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SECURITIES ACTIVITIES IN BANKING CONGLOMERATES: SHOULD THEIR LOCATION BE REGULATED?

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ABSTRACT

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 securities units' predominant location in the G–10 countries and in the United States before the Glass–Steagall Act. The paper argues that correcting the safety net's distortions and allowing banks to choose where to locate their securities units is a better alternative than retaining such distortions and relying on corporate separateness to limit the problems they may create. Separateness imposes costs and provides banks with insulation that is more apparent than real. However, if authorities opt for requiring separateness, a regulation allowing banks to choose between the bank-parent model and the holding-company model seems more appropriate than a regulation requiring them to adopt either one of these models.

1 Introduction

The separation between commercial and investment banking has been a distinct feature of the American financial system for decades. In 1933, reacting to the wave of bank failures that followed the Great Depression, Congress passed the Glass–Steagall Act, which separated the two industries. For 30 years, firms on both sides seemed to lack the incentive (or the ability) to explore some of the gray areas of that legislation. Since the 1960s, however, commercial banks and securities firms have tried to expand their activities into each other's strongholds. These attempts, in conjunction with a more flexible interpretation of the existing legislation by the regulatory agencies and the courts, contributed to a gradual erosion of the separating barriers.

Currently, the 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 such barriers further, provided that securities activities are housed in a separately incorporated and 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 prefer a regulation that allows banks to choose between the bank-parent model, in which securities activities are offered by a subsidiary of the bank, and the holding-company model, in which such activities are offered by a subsidiary of the holding company that also owns the bank. The Fed has expressed its preference for a regulation requiring the holding-company model.

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 should be subject to regulation. This debate has focused on two general issues one related to the economic implications of different locations for securities units, the other related to how each of these locations would affect regulatory agencies' banking constituencies, that is, how it would affect the portion of the banking industry that each agency oversees.

This paper addresses the first of these issues. It reviews the arguments as to whether the location of the securities unit in a banking conglomerate should be subject to regulation, taking into account 1) why commercial banks exist, 2) the problems associated with these institutions and the devices adopted to address them, and 3) the potential effects of combining commercial and investment banking. This review is complemented with evidence on the regulations and on the predominant banking conglomerate models in the G–10 countries and in the United States before the Glass–Steagall era.

The paper proceeds as follows: Section 2 briefly presents the potential benefits and costs that could result from combining commercial banking with securities services. Section 3 describes the alternative conglomerate models that can be adopted to integrate both activities. Sections 4 and 5 present evidence on the regulations and predominant banking conglomerate models in the G–10 countries and in the United States before the Glass–Steagall Act, respectively. Section 6 discusses the most important advantages and disadvantages of the different conglomerate models, and section 7 concludes the paper.

2 Commercial Banks in the Securities Business

In a Arrow–Debreu world, financial intermediaries are not necessary except for reducing transaction costs. The presence of moral hazard and adverse selection problems, however, creates a role for financial intermediaries. They can improve resource allocation, for example, by offering liquidity services (transforming illiquid assets into liquid liabilities) or by providing monitoring services (acting as delegated monitors of investors).[1]

Within that setup, it is conjectured that the main gains from combining commercial banking with securities activities result from the enhancement of the bank/firm relationship made possible by such a combination and from economies of scope in the production and consumption of financial services. It is also conjectured that such a combination may create

[1]For an extensive review of the banking literature see, for example, Bhattacharya and Thakor (1993).

conflicts of interest and threaten the safety and soundness of the banking system.[2]

2.1 Potential Benefits of Combination

Firms generally have information about their investment opportunities that is not readily available to outsiders. In this case, important savings can be achieved by delegating certain functions to financial intermediaries. The costs of financial intermediation are reduced by avoiding duplication of such functions as gathering relevant information before making the funding decision and monitoring borrowers' actions once they have received the funds to undertake their investment projects.

Under these circumstances, it is usually believed that an institution that offers both commercial banking and securities services can develop a "wider" and "lengthier" relationship with firms than can a specialized bank. This enhancement of the bank-firm relationship may be a source of important gains to both parties.

Increasing the number of contact points between a bank and a firm gives the bank more instruments to consider in the design of financing contracts. It makes it easier for the bank to gather information and monitor the borrowing firm, and allows usage of that information 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 length of the bank-firm relationship is also important. Young firms generally obtain most of their funding from banks, but as they mature, they often divert 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 funding needs throughout a firm's existence. This fosters a long-term relationship that can provide significant gains to both parties. If the bank and the firm expect to be doing business for a long time, then the bank is more willing to invest in gathering information about this firm

[2]For a review of these issues see, for example, Santos (1996).

and it can spread the costs of such an investment over a longer time horizon, reducing the firm's up-front capital cost.

In sum, there seem to be important information advantages associated with offering commercial and investment banking activities jointly. Empirical research on these issues is still in its early stages. However, the results already available seem to confirm that enhancement of the bank-firm relationship is a source of significant benefits in cost and availability of funding.[3]

Another potential advantage of combining commercial banking with securities activities is economies of scope, which arise in production when inputs are shared or used jointly. Several reasons are frequently given as to why the combination of commercial and investment banking may be the source of scope economies. They include 1) the ability to spread the fixed cost (in terms of physical and human capital) of managing a client relationship over a wider set of products, 2) the possibility of using the branch network to distribute additional products at a low marginal cost, and 3) the ability to face shifts in the demand for products more easily because of the possibility of shifting resources internally.

Economies of scope could also emerge 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.

From a theoretical point of view, there seem to exist a significant number of 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 stronger evidence of these economies.[4]

[3]Petersen and Rajan (1994) and Berger and Udell (1995) find empirical support for the claim that bank-firm relationships are valuable.

[4]For a survey of the empirical research on scope economies see, for example, Mudur (1992), Forestieri (1993), and Berger, Hunter, and Timme (1993).

2.2 Potential Costs of Combination

When commercial banking was legally separated from investment banking by Glass–Steagall 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 are still invoked by those who favor maintaining that separation.

Conflicts of interest associated with that combination of activities are said to emerge for several reason. These include 1) the combination of the bank's advisory role to depositors and its promotional role in the investment arena, 2) the possibility that the bank could impose tie-in deals by coercing current borrowers to buy its underwriting services or have their credit rationed, and 3) the bank's ability to transfer bankruptcy risk to investors by entering into deals whereby it underwrites securities issued by an insolvent borrower in order to rescue a bad loan.[5]

The critical issue regarding any potential conflict of interest is 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 are competition in financial markets, the requirement to release information, and consumers' expected behavior. If firms perceive that they may be forced into tie-in deals, they can protect themselves by maintaining relationships with several banks. If investors believe that a bank is "infected" by conflicts of interest, they can apply a discount to the securities underwritten by the bank.[6]

Another frequently cited problem with combining commercial banking and securities activities relates to the safety and soundness of banks. Negative externalities that may

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

[6]Empirical research on banking conglomerates' securities activities prior to Glass–Steagall failed to find evidence that banks systematically exploited conflicts of interest (Kroszner and Rajan [1994], Ang and Richardson [1994], and Puri [1994, 1996]). An identical conclusion was reached by Gande, Puri, Saunders, and Walter (1996) when studying Section 20s' securities activities in recent years.

result from a bank failure continue to be used as a major justification for making bank soundness the subject of regulation. It is often argued that the failure of a bank, particularly a big one, may spread domino-fashion, forcing other banks (solvent and insolvent) into bankruptcy and creating a system failure. A bank may fail because of insolvency (it may not be able to completely diversify the risk of its assets) or because of a run on its deposits (the provision of liquidity services leaves the bank susceptible to runs). In most countries, the desire to protect banks from runs, and thus reduce the risk of a system failure, led to the development of safety nets.[7] However, because of their design and/or because of the way they are operated, these mechanisms create problems of their own. Most notably, they give banks an incentive to take excessive risks and they reduce depositors' incentives to monitor banks.[8] These problems, in turn, have been used to justify introducing a wide range of regulations aimed at limiting banks' incentives and opportunities to undertake too much risk. These include capital regulation as well as restrictions on banks' permitted activities, such as the U.S. prohibition against commercial banks' entering the securities business.

Without the distortions created by the safety net, it seems difficult to argue that banks should be barred from activities such as underwriting corporate securities, because of risk considerations alone. It appears that the securities business would give banks an additional opportunity to diversify, that is, an opportunity to create an alternative source of revenue for periods of disintermediation (when firms sidestep banks and obtain funding directly from capital markets). The question thus becomes whether the moral hazard introduced by the safety net justifies a regulation prohibiting banks from entering the securities business.

Some argue that banks should not be allowed into the securities business because this would give them additional instruments to pursue risk-shifting policies. Others go even

[7]Safety nets usually include a deposit insurance system, discount window facilities, and a payment system.

[8]Schwartz (1992) discusses the problems associated with the discount window, while Kareken and Wallace (1978), Merton (1977, 1978), and Dothan and Williams (1980), among others, analyze deposit insurance's risk-shifting incentives.

further, arguing that banks should be allowed to invest only in risk-free assets. In opposition are those who maintain that measures aimed at reducing the source of the moral hazard *directly* provide a more appropriate avenue to address the problems that it creates. In their view, prohibiting banks' securities services does nothing to mitigate moral hazard, yet it eliminates the possibility of exploiting the synergies that result from mixing commercial and investment banking.[9]

3 Alternative Forms of Integration

The potential benefits and costs of allowing banking conglomerates to offer securities services depend to a large extent on these organizations' freedom to integrate such services with their current businesses. This integration is greatly influenced by the conglomerate model they 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.

3.1 Universal Banking Model

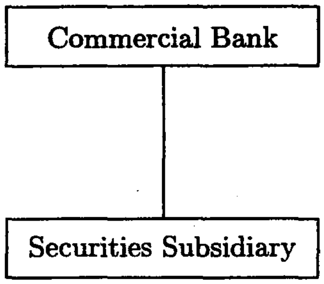
Commercial Banking Activities	Securities Activities

A distinct feature of the universal banking model is that both commercial banking and securities activities are conducted within a single corporate entity. As a result, the complete

[9]Empirical research finds no evidence that securities activities were responsible for the bank failures that occurred before the Glass–Steagall Act. For the period after the Act's passage, many studies have attempted to evaluate the risk effects to banks and BHCs of expansion into securities activities. The results are mixed, but on balance they appear to disprove the idea that the securities business is highly risky for banks. For a review of this literature see, for example, Brewer, Fortier, and Pavel (1989) and Benston (1990).

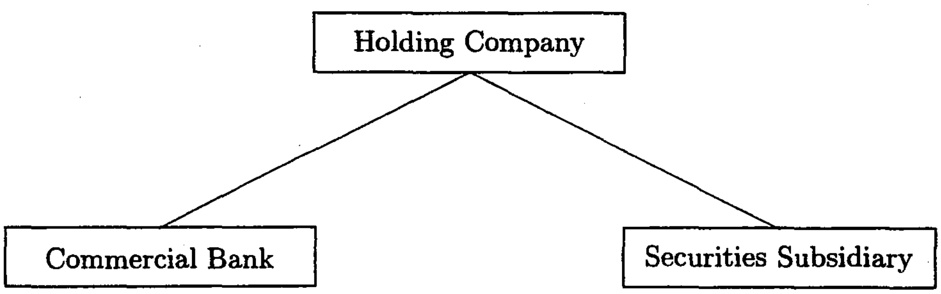
integration of these activities can be achieved at the lowest cost. Resources can be shared among the organization's various departments with maximum flexibility. This integration, however, may be reduced either because of existing regulations or because of management's decision to introduce some operational separateness, that is, to separate by firewalls certain departments within the conglomerate.

3.2 Bank-Parent Model



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, so if the subsidiary fails, limited liability confines the bank's loss to its investment in the subsidiary. Legal separateness also introduces some operational separateness. As a result, integration of the two activities can be only partially achieved. It may be further limited, as in the universal-banking model, either because of existing regulations or because of management's decision to separate both units operationally.

3.3 Holding-Company Model



In this model, a holding company owns both the bank and the securities subsidiary. As in the previous model, legal separation exists between the two units, thus limiting the integration of commercial banking with securities activities. The critical difference between that model and the holding-company model is that in the latter the securities subsidiary's capital—and everything else associated with its ownership—is owned by the holding company, while in the former it is owned by the bank itself. As a result, in the holding-company setup the relationship between the bank and the securities subsidiary is only indirect, while in the bank-parent setup it is direct.

4 International Evidence

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, conveys important insights on the different models. Table 1 presents this information for the G–10 countries. It puts three important results in evidence.[10] First, none of the G–10 countries has regulations completely separating commercial banking from the securities business.

Second, a large majority of such countries allow banks to engage directly in securities underwriting, dealing, and brokering. The most restrictive regulations on the securities unit location are found in the United States, followed closely by Japan and then Canada. Of the remaining countries, banks in Belgium and Italy are required to use an outside unit for securities dealing and brokering in stock exchanges, and in France, for securities brokering.

Third, in countries where banking firms have more latitude to choose where to locate

[10]Due to the level of aggregation and the details that are specific to each country, table 1 should be seen as a synopsis of the information it contains. It should also be taken into account that changes may have occurred since the time the sources to that table were elaborated. Despite this, when the comparison is possible the information contained in that table generally accords with that presented by the most recent study on this topic, Barth, Nolle, and Rice (1997).

the securities unit in the conglomerate, most of the time they choose to locate it in a department of the bank, that is, they adopt the universal banking model. When they choose to implement corporate separateness, they prefer to offer securities services through one of their subsidiaries, that is, they adopt the bank-parent model. The United States is the only country where the holding-company model is the predominant vehicle adopted to integrate commercial banking with securities activities.

Table 1	Banks' Securities Activities in the G–10 Countries: Evidence on Banking Conglomerates			
Country	Permitted by Regulation[a]			Predominant Model[b]
	Underwriting	Dealing	Brokering	
Belgium	Bank	Bank[c]	Bank[c]	Bank-Parent Model
Canada[d]	Subsidiary	Subsidiary	Subsidiary	Bank-Parent Model
France	Bank	Bank	Subsidiary	Universal Banking Model
Germany	Bank	Bank	Bank	Universal Banking Model
Italy	Bank	Bank[c]	Bank[c]	Universal Banking Model
Japan[e]	Subsidiary	Subsidiary	Subsidiary	Bank-Parent Model
Netherlands	Bank	Bank	Bank	Universal Banking Model
Sweden	Bank	Bank	Bank	Bank-Parent Model
Switzerland	Bank	Bank	Bank	Universal Banking Model
UK	Bank	Bank	Bank	Bank-Parent Model
US[f]	Affiliate	Affiliate	Bank	Holding-Company Model

[a] Source: Koguchi (1993).
[b] Source: Cumming and Sweet (1987), Edwards and Fischer (1994), Kilgus (1996), and Hoshi (1996).
[c] For securities dealing and brokering, a subsidiary is required for transactions in stock exchanges.
[d] Banks may provide a limited number of these activities directly.
[e] Banks' securities subsidiaries are not allowed to engage in underwriting, dealing, and brokering in equities.
[f] The information contained here pertains to state-chartered member banks. These banks are allowed to offer underwriting and dealing services through a subsidiary of the bank's holding company on a limited basis. National banks and state-chartered nonmember banks are allowed to offer certain securities services through subsidiaries owned by them. See next section for a detailed presentation of the U.S. regulations.

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' choices of the securities' unit location in the conglomerate. Second, if there are market imperfections, a certain conglomerate model may predominate, not because it is the most efficient way to integrate particular activities but because it is, for example, the best organizational structure to extract rents.

5 Banks' Securities Activities in the United States

Throughout American history, the conglomerate models that banks have chosen for integrating commercial banking with securities activities have been greatly influenced by regulations.[11] Among these regulations, the most influential appear to have been the National Banking Act of 1864 and the Glass–Steagall Act enacted in 1933.

5.1 Before the Glass–Steagall Act

According to the National Banking Act of 1864, national banks were allowed to exercise ".... all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; .... by loaning money on personal security; ...."[12] After the passage of this Act, national banks were at a disadvantage with respect to their main competitors—trust companies and state-chartered banks—because they could not offer trust services and their ability to offer securities services was very limited.[13] The Federal Reserve Act of 1913 reduced that disadvantage by authorizing national banks to offer trust services through an in-house department. Their ability to offer investment banking services directly, however, remained very limited until the enactment of the McFadden Act in 1927.

National banks were never allowed to invest in or deal in stocks. They were, how-

[11]For a history of investment banking in the United States see, for example, Carosso (1970).

[12]See Blair (1994) for a detailed presentation of some regulations on bank powers.

[13]White (1984) discusses commercial banks' trust and securities services prior to Glass–Steagall.

ever, always allowed to invest in and distribute U.S. government obligations. Favorable court decisions open the way for them to deal in these obligations and invest in bonds, notes, debentures, and other evidences of debt of municipalities and corporations.[14] Despite not being explicitly allowed to underwrite and deal in debt securities, other than those of the U.S. government, there is evidence that national banks did perform these services for a number of years under the "incidental powers" clause. In 1927, Congress established, through the McFadden Act, that national banks were allowed to underwrite and deal in "investment securities" that evidence the issuing party's indebtedness and gave the OCC the responsibility of further defining the securities matching that classification.

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. As when they entered the trust business, national banks started developing separately capitalized and incorporated securities units. These units were generally chartered under a state's corporation laws rather than under state banking or trust company laws. As a result, they could engage in any type of financial services not covered by banking and trust laws, and they could do so without being subject to capital regulations and supervision. In addition, they were free to operate offices throughout their home states and across state lines.

Securities units' ability to operate multiple offices was very attractive to both state and national banks, but especially for the latter group. At that time, state regulations prohibited state banks from branching across state lines; some states even limited intrastate branching. National banks' branching powers started to be defined in 1927 with the McFadden Act, but only with the Banking Act of 1933 were their powers made identical to those of the

[14]For a detailed analysis of national banks' securities powers see, for example, Peach (1941).

local banks in the states where they were located.[15]

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'; 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.[16]

Securities units were legally organized so that either their capital was controlled or owned by their sponsor banks, or else it was owned proportionally by their sponsor banks' shareholders. Banks generally chose one the following three organizational forms to integrate their activities with securities services. In the first and 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 form corresponds to the bank-parent model, that is, the capital of the securities unit was owned by the bank. Note that, as mentioned above, national banks could not promote this organizational structure because they did not have the power to own stock directly. Trust companies and state chartered banks, however, could do so in some states. The third form corresponds to the holding-company model. In this case, a holding company owned the securities unit and the bank simultaneously.

The number of national banks and state banks engaged in the securities business (directly and through separate units) increased steadily from 1923 to the end of the 20s, at

[15]The McFadden Act gave national banks the same right as local state banks to branch within the cities where 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 ended this disadvantage. For a discussion of branching regulations see Pollard, Passaic, Ellis, and Daly (1988).

[16]Banks 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, passed in 1933, closed this loophole by limiting loans to all affiliates to 20 percent of the bank's capital.

which time their numbers started declining (table 2). Throughout the entire 1923–33 period and particularly at the beginning of the 1920s, there were significantly more state banks engaged in the securities business 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 the state banks.

Table 2 The Number of National, State Banks, and the Number of these Banks Engaged (Directly or through Separate Units) in the Securities Business[a]

Year	National Banks				State Banks			
	Total[b]	Engaged in the Securities Business			Total[b]	Engaged in the Securities Business		
		Total[c]	Directly[d]	Through Sep. Units[d]		Total[c]	Directly[d]	Through Sep. Units[d]
1923	8,179 (27.8)	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 (72.1)	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 (71.1)	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 (70.0)	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)

[a] Sources: Banking and Monetary Statistics (1943, p. 16) for the total number of national and state banks. Peach (1941, p. 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.
[b] Numbers in parentheses in these columns indicate the percentage of total banks that had a national and state charter, respectively.
[c] Numbers in parentheses in these columns indicate the percentage of total banks with the corresponding charter that were engaged in securities business.
[d] Numbers in parentheses in these columns indicate the percentages of the total banks with the corresponding charter that were engaged in securities business directly and through separate units, respectively.

Two aspects put in evidence by table 2 have particular importance for the subject of the current 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, that is, the majority of banks preferred to integrate commercial banking with securities business using the universal banking model. In time, however, that preference 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 appears 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 lack of any direct influence by that act on these banks' securities and branching powers. The McFadden Act, however, gave national banks a potential incentive to bring their securities operations to a department inside the bank. As stated above, this act clarified national banks' securities powers and gave them branching capabilities similar to those of the state banks where they were located.[17] 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 activities 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. This, together with a significant increase in corporate equities issues (Kroszner, 1996) in 1927 and in the years immediately following, gave national banks an important incentive to continue offering securities services through separate units.

It is possible, on the other hand, that banks preferred to offer securities services through separate units because of the advantages associated with corporate separateness (see the next section for a discussion of these issues).[18]

[17]Peach (1941) and Mote and Kaufman (1989), among others, argue that the McFadden Act mainly gave national banks legal coverage for the securities activities they were already offering, rather than giving them new securities powers.

[18]Empirical research on conglomerate models is very limited. Two studies of the period before Glass–Steagall produce opposite results. Kroszner and Rajan (1995) conclude that underwriting securities in a

The data available for that period do not permit a complete explanation of the banks' choices. The information contained in the number of state banks, national banks, and securities units engaged in securities services would be greatly improved if it could be matched with detailed data on the financial services offered by each entity and with information on the organizational structure adopted to operate the securities unit. Data on these issues, however, is very limited or nonexistent. Available statistics indicate that commercial banks and their separate securities units captured an increasing share of the market for underwriting and distributing corporate bonds during the 1920s (Peach 1941). But no breakdown of these data is available, for example, on state and national banks, and, within each of these groups, on the proportions undertaken in-house or through affiliates. Information on banks' separate securities units is even more scarce, because these entities were not subject to examination and because they were not required to disclose information on their activities.

5.2 The Glass–Steagall Act

The coincident involvement of banking conglomerates in the securities business and the securities market boom in the 1920s, and the coincident wave of bank failures and 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 with the enactment of the Glass–Steagall Act.

unit outside the bank was helpful in reducing conflicts of interest. Puri (1996) concludes that underwriting securities in-house did not lead to more conflicts of interest than conducting them in a separate unit. A possible explanation for the difference in the results is that both studies use the concept of legal separateness rather than that of corporate separateness, which, as explained in the next section, is more important for determining the market's perception of the "distance" between the banking unit and the securities unit in the conglomerate.

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 disclosed in some banks' practices were common to the industry.[19] 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, enacted in 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 themselves with entities that were primarily engaged in such activities. Member banks offering securities services had until June 16, 1934 to choose either to continue accepting deposits or offering securities services, but not both. 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 accounts of certain securities as defined by OCC regulations; and dealing in some government securities.[20] Section 20 prohibits member banks from affiliation 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.[21] 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.[22]

[19]For an analysis of the events that culminated in the enactment of Glass–Steagall see, for example, Carosso (1970) Perkins (1971), and Benston (1990, 1996).

[20]See Pollard et al. for a presentation of the securities that national banks are allowed to invest in for their own account. Section 16 restrictions were extended to state member banks by 12 USC §355.

[21]One implication of Section 21 was to extend Section 16's prohibitions to state nonmember banks. Note, however, that these banks were free to affiliate themselves with investment banking firms.

[22]The 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

5.3 After the Glass–Steagall Act

The Bank Holding Company (BHC) Act of 1956 and its subsequent amendments did not impose further restrictions on the permissible securities activities of banking conglomerates. It did, however, close a loophole of the Banking Act of 1933. According to Section 19(e) of the Banking Act, a BHC could not obtain a permit 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-subsidiary 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 corporations engaged in approved banking-related activities.[23] The Fed was given the authority to allow BHCs to engage in nonbanking activities other than those explicitly permitted.[24]

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, this changed when both sides began attempting to expand their activities into some areas not explicitly closed to them by that Act. Pressured in part by these challenges, regulatory agencies started changing the regulations under their control in order to accommodate, within the existing law, some of their constituents' needs. It is beyond the scope of this paper to present all the regulatory changes introduced by

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23B of the Federal Reserve Act was created (Blair [1994] and Walter [1996]).

[23]That 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 Amendments to the BHC Act closed this loophole by reclassifying as BHCs companies that owned or controlled only one bank.

[24]The 1970 Amendments allow a BHC or its nonbank subsidiaries to engage in any activity that is "closely related to banking," as long as its provision of such activity produces expected benefits that outweigh the expected costs to the economy.

the three banking regulatory agencies in the era after Glass–Steagall.[25] Instead, in what follows, I present the most influential regulatory changes made by each agency regarding banks' securities powers and their choice of an organizational structure to integrate banking with the new securities activities permitted them.

The promotion of the holding-company model and the rulings since the late 1980s allowing BHCs to offer through a subsidiary a wide range of "ineligible" activities, that is, activities prohibited to the banks themselves by Section 16 of Glass–Steagall, probably constitute the Fed's most important influence in this area. Since 1987, the Fed has allowed BHCs to offer through their so-called section 20 subsidiaries, such "ineligible" activities as underwriting commercial paper, municipal revenue bonds, and securities backed by mortgages and consumer receivables. To insure that these subsidiaries were not "principally engaged" in the securities business and thus meet Glass–Steagall's Section 20 requirements, the Fed limited the revenue generated by "ineligible" activities to less than 5 percent of the subsidiary's total revenue. In addition, the Fed imposed a set of firewalls. In 1989, that revenue limit was increased to 10 percent and the set of "ineligible" activities allowed to section 20 affiliates was extended to include underwriting and dealing in corporate bonds and equities, provided that some more stringent firewalls between the bank and the securities affiliate were established.[26] Finally, in 1996, the Fed announced another increase in the revenue limit—to 25 percent—and dropped some of the firewalls until then required of BHCs with section 20 subsidiaries.

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 under the authority granted by Section 16 of the Glass–Steagall Act. However, the most important decision in this area occurred last year when the OCC cleared the way for national banks to

[25] A detailed presentation of these changes can be found in Pollard et al. (1988)

[26] For a detailed list of firewalls, see GAO (1995).

offer securities services through their subsidiaries. To do so, banks will have to observe some firewalls separating them from their securities subsidiaries; they will not be allowed to invest or lend more than 10 percent of their capital to their subsidiaries and their investments in these units may not count towards their capital requirements.

Nonmember banks are subject only to Section 21 of Glass–Steagall. As a result, they are free to affiliate themselves with securities firms. In 1984, the FDIC ruled that it would allow banks under its supervision and regulation—insured nonmember banks—to offer securities services, including underwriting and dealing in corporate securities, through a "bona fide" subsidiary. The subsidiary, however, had to be distinct and physically separate from the parent bank; in addition, its transactions with that bank were subject to some restrictions. In 1987, the FDIC amended that regulation, easing the operational separation between the bank and its securities subsidiary. Among other things, it dropped the different name or logo requirement and the physical separation requirement (Pollard et al. [1988]). It maintained, however, an extensive set of firewalls between the bank and its securities subsidiary.[27]

6 The Location of the Securities Unit in the Conglomerate

This section discusses the potential impact of different securities units' locations in banking conglomerates. The first of its three parts focuses on the potential advantages and disadvantages of corporate separateness. The second part compares the two organizational models most frequently adopted to implement corporate separateness—the bank-parent model and the holding-company model. The third part discusses whether the securities units' location in banking conglomerates should be subject to regulation.

[27]GAO (1995) presents the list of firewalls required by the FDIC.

6.1 Advantages and Disadvantages of Corporate Separateness

Legal separateness and operational separateness are the two most important determinants of corporate separateness. Legal separateness implies that different products are offered by separately capitalized and incorporated units of the conglomerate. Each unit has its own management team, possibly its own board of directors, its own accounting records, and its own capital. Furthermore, limited liability protects each unit's shareholders from any other units' losses in case of failure. Operational separateness results from restrictions separating the production of different products. Such restrictions generally prohibit the exchange of information, personnel, or other inputs among the conglomerate's various units.

Corporate separateness between banking and securities units is usually believed to be the source of important advantages for several reasons. First, it insulates banks—and through them the safety net and the taxpayers—from the risks of their securities activities. This advantage stems from the perception that securities activities are riskier than traditional banking. Therefore, it is argued, if banks were to offer securities activities through one of their departments, they would increase their risk of failure and, consequently, expand the safety net's liabilities.

Second, it retains the scope of the safety net and limits the competitive advantage resulting from access to the safety net. These advantages result from the subsidy said to benefit institutions with access to the safety net. Accordingly, it is argued, if banks were allowed to offer securities services in-house, the safety net coverage would be extended to activities that are beyond traditional banking and that banks would have a competitive advantage over securities firms because they could use the safety net subsidy to cross-subsidize their securities operations.

Third, it reduces potential conflicts of interest that can emerge with the simultaneous offering of banking and securities services. Even though these activities are offered by units that are part of the same conglomerate (and thus subject to common goals and eventually common policies) it is still claimed that separateness is an important means of addressing the conflict-of-interest problem. Separateness allows for the implementation of mechanisms, such as compensation schemes for each unit's management team, aimed at reducing their incentives to exploit conflicts (Saunders [1985]), and it permits the introduction of firewalls explicitly designed to limit management's ability to exploit conflicts.

Finally, it facilitates regulation and supervision of banking conglomerates. Requiring banking and securities activities to be offered by separate units keeps each of these units simpler and thus easier to supervise, and facilitates implementation of functional regulations that are considered less expensive to enforce than institutional regulations (Herring and Santomero [1990]). Furthermore, it is argued that corporate separateness permits banks to be regulated differently than securities firms. This 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.[28]

The effectiveness of corporate separateness (and, by extension, of some benefits claimed to emerge with it) has been questioned on several grounds. Most of the questions raised rely on the fact that despite legal separateness and the existence of firewalls imposing operational separateness between two units of the conglomerate, the market still does not perceive these units to be independent. Several reasons are usually presented to justify the market's perception that the units are integrated: First, there are incentives to manage the conglomerate as an integrated entity (in order, for example, to exploit scope economies), rather than as a portfolio of independent firms.[29]

Second, conglomerates have a strong incentive to protect their member units from bankruptcy, even if it requires them to go beyond their equity investment in the finan-

[28]Ferrarini (1995) discusses the differences between banks' prudential regulations and securities firms'.

[29]There is some evidence of integrated management in the BHCs in the United States. Studies of these companies' operating policies generally yield examples of policies that are centralized at the holding company level (see Cornyn, Hanweck, Rhoades, and Rose [1986] for a review of these studies).

cially distressed unit.[30] Conglomerates' incentives result from their interest in 1) protecting the organization's reputation and the market's assessment of it, 2) preserving the reputation of the management (Wall [1984] and Tailey [1985]), and 3) shielding the conglomerate's other units from any potential contagion effects resulting from the failure of a member unit. (Even with corporate separateness, adverse information resulting from news that a unit of the conglomerate is in financial distress may cause a run on the bank that is part of the conglomerate, Flannery [1986].[31]) Conglomerates' incentive to protect their member units is clearly illustrated by the following statement of Walter Wriston, former chairman of Citicorp: "It is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way."[32]

Third, the market may not view a conglomerate's units as completely independent, despite their being legally separated, because the courts may "pierce the corporate veil." Limited liability does not generally give the creditors of one unit any claim on the assets of any other legally separated unit of the same 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 "pierce the corporate veil" and hold the bank liable for the debts of the securities

[30]See FDIC (1987) for several examples in which banking conglomerates helped financially troubled nonbanking units, some of which involved bank-sponsored real estate investment trusts in the mid-1970s.

[31]The most frequently cited example of internal contagion caused by a noisy signal are the runs on the Beverly Hills National Bank's deposits in 1974. They started when it became public that the bank's parent, the Beverly Hills Bancorp, had incurred significant losses in its real estate investment trust. The crisis ended with the sale of the troubled bank to the Wells Fargo Bank. See and Cornyn et al. (1986) for other examples of bank failures involving problems with their nonbank affiliates.

[32]In the Financial Institutions Restructuring and Services Act of 1981, Hearings on S. 1686, S. 1703, S. 1720 and S. 1721, before the Senate Committee on Banking, Housing, and Urban Affairs, 97th Congress, 1st Session, Part II, pp. 589–590.

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

Finally, the market's perception of independence among the units belonging to the same conglomerate is also influenced by conglomerates' policies, including their reporting practices. For example, emphasis on consolidated financial reporting will reinforce the integrated entity perception in the marketplace. Other influences on market perception include procedures adopted by the regulatory agencies in charge of overseeing the banks that are part of conglomerates, particularly if they give the impression that they oversee the financial affairs of nonbanking units as well as those of the entire conglomerate.[33]

Besides being questioned on all these grounds, corporate separateness is also blamed for imposing disadvantages on conglomerates that mix banking with securities services for several reasons. First, it requires development and operation of a more costly organization because, for example, of the cost of developing and operating an additional separate unit. In addition, it reduces scope economies, particularly those involved in the production of financial services, and it weakens conglomerates' ability to exploit the synergies resulting from their relationships with firms. These disadvantages emerge mainly as a result of the firewalls that restrict exchange of information between the conglomerate's banking and the securities units.

Second, it increases agency problems due to the separation of ownership from control. Several reasons are usually presented to justify the costs resulting from this separation, one of the most frequently cited being the difference between shareholders' objectives and management's objectives (such as those arising from differences in the decision horizon). Corporate separateness is prone to increase such agency costs, because it separates control, that is, it replaces one management team with several, somewhat independent teams.

Third, it may also be the source of some new conflicts of interest. These conflicts may

[33] Cornyn et al. (1986) and Chase (1988) present examples of procedures, currently used by the Fed to supervise BHCs, which play down separateness and instead promote a consolidated view of these organizations.

develop if the banking and securities units have different capital structures and/or different ownership structures. 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 transference of assets between the two units, to favor one group of shareholders at the expense of the other (Edwards [1979] and Saunders [1985]).

Finally, it limits banks' ability to diversify their sources of revenue because revenue generated by securities activities accrues to the securities unit. Corporate separateness, in addition, may introduce incentives for conglomerates to move some operations from banks to securities units, thus reducing banks' assets base. The conglomerate may find it advantageous (because, for example, of differences in regulation and supervision of its banking and securities units) to move some low-risk, profitable activities, such as the underwriting of government bonds, from the bank to the securities unit (Eisenbeis [1983]).[34]

6.2 The Bank-Parent Model versus the Holding-Company Model

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

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. The critical differences between these models derive from the fact in the former there

[34]An example of this migration of activities has occurred in the BHCs that have established section 20 subsidiaries. Due to the "ineligible" activities revenue limit, BHCs have been forced to move "eligible" activities, such as the underwriting and trading in U.S. Treasury securities, from their banking subsidiaries to their securities subsidiaries, in order to provide a base of eligible revenue.

is a direct relationship between the bank and the securities unit, while in the latter that relationship is only indirect. In the bank-parent model, the securities unit's capital is an asset of the bank, it's profits accrue to the bank, and, if it fails, limited liability confines the bank's losses to the investment made in that unit. In the holding-company model, because the securities unit's capital is an asset of the holding company, that is, there is a cushion—the holding company—between the bank and the securities unit, all those relationships are held with the holding company instead of the bank.

As a result of these differences, it is usually argued that the holding-company model performs better than the bank-parent model with respect to the following issues: It insulates the bank from problems that may emerge in its sister securities unit, particularly if this unit would fail. It gives the bank less incentive to bail out the securities unit, which is a sister affiliate rather than a directly owned subsidiary. It makes the resolution of a bank failure less complicated because in the holding-company model the securities unit's capital is an asset of the holding company not of the bank. Thus, in case the bank becomes insolvent, such assets need not be considered in the failure resolution procedure.

In other respects, however, 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 its securities unit's profits 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 the conglomerate through the holding company. It increases the pool of assets that the bank's creditors can claim, thus reducing bank's incentive to move assets to the securities unit in order to shield them from creditors. In the bank-parent model, the securities unit's capital is an asset of the bank, while in the holding-company model it is an asset of the holding company, hence beyond the reach of the bank's creditors. As a result, if a bank gets in financial trouble, its 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.[35]

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 get from accessing the safety net to the securities units. Leaving aside the issue of whether such a subsidy exists and how large it is, the many channels that banks can use to transfer it to their conglomerates' securities units include three particularly important ones.[36] First, banks can transfer the subsidy through credit extensions, or the exchange of information, or the purchase and/or sale of assets and services to/from the securities units in their conglomerates on terms that favor these units. Given that bank's transactions with the securities unit can be equally well regulated 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 regarding bank's ability to transfer the subsidy through that channel.

Second, banks can transfer the subsidy through capital infusions in the securities units, on terms that favor the latter. In the holding-company model, this channel is severely blocked by the fact that the securities unit's capital is an investment of the holding company and by restrictions on the dividends that the bank can pay to its holding company. In the bank-parent model, despite the fact that the securities unit's capital is an investment of the bank, that blockage can also be closely mimicked if such investment is subtracted from the

[35]Regulators in the United States have attempted to replicate this structure of claims in the holding-company model, through the so-called "source of strength" doctrine. According to this doctrine, the holding company has the duty to provide financial and managerial strength to its banking subsidiary. It remains unclear, however, whether this doctrine can be legally enforced, since the Fed's first attempt to do so was unsuccessful. It happened in 1987, when Hawkeye Bancorporation refused to comply with the Fed'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]).

[36]For a discussion on the existence of the safety-net subsidy see, for example, Helfer (1997), Greenspan (1997), and Whalen (1996).

bank's capital in order to meet prudential capital requirements.

The last important channel through which the safety net subsidy can be transferred to securities units relates to the market perception of the relationship between these units and the banks in their conglomerates. The stronger the perception that these are integrated organizations, rather than portfolios of independent firms, the better the chances that the subsidy will be transferred. The location of the securities unit in the conglomerate will affect that perception. The closer the securities unit is to the bank in economic terms, the stronger will be the perception that they form an integrated organization. This may contribute to a higher transference of the subsidy in the bank-parent model than in the holding-company model. However, this is not the only determinant of market perception, probably not even the most important one. The firewalls defining corporate separateness, the policies adopted by conglomerates, as well as supervisory agencies' regulations and practices appear to have far more influence on how the market views the relationship between securities units and banks that are legally separated but part of the same conglomerate. When all these issues are taken into account, it is difficult to distinguish the two conglomerate models with respect to banks' ability to transfer the safety-net subsidy to securities units.

6.3 Should the Securities Unit's Location be Regulated?

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

The decision to regulate the securities unit's location within banking conglomerates needs to consider 1) the reasons why financial intermediaries like commercial banks exist (the provision of liquidity and the performance of monitoring services), 2) the problems associated with these intermediaries, (being subject to runs and failure because of insolvency), 3) the device most frequently adopted to address these problems (the safety net), and 4) 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 safety net's distortions, 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 the services through a separately capitalized and incorporated unit. Because these effects vary with the securities activities and with factors intrinsic to each bank (such as reputation), certain banks would attempt to minimize some potential problems of offering the securities in-house by using firewalls to separate the securities department from the rest of the bank. Others would choose instead to transform firewalls into brick walls and conduct the securities business in a separated unit, under either a bank-parent model or a holding-company model. Under these circumstances, given the evidence on the potential contribution of securities activities to a bank's risk diversification, there seems to be no fundamental justification for a regulation limiting the bank's choices 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 models used to integrate commercial banking with securities services, make a compelling case for answering with a qualified no. Given that such distortions can be eliminated or greatly reduced (for example, by requiring market value accounting, by introducing more risk sensitive insurance premiums and capital requirements and by adopting a prompt corrective action procedure) and given that policies which amplify them can also be amended (for example, by committing not to bail out any bank, whatever its size or importance), then both should be corrected and banks should have the option of choosing the conglomerate model they find most efficient to integrate both activities.

This appears far more appropriate than a proposal that takes the safety net's distortions as given and uses them to justify introducing another layer of distortions, such as those that would result from a regulation requiring corporate separateness. This does not appear to meet the burden of proof required to justify introducing such a regulation. The first proposal would correct the source of the distortions and would, among other things, give banks the opportunity to explore the advantages of various organizational models (which, judging from the diversity of their choices abroad and in the United States during the era before Glass–Steagall, they seem to value). The other alternative—leaving the distortions in place and relying on corporate separateness to confine the problems they cause—limits the synergies of combining both activities and gives banks an insulation that is more apparent than real.

A regulation that requires corporate separateness limits the choices of all banks alike, regardless of pertinent factors, such as banks' capitalization, which determine their risk-taking incentives. In addition, that regulation introduces costs, some of which increase with the degree of separateness—particularly operational separateness—that it imposes. Given that corporate separateness is the relevant concept, not legal separateness per se, this creates a dilemma. The stronger the separateness imposed by such regulation, the stronger the insulation it provides the banking unit but the larger the costs it imposes. At the very extreme, if absolute separateness is imposed, nothing is to be gained from allowing that combination of activities. The dilemma is further complicated by the limitations of corporate separateness, particularly those resulting from the fragility of the firewalls in the situation where they are most needed—that is, under conditions of financial distress.

Despite these problems, if regulatory authorities still opt for not correcting the causes of the safety net's distortions and use these distortions to justify imposing separateness, the question becomes: Do such distortions justify a regulation requiring either the holding-company model or the bank-parent model? This is the question at the center of the ongoing debate among the three U.S. banking regulatory agencies. They all propose requiring 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 choose only 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 these models to mimic the other with respect to some relevant dimensions, there appears to be no sufficiently clear reason for requiring one over the other. To force banking conglomerates to adopt either one of these two models would be to introduce a regulatory framework that already lags the market and that would restrict these institutions' choices even further, thus limiting their ability to adjust and compete with other close competitors that are emerging in the financial markets.

7 Final Remarks

One issue that has been raised concerning a regulation that would allow banks in the United States to choose between the bank-parent model and the holding-company model has to do with its potential impact on regulatory agencies' banking constituencies, that is, 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 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 bank holding companies (BHCs) and their nonbank subsidiaries.[37] The Fed is also responsible for providing discount-window loans to depository institutions, for running the payment system, and for conducting monetary policy.

Given the agencies' current powers, if a bank were to offer securities activities through a subsidiary that it owns, these activities would be regulated and supervised by the OCC, the FDIC, or the Fed, depending on whether the bank were national, a state-chartered nonmember, or a state-chartered member, respectively. If these activities were to be offered through a BHC subsidiary, they would be regulated and supervised by the Fed. These differences explain why the constituency issue has become part of the debate over the securities unit's location in banking conglomerates. Some have argued that if banks were given the opportunity to choose between the bank-parent model and the holding-company model, most would choose the former, and the Fed's banking constituency would consequently be reduced to levels that would impair the central bank's ability to meet its responsibilities. For example, the Fed has claimed that it needs a "significant and important role as a bank supervisor" in order to keep its ability to "manage crises, assure an efficient and safe payment system, and conduct monetary policy" (Greenspan [1997]).

The central bank's need for an important regulatory and supervisory role remains an unsettled issue, which has been discussed elsewhere.[38] Leaving that aside and assuming that such an association of powers is, in fact, desirable, an important question for future research remains. In a system with multiple regulatory agencies, each having different powers and responsibilities, is it possible to sustain such an association of powers in the absence of regulations that limit banks' choices or the competition among regulatory agencies?

The supervisory authority of any agency can—and, if necessary, should—be changed

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

[38] For a discussion of whether the central bank needs supervisory authority in order to conduct monetary policy see, for example, Haubrich (1996).

by altering its charter. Attempting to maintain an agency's constituency through other means, such as requiring a particular location in the conglomerate for the securities unit, limits competition among regulatory agencies and may introduce important distortions by requiring an inefficient location for that unit. Adoption of a regulation requiring banks to follow the holding-company model would guarantee the Fed's supervisory authority but would limit both banks' choices and the competition among regulatory agencies. A more appropriate alternative is to combine a regulation that does not limit banks' choices with a change in regulatory agencies' supervisory authority in such a way as to guarantee the Fed's supervisory authority. Like the first proposal, this one limits competition among the regulatory agencies, but it has the advantage of letting banks choose between the bank-parent model and the holding-company model.

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