a detailed list of the firewalls, see GAO (1995).

¹⁵For the list of firewalls that the FDIC demands from banks with "bona fide" subsidiaries, see GAO (1995).

of the potential advantages and disadvantages of corporate separateness and then compares the organizational models usually adopted to implement corporate separateness. The section ends with a discussion of whether the location of the securities unit in a banking conglomerate should be subject to regulation.

Advantages and Disadvantages of Corporate Separateness

Corporate separateness is determined by legal separateness and by operational separateness. Legal separateness leads to the development of separately capitalized units in the conglomerate. Each unit usually has its own management team and its own accounting records and it offers its own products. Furthermore, limited liability protects each unit's shareholders from losses in the event of failure of any other unit of the conglomerate. Operational separateness limits the joint management of the separate units that are part of a conglomerate. It usually results from restrictions on the exchange of information, personnel, or other inputs among the different units.

With respect to banking conglomerates, corporate separateness between banking and securities units is frequently believed to be a source of important advantages. First, because it insulates banks (and through this the safety net and the taxpayers) from the risks in their conglomerates' securities activities. This advantage stems from the perception that securities activities are riskier than traditional banking. Therefore, if banks were to engage in securities activities through an in-house department, they would increase their risk of failure and, consequently, expand the liabilities of the safety net.

Second, because it limits the competitive advantage resulting from the subsidy said to benefit the institutions with access to the safety net. Accordingly, if banks were allowed to offer securities services in-house, the safety net coverage would be extended to these activities and banks would have a competitive advantage over securities firms because they would be able to cross-subsidize their securities operations.

Third, because it reduces potential conflicts of interest that can emerge with the simultaneous provision of banking and securities services. Separateness makes it possible to implement mechanisms, such as compensation schemes for each unit's management team, aimed at reducing the incentives to exploit conflicts (Saunders 1985), and it permits the introduction of firewalls explicitly designed to limit management's ability to exploit conflicts.

Finally, corporate separateness is said to be beneficial because it facilitates the regulation and supervision of banking conglomerates. Requiring banking and securities activities to be conducted by separate

units keeps each of these units simpler and thus easier to supervise, and it facilitates the adoption of functional regulations, considered to be easier to implement than institutional regulations (Herring and Santomero 1990). Furthermore, it allows banks to be regulated differently from securities firms, which is said to be important because of differences in the types of risk faced by the two entities and because it levels the playing field in a system where banking conglomerates coexist with independent securities firms (Ferrarini 1995).

Despite all these potential advantages, corporate separateness continues to be questioned largely because the market generally does not perceive the units of a conglomerate to be independent, even though they are legally and operationally separated from each other. Several reasons are usually cited to justify the market's perception. First, there are strong incentives to manage a conglomerate as an integrated entity (in order, for example, to exploit scope economies) rather than as a portfolio of independent firms.¹⁶

Second, conglomerates have an incentive to protect their member units from bankruptcy, even if it is necessary for them to go beyond their equity investment in the financially distressed unit.¹⁷ This incentive results from the conglomerate's interest, for example, in protecting the market's assessment of it, in preserving the reputation of its management (Wall 1984), and in shielding the other units from any potential contagion effects resulting from the failure of a member unit.

Third, the market may not view the units in a conglomerate as being independent of each other because the courts may "pierce the corporate veil." Limited liability does not generally give the creditors of one unit a claim on the assets of another, legally separated unit of the conglomerate. However, there are exceptions to this rule. For example, in a banking conglomerate, if the securities unit misled its creditors into thinking that they were dealing with the bank, then under certain circumstances the courts may hold the bank liable for the debts of the securities unit.¹⁸

Finally, the market may perceive the units of a conglomerate as not being independent if the conglomerate places more emphasis on its consolidated accounts than on the separate accounts of its units. That perception may also result from the practices of the regulatory

¹⁶Studies of the management of BHCs in the United States generally yield examples of policies that are centralized at the holding company level (see Cornyn et al. 1986).

¹⁷For examples of BHCs helping financially troubled nonbanking units, see FDIC (1987) and Cornyn et al. (1986).

¹⁸For other circumstances that can lead courts to "pierce the corporate veil," see Black, Miller, and Posner (1978) and Thompson (1991).

agencies in charge of overseeing the banks that are part of conglomerates, particularly if they choose to oversee the financial affairs of the nonbanking units in the conglomerate and those of the entire conglomerate.

Besides being questioned on all these grounds, corporate separateness is also blamed for some problems. First, because it forces the adoption of a more expensive organizational structure (firms must develop and operate an additional separate unit) and because it reduces the scope economies, particularly those on the production side.

Second, because it increases the agency problems arising from the separation of ownership from control. These problems are frequently associated with differences between shareholders' objectives and managers' objectives. Corporate separateness is prone to increase such problems, because it separates control and introduces one additional management team in the conglomerate.

Third, because it may be the source of conflicts of interest. For example, if the banking unit's capital and the securities unit's capital are not owned ratably by the same shareholders, then there will be opportunities, such as through the transference of assets between the two units, to favor one group of shareholders at the expense of the other (Edwards 1979, Saunders 1985).

Finally, corporate separateness is also blamed for giving conglomerates an incentive to move some operations from banks to securities units, leading to a reduction in banks' asset base. The conglomerate may find it advantageous to move some activities which may be profitable and of a low-risk nature from the bank to the securities unit because, for example, of differences in the regulation and supervision of its banking and securities units (Eisenbeis 1983).¹⁹

The Bank Parent Model versus the Holding Company Model

Some of the advantages and disadvantages of corporate separateness, such as the potential reduction in conflicts of interest that may emerge from the combination of commercial and investment banking, the ability to implement functional regulations and the reduction in scope economies, do not seem to be greatly affected by the conglomerate model adopted to implement the separation. Others, however, do appear to be dependent on that model.

¹⁹The "ineligible" activities revenue limit has given BHCs an incentive to move "eligible" activities from their banking subsidiaries to their securities subsidiaries in order to create a base of eligible revenue.

The bank parent model and the holding company model remain the two organizational structures most frequently used to separate banks from securities units within conglomerates. As discussed above, the critical differences between these models derive from the fact that in the former there is a direct relationship between the bank and the securities unit (this unit's capital is an investment of the bank) while in the latter the relationship is only indirect (the securities unit's capital is an investment of the holding company). As a result of that difference, it is usually argued that the holding company model performs better than the bank parent model in the following respects. It provides a better insulation for the bank from problems that may emerge in the securities unit and it gives the bank less incentive to bail out the securities unit, since it is a sister affiliate rather than a directly owned subsidiary. In addition, the model is praised for facilitating the resolution of a bank failure because the capital of the securities unit is an asset of the holding company, not of the bank. As a consequence, if the bank becomes insolvent, such assets need not be considered in the failure resolution procedure.

In other respects, however, it is argued that the bank parent model performs better than the holding company model. It is less expensive to develop and operate because it does not require an additional company, the holding company. It gives the bank more control over the profits of the securities unit because these can leave the conglomerate as profits only through the bank, while in the holding company model they can sidestep the bank and leave through the holding company. In addition, it increases the pool of assets that bank creditors can claim in case the bank gets into financial trouble, thus reducing the bank's incentive to move assets to the securities unit in order to shield them from its creditors. Bank creditors can claim the investment in the securities unit if the conglomerate is organized on the bank parent model, but they cannot do so if the conglomerate is organized on the holding company model.²⁰

A final subject of debate on how the holding company model compares to the bank parent model relates to banks' ability to transfer the subsidy they are said to receive from having access to the safety net to the securities units in their conglomerates. Leaving aside the

²⁰Regulators in the United States have tried to replicate that claim structure in the holding company model through the "source of strength" doctrine, but it remains unclear whether that doctrine can be legally enforced. The first attempt to apply it was not successful. It happened in 1987, when Hawkeye Bancorporation refused to comply with the Federal Reserve's order to inject \$1.2 million in capital into a failing bank subsidiary. The Fed reacted to the refusal by charging Hawkeye with unsafe and unsound practices, but subsequently withdrew that complaint (FDIC 1987).

question of whether such a subsidy exists and how large it is, there are at least three important channels that banks could use to transfer it to the securities units.²¹ First, banks can transfer the subsidy through credit extensions or the exchange of information or the purchase of assets and services from the securities units in their conglomerates on terms that favor these units. Given that banks' transactions with the securities units in their conglomerates can be regulated in the same way irrespective of whether the organizational structure follows the bank parent model or the holding company model, there seems to be no significant difference between the two models with regard to banks' ability to transfer the subsidy through that channel.

Second, banks can transfer the subsidy through capital infusions into the securities units on terms that favor the latter. In the holding company model, it is difficult for banks to use that channel. The capital of the securities unit is an investment of the holding company and not of the bank and there are restrictions on the dividends that a bank can pay to its holding company. In the bank parent model, the ability to use that channel can also be blocked by requiring that the bank's investment in its securities subsidiary be subtracted from the bank's capital for the purposes of meeting the prudential capital requirements.

The last important channel through which the safety net subsidy can be transferred to securities units relates to the market's perception of the relationship between these units and the banks in the conglomerates. The stronger the perception that these are integrated organizations rather than portfolios of independent firms, the higher the chances that the subsidy will be transferred. That perception depends on some factors that affect both organizational models equally, such as the practices of supervisory agencies. It also depends on other factors that vary with the model, namely, how close the bank is to the securities unit in its conglomerate. As discussed above, the direct relationship between the bank and the securities subsidiary that exists in a bank parent model may lead to a stronger market perception of integration than that associated with the holding company model, where the relationship between the two units is only indirect. If that is the case, then the likelihood of a transfer of the subsidy through that channel may be higher under a bank parent model than under a bank holding company model.

²¹For a discussion of the safety net subsidy, see Whalen (1996), Helfer (1997), and Greenspan (1997).

Should the Location of the Securities Unit Be Regulated?

Economic theory suggests that in the absence of imperfections, such as asymmetries of information, and in the absence of other distortions, such as regulations, the “invisible hand” of the market will promote the most efficient organizations. Deviations from that setting, however, may lead to the development and survival of the “fattest” rather than the “fittest” organizations. For this reason, the burden of proof should be on those who propose restrictions that will interfere with the normal functioning of market forces.

In making the decision about whether to regulate the location of the securities unit within a banking conglomerate, one needs to consider the reasons why banks exist (the provision of liquidity and the performance of monitoring services); the problems associated with these intermediaries (being subject to runs); the devices most frequently adopted to address these problems (the safety net); and the impact of such regulation on the potential advantages and disadvantages of combining commercial with investment banking (scope economies, risk considerations, and conflicts of interest).

Were it not for the distortions arising from the safety net, in a competitive market a bank would choose the most appropriate conglomerate model to integrate traditional commercial banking activities with securities services by comparing the advantages and disadvantages of offering securities services in-house with those resulting from offering them through a separately capitalized unit. Because these effects vary with the securities activities and with factors intrinsic to each bank (such as reputation), some banks would offer their securities services through an in-house department and others would choose to conduct the securities business in a separate unit, under either a bank parent model or a holding company model. Under these circumstances there does not seem to be any fundamental justification for limiting the bank’s choice of where to locate its securities operations.

Do the distortions created by the safety net justify a regulation requiring securities activities to be housed outside the bank? The arguments reviewed here, together with evidence on the predominant conglomerate models used outside the United States, make a compelling case for answering that question with a qualified “no.” Correcting the distortions at their source (for example, ending the too-big-to-fail policy, requiring market-value accounting, introducing more risk-sensitive insurance premiums and capital requirements and adopting a prompt corrective action procedure) and allowing banks to choose the conglomerate model they find most efficient appears to be a more appropriate policy than maintaining the distortions from the safety

net and using them to justify the introduction of another layer of distortions, such as those that would result from a regulation requiring corporate separateness.

That proposal would give banks the opportunity to explore the advantages of the various organizational models which, judging from the diversity of their choices elsewhere and in the United States before Glass-Steagall, they seem to value. The alternative of leaving the distortions of the safety net in place and relying on corporate separateness to confine the problems they cause limits the synergies of combining the two activities and gives banks an insulation that is more apparent than real.

A regulation requiring corporate separateness limits the choices of all banks alike, regardless of pertinent factors that are specific to each bank and that influence their risk-taking incentives. In addition, such a regulation introduces costs, some of which increase with the degree of separateness imposed. Given that corporate separateness is the relevant concept, not legal separateness per se, this creates a dilemma. The stronger the separateness imposed, the stronger the insulation it provides the banking unit but the greater the associated costs. At the very extreme, if absolute separateness is imposed, nothing is to be gained from allowing the combination of activities. The dilemma is further complicated by the limitations of corporate separateness, particularly those resulting from the fragility of the firewalls when they are most needed, that is, in conditions of financial distress.

If, despite these problems, regulators still choose to demand separateness, the question that then arises is whether there are any reasons to justify a regulation requiring either the holding company model or the bank parent model?⁹ This is the question at the center of the ongoing debate among the three U.S. banking regulatory agencies. They all support corporate separateness, but while the FDIC and the OCC propose a regulation that gives banks the opportunity to choose between the two conglomerate models, the Fed proposes one that requires them to adopt the holding company model.

Given that neither of these models completely dominates the other, and given that it is possible to design provisions which force each of them to mimic the other with respect to most of the relevant dimensions, there does not appear to be a strong justification for requiring one rather than the other. To force banking conglomerates to adopt either of these two models would be to restrict their choices even further, thus exacerbating some of the problems introduced by separateness, and to introduce a regulatory framework that already lags behind the market, thus limiting banks' ability to compete with other intermediaries that are evolving in the financial markets.

Conclusion

One issue that has been raised in connection with the introduction of a regulation allowing banks to choose between the bank parent model and the holding company model has to do with its potential impact on the portion of the banking industry that each agency supervises and regulates. This issue has emerged because the United States has multiple regulatory agencies, each with different powers and responsibilities. Currently, the OCC charters, supervises, and regulates national banks. The FDIC insures deposits at commercial banks, manages the assets and liabilities of insolvent banks, and supervises and regulates state-chartered banks that are not members of the Federal Reserve System. The Fed supervises and regulates state-chartered member banks as well as BHCs and their nonbank subsidiaries.²² The Fed is also responsible for providing discount-window loans to depository institutions, for overseeing the payment system, and for conducting monetary policy.

The differences in the regulatory agencies' current powers have led many to argue that if banks were given the opportunity to choose between the bank parent model and the holding company model, many would choose the former and this would reduce the share of the banking industry that the Fed oversees to levels that would impair the central bank's ability to fulfill its responsibilities. The Fed, for example, has claimed that it needs a "significant and important role as a bank supervisor" in order to maintain its ability to "manage crises, assure an efficient and safe payment system, and conduct monetary policy" (Greenspan 1997).

The need for the central bank to play a significant regulatory and supervisory role remains an unsettled issue, which has been discussed elsewhere (see Goodhart and Schoenmaker 1993, Haubrich 1996). Assuming, however, that the central bank does need to oversee a certain segment of the banking industry, this creates a problem in systems where the central bank competes with other banking regulatory agencies. The problem is that with free competition among the regulatory agencies there is no guarantee that any of them will be able to retain a certain market share, much less that they will oversee a particular segment of the banking industry. It will therefore be necessary to interfere in that competition in order to guarantee that the central bank maintains the desirable supervisory role. The question then becomes: how can that objective be best achieved?

²²In addition, the Fed supervises the international activities of U.S. banks and BHCs, and the operations of foreign banks in the United States.

The supervisory authority of any regulatory agency can be changed by altering its charter. Attempting to maintain an agency's supervisory role through indirect means, such as by requiring banks to adopt a particular conglomerate model just because that agency has the authority to oversee that model, limits competition among agencies and may introduce important distortions. The introduction of a regulation requiring banks to adopt the holding company model if they want to enter the securities business would guarantee the Fed's supervisory authority but would limit both banks' choices and the competition among regulatory agencies. A more appropriate alternative would be to combine a regulation that does not limit banks' choices with regard to organizational model with a change in the regulatory agencies' supervisory authority in such a way as to guarantee the Fed's supervisory role. Like the first proposal, this would limit competition among the agencies, but it has the advantage of allowing banks to choose between the bank parent model and the holding company model.

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