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The Separation of Banking and Commerce Reconsidered

Stephen K. Halpert*

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The United States, throughout its history, has imposed substantial legal impediments to the integration within a firm of both banking and nonbanking businesses. This policy—often called the separation of banking and commerce—ranks among the most enduring doctrines in Anglo-American financial regulation, with a genealogy that extends almost three hundred years under English law.\(^1\) In the United States, the separation is maintained by numerous state and federal laws that elaborate upon their historical English antecedents.\(^2\) Despite its advanced age, the separation maintains considerable vitality, and the last half century of banking law in the United States has been marked by progressive expansion and refinement of the separation.\(^3\) Even in the current climate of skepticism about economic regulation by academics and policymakers, the separation continues to attract a substantial degree of uncritical support among both scholars and legislators.\(^4\) Indeed, when the outgoing chairman of the Federal Deposit


2. See infra text accompanying notes 20-78 (discussing the legal prohibitions on non-banking business in the United States).


4. See, e.g., E. Symons & J. White, Teaching Materials on Banking Law 377 (2d. ed. 1984) (arguing that the separation is justified by historical experience); Salley, supra note 1, at 196-98 (discussing the continued strength of the separation); Shull, The Separation of Banking and Commerce, 28 Antitrust Bull. 255, 275-77 (1983) (expressing concerns about the effects of the erosion of separation on private entrepreneurs). Other commentators have criticized existing law as unduly restrictive and championed expanded bank powers, but would include only financial or investment services. See, e.g., Harfield, Sermon on Genesis 17:20; Exodus 1:10, 85 Banking L.J. 565, 578 (1968) (maintaining that banks should be allowed to provide any service related to money and credit).

5. At this moment, despite pressures from the banking industry and the Reagan administration, it is considerably more likely that the separation will be strengthened than weakened. Congressional support for the separation remains strong, particularly in the House of Representatives. During the 1986 term, Senator Garn dropped provisions intended to expand bank
Insurance Corporation (FDIC) suggested to the usually austere Senate Banking Committee that the separation be relaxed, his comment provoked "uproarious laughter."  

This continuing vitality begs examination. The legal separation of banking and commerce has persisted despite some obvious disadvantages: it prevents the development of integrated banking and nonbanking firms that could operate more efficiently than fragmented enterprises; it burdens bank customers by requiring them to divide related transactions among unrelated vendors; and it precludes banks from engaging in equity finance even when desirable both to the bank and to its customers. Whether these costs are offset by countervailing benefits is problematic, but the experience in the United States and abroad provides grounds for skepticism. Most other countries with well developed capital markets either do not enforce the separation of banking and commerce or have significantly less restrictive enforcement than the United States, without apparent adverse effects. Even in the United States, the body of law that effects the separation is complex and incomplete, and provides for disparate treatment of the various forms of depository institutions and modes of integration. The failure of these anomalies to erode over time suggests that the policy is not fundamental to sound capital markets.

The accelerating pace of change within the financial services industry underscores the importance of inquiry into the purposes and justifications for the separation of banking and commerce. In the past decade, most of the once great investment houses of Wall Street have either merged or have become

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7. There are less obvious costs. See infra text accompanying notes 189-231 (identifying and assessing the costs of the separation).
8. See Goodman, Cumming & Kumekawa, Product Line Regulations for Financial Institutions: A Cross Country Comparison, in Proceedings of a Conference on Bank Structure and Competition, at 79 (Fed. Reserve Bank of Chicago 1984) (surveying product line restrictions in West Germany, Switzerland, the United Kingdom, Canada, and Japan). According to Goodman, Cumming, and Kumekawa, all the surveyed countries, except Japan, exerted significantly less restrictive regulation of the commercial activities of banks than the United States. Japan presents an exceptional case because the United States compelled the disaggregation of large integrated financial and industrial holding companies, the Zaibatsu, following World War II. Notwithstanding the voluntary enactment of legal regulations that are nearly identical to United States law, the relationship between commercial enterprises and banks is considerably closer in Japan than in this country. Moreover, unlike United States banks, which generally may not own equity in nonbanking corporations, Japanese banks can own up to 10% of the outstanding stock of a corporation (to be reduced to 5% under current law) and may exercise significant influence over the corporation's affairs. Id. at 100-03; see also W. Ouchi, THE M-FORM SOCIETY 65-81 (1984) (discussing benefits of equity ownership by Japanese banks).
subsidiaries of industrial corporations. Financial conglomerates offering a range of financial products have appeared, and the walls constraining the geographical expansion of banks have been breached. Commercial banks have exhibited unprecedented vitality in exploring the limits of their legal powers, and a wave of bank consolidations has increased significantly the dominance of the largest bank organizations.

This Article closely examines the separation of banking and commerce, identifies the separation's purposes, and evaluates the fit between its means and ends with the objective of promoting the rationalization of bank regulatory policy. First, this Article briefly sketches relevant current banking law. Second, this Article exhumes the historical purposes of the principal relevant federal laws and analyzes these purposes through the conceptual lenses of law and economics. The separation initially was copied from English law and subsequently was expanded for two principal reasons: to relieve bank panics and, later, to alleviate the perceived tendency of the financial sector to assume unacceptable levels of economic aggregation and power. This Article concludes that neither of these historical purposes justifies incurring the costs of existing law. Third, this Article broadens the inquiry to consider the proposition of some contemporary banking experts that the separation is desirable to counter a tendency of federally insured banks to undertake excessive risks. While it is true the separation probably reduces the incidence of bank failure, the welfare significance of this effect is ambiguous. Last, this Article elaborates on the preceding section by attempting to weigh approximately the costs and benefits of the separation and by considering alternative regulatory strategies.

II. LEGAL PROHIBITIONS ON NONBANKING BUSINESS

United States banking law has been described as unparalleled "in terms of complexity, confusion, irrationality, and difficulty of administration" and as


12. Between 1975 and 1985, the share of total domestic banking assets held by the 100 largest banking organizations in the United States rose from 50.8% to 57.7%. Id. at 90. In contrast, from 1970 to 1975, the share remained virtually constant, rising only .4%. Id.

13. See infra text accompanying notes 20-78.

14. See infra text accompanying notes 79-167.

15. Id.

16. See infra text accompanying notes 150-167.

17. See infra text accompanying notes 168-188.

18. See infra text accompanying notes 194-239.


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“intricate and baffling.” Banks are subject to an elaborate system of regulation involving numerous and overlapping federal and state authorities. A bank may choose to charter under either state or federal law and, in many states, may “flip” between federal and state status. If a bank charters under federal law, it is subject to the National Bank Act (the NBA), and its primary regulator is the Comptroller of the Currency. National banks must join the Federal Reserve System and obtain deposit insurance from the FDIC. Banks opting for a state charter are subject to state law and are supervised principally by state banking authorities. In most states, a state bank must insure with the FDIC. Virtually all banks have elected to obtain FDIC coverage, even where it is not mandatory. In addition, a state bank voluntarily may choose to join the Federal Reserve System and become subject to the regulatory jurisdiction of the Federal Reserve Board (the Board). The Board becomes the primary federal regulatory authority for such state member banks; nonmember insured banks are primarily supervised at the federal level by the FDIC.

Bank holding companies—corporations, partnerships, and long-lived trusts that control one or more banks—also are subject to overlapping federal and state regulation. The federal Bank Holding Company Act (the BHCA) imposes voluminous substantive and disclosure requirements on all bank holding com-

22. See generally Office of the Vice-President, Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services (July 1984) [hereinafter Vice-President's Task Group Report] (briefly describing the existing regulatory system); see also S. Huber, supra note 20, ¶ 3.01-4.08 (providing a detailed description of banking activities supervised by multiple regulatory authorities). Other depository institutions—savings and loan associations, mutual savings banks not regulated as commercial banks, and credit unions—are subject to similar, but not identical, regulatory systems. While this Article will focus primarily on commercial banks, its analysis should apply with equal force to savings and loan associations and savings banks—collectively, “thrifts.”
23. This dual system of banking regulation has been the subject of both praise and condemnation. To its partisans, the system is a logical analog of constitutional checks and balances, protecting depository institutions from regulatory excesses by permitting exit form one regulatory jurisdiction to another. To its detractors, the dual system promotes an unhealthy competition in regulatory laxity by giving excessive leverage to regulated financial companies. See Scott, The Dual Banking System: A Model of Competition in Regulation, 30 Stan. L. Rev. 1 (1977) (discussing the operation of the dual system and its policy consequences); see also Niskanen, Commentary on Scott, The Dual Banking System, in Issues in Financial Regulation 46 (F. Edwards ed. 1979) (presenting a Chicago-style critique of the dual system).
27. As of December 31, 1983, only 677 of the 15,440 banks and trust companies in the United States were uninsured and 123 of these were nondepository institutions. Federal Deposit Insurance Corporation, Changes Among Operating Banks and Branches: FDIC 1983, Table 1, at 4 (1984). As of that date, uninsured institutions accounted for only 287 bank branches of a total of 43,610 branches nationwide. Id. at 6.
panies, whether they control a federal or state chartered bank, and subjects them to the regulatory supervision of the Board. The "separation of banking and commerce," as used in this Article, denotes three categories of restrictions on bank conduct embedded within this regulatory matrix: (1) prohibitions on direct engagement in nonbanking activities by banks and subsidiaries of banks; (2) prohibitions on investments by banks in nonbanking business; and (3) prohibitions on engagement in businesses unrelated to banking by bank holding companies and their affiliates.

A. Restrictions on Nonbanking Activities of Banks

1. National Banks

National banks are limited by the NBA to the exercise of "such incidental powers as shall be necessary to carry on the business of banking" plus a few additional expressly granted statutory powers. They also are subject to provisions of the Glass-Steagall Act that bar them from engaging in most underwriting activities or operating a full-time service stock brokerage. These restrictions apply to bank subsidiaries, except that a small fraction of bank assets may be invested in a subsidiary with the somewhat broader powers permitted a bank holding company affiliate.

The precise ambit of "the business of banking" for the purposes of the NBA is disputed. Contemporary courts, however, generally have applied a

30. Id. § 24.
31. Express powers include government depository functions, id. § 90, and trust powers, id. § 92a. A provision in 12 U.S.C. § 92 (1982) that permitted national banks doing business in communities with less than five thousand residents to act as insurance agents and to broker real estate loans apparently was repealed inadvertently by omission from the 1918 recodification of federal statutes. See codification note, 12 U.S.C.A. § 92 (West Supp. 1987). Nevertheless, the provision generally is treated as though it still were in force, perhaps on the theory that it was reenacted implicitly by the Garn-Saint Germain Act, which purported to amend it.
34. Id. § 24.
35. The NBA prohibits ownership of equity securities by national banks, except as provided by statute or regulation. Id. Equity ownership of only two categories of subsidiaries has been authorized. First, the Comptroller by regulation permits banks "to engage in activities which are a part of or are incidental to the business of banking" through subsidiary corporations, so long as the parent bank owns at least 80% of the voting stock of the subsidiary. 12 C.F.R. § 5.34 (1987). Second, a national bank may invest up to 5% of its total assets in one or more "bank service corporations." 12 U.S.C. § 1862 (1982). Such corporations may engage only in specified services for depository institutions or in lines of business permitted national banks or permitted bank holding companies by regulation of the Board pursuant to § 4(c)(8) of the BHCA. Id. §§ 1863-1864; see infra text accompanying notes 64-78 (discussing § 4(c)(8) powers). Investment by a national bank in a bank service corporation engaged in certain activities requires the approval of the Comptroller of the Currency or the Board. Id. § 1865.
36. See generally Beaty, What are the Legal Limits to the Expansion of National Bank Services?, 85 Banking L.J. 3 (1969) (explaining how rules have changed with changing conditions); Harfield, supra note 4, at 571-80 (proposing a test for permissible bank services based on whether the business is related to "money and credit" and involves only "credit risk"); Huck, What is the Banking Business?, 21 Bus. Law 537 (1966) (discussing controversies at both the administrative and agency levels); Symons, The "Business of Banking" in Historical Perspective, 51 Geo. Wash. L. Rev. 676 (1983) (tracing the development of bank powers).
restrictive test: whether the activity is "convenient or useful in connection with
the performance of one of the bank's established activities pursuant to its express
powers under the [NBA]." According to the leading exposition of the standard,
a proposed activity found "functionally interchangeable" with a traditional bank
service will be permitted. Conversely, an activity that is attractive to the bank
only because of the bank's superior access to capital, or that is found to expose
the bank to risks "more onerous" than traditional banking businesses will be
denied. Under the NBA, courts have permitted national banks to sell travelers'
checks and foreign currency, issue letters of credit," engage in full-payout
leasing, operate discount brokerages, underwrite and sell credit life insurance,
and manage and sell collective trust funds for individual retirement accounts.
Courts, however, have refused to permit national banks to underwrite nongeneral
obligation government bonds, manage or sell collective investment accounts to
be held in a nontrust capacity, operate a travel agency, market travel services
for others, offer nonfinancial data processing services, engage in personal
property leasing, or broker real estate loans in urban communities.

2. State Banks

The powers of state banks and their subsidiaries are determined primarily
by state law. Historically, most states have imposed restrictions on permissible

37. Arnold Tours, Inc. v. Camp, 472 F.2d 427, 432 (1st Cir. 1972). Express powers
include "discounting and negotiating promissory notes, drafts, bills of exchange, and other
evidences of debt; receiving deposits; buying and selling exchange, coin, and bullion; loaning
money on personal security; and obtaining, issuing, and circulating notes ...." 12 U.S.C. §
24 (1982).
38. M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377, 1383 (9th Cir.
39. Id. Two implicit assumptions of the M & M Leasing Corp. approach—that banks are
inclined toward expansion into nonbanking businesses to exploit cheap capital, and that en-
gagement in businesses more risky than banking is destabilizing to banks—pervade debates over
the separation of banking and commerce. See infra text accompanying notes 189-243 (examining
critically the debates over the separation of banking and commerce).
40. Arnold Tours, Inc., 472 F.2d at 438.
41. Id.
42. M & M Leasing Corp., 563 F.2d at 1383.
44. Independent Bankers Ass'n of Am. v. Heimann, 613 F.2d 1164, 1170 (D.C. Cir.
45. Investment Co. Inst. v. Conover, 790 F.2d 925, 927 (9th Cir. 1986), reversing 593
aff'd per curiam, 789 F.2d 175 (2d Cir.), cert. denied, 107 S. Ct. 422 (1986); Investment
315 (D.C. Ariz. 1976), aff'd, 604 F.2d 32 (9th Cir. 1977).
51. M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377, 1383 (9th Cir.
1977).
lines of business for state banks similar to restrictions imposed by federal law on national banks, although a handful of states have granted somewhat broader powers. Recently, however, a number of states have liberalized substantially the powers of state banks. In response, the FDIC has proposed rules that would prohibit federally insured state banks from engaging directly in certain businesses, including real estate development and insurance underwriting, and would place restrictions on bank transactions with affiliates engaged in such businesses. Federal law prohibits all state banks from directly engaging in the business of underwriting securities other than general government obligations. State banks that have opted to become members of the Federal Reserve System (state member banks) are subject to the same limitations on ownership of subsidiaries as imposed by the NBA on national banks.

B. Restrictions on Investments by Banks

National banks may invest in treasury securities, general obligation government debt instruments, and the debt of certain quasi-governmental issuers. They generally may not, however, own corporate equity, nor may they invest voluntarily in real estate, except in premises for bank operations. Investments in securities by state member banks are subject to the same limits as national


54. See generally Continued Banking Deregulation Seems Inevitable, Legal Times, March 5, 1984, at 14 (tracing the history of non-banking powers of state banks).


56. 50 Fed. Reg. 23,963 (1985). The FDIC asserts authority to issue the rules pursuant to its statutory jurisdiction to police bank safety and soundness.

Prompted by the de facto insolvency of the FSLIC insurance fund, the Federal Home Loan Bank Board (FHLBB) has imposed regulations on insured thrifts that are considerably more stringent than those proposed by the FSLIC for commercial banks. Notwithstanding any powers granted under state law, the regulations limit investments by insured thrifts in equity securities, real estate, thrift service corporations, and operating subsidiaries to the greater of 10% of assets or twice “regulatory net worth,” i.e., net worth computed in accordance with regulatory accounting principles. Direct investment by thrifts with less than minimum required capitalization is prohibited without supervisory approval, and direct investment by thrifts with a regulatory net worth of less than 3% of total liabilities is limited to twice regulatory net worth. 12 C.F.R. § 563.9-8(c)(2) (1987).


58. Id. § 335.

59. Id. § 24.

60. Id. An exception is made for ownership of the stock of a corporation organized to conduct the safe-deposit business. Id. Although a national bank may purchase corporate debt, only issues that have minimal default risk and that are readily marketable are permissible. 12 C.F.R. § 1.5(a) (1987).

61. 12 U.S.C. § 29 (1982). A national bank also may acquire real property for lease to a public tenant provided that, pursuant to the lease agreement, the tenant will become owner of the property at the completion of the lease. 12 C.F.R. § 7.3300 (1987).
banks, however, their real estate powers are determined by state law. Restrictions on nonmember state banks vary. Most states prohibit ownership of corporate equity, but many permit investments in real property.

C. Restrictions on Bank Holding Companies

Bank holding companies and their affiliates generally are restricted by the BHCA to the business of banking and other businesses determined by the Board "to be so closely related to banking or managing or controlling banks as to be a proper incident thereto . . . ." The BHCA directs the Board "[i]n determining whether a particular activity is a proper incident to banking . . . [to] consider whether its performance by an affiliate of a [bank] holding company can reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects . . . ." Judicial constructions have treated these provisions disjunctively with the result that bank holding company affiliates can engage only in businesses that are "closely related" to banking and that offer a preponderance of "public benefits." The Board permits nonbanking activities by means of regulation or, on application for permit, by individual order. Among the activities permitted by regulation are a number of functions historically performed by banks or permissible by national banks. These activities include making and servicing loans, performing trust company functions, and engaging in full-payout leasing. In addition, the Board also has approved by regulation a number of activities not historically regarded as banking functions. The Board, however, has restricted them in various ways such that the activities qualify as "closely related" to banking. For example, the Board permits a bank holding company or its sub-

63. See, e.g., Fla. Stat. § 658.67(7) (1985) (permitting Florida banks to place up to 60% of their capital accounts into real property investments).
64. 12 U.S.C. § 1843(c)(8) (1982). In a significant departure from the usual parallelism of bank and thrift regulation, restrictions on engagement in unrelated businesses by savings and loan holding companies apply only to holding companies that own two or more thrifts. Id. § 1730a(c)(2). As a result, nonfinancial corporations legally may acquire a thrift subsidiary and a number of them have done so, including Sears, Roebuck, and Co., National Steel Corp., J. C. Penney Co., and Parker Pen Co.
65. Id. § 1730a(c)(2).
67. The list of nonbanking activities permitted by regulation is codified in Federal Reserve Board Regulation Y. 12 C.F.R. § 225.25 (1987). Engagement in these activities de novo only requires notice to the Board. Id. § 225.23(a). Permission to enter other lines of business or acquisition of a business engaged in a listed activity requires the affirmative approval of the Board. Id.
68. Id. § 225.25(b)(1).
69. Id. § 225.25(b)(3).
70. Id. § 225.25(b)(5).
sidiary to provide courier services, but only for specified kinds of documents or financial instruments between financial institutions or for business documents constituting or used in processing "[a]udit and accounting media of a banking or financial nature . . . ." 71 Management consulting services are permitted, but only to specified financial institutions. 72 Data processing services are allowed, but only if the data processed are "financial, banking or, economic" and any hardware provided in connection with the services is limited in value to not more than thirty percent of the total cost of the package. 73 The Board also has permitted a number of activities by order, but has not added them to the list of activities permitted by regulation. 74 Presumably, these activities qualify as "closely related" to banking, but the Board is unwilling to permit bank holding companies to engage in them without case-by-case consideration of "public benefits" issues.

As applied by the Board, the "public benefits" test has been concerned primarily with antitrust policies and bank solvency. A bank holding company proposing to engage in a "closely related" business generally has been denied permission when the Board has perceived either a likely anticompetitive effect or the possibility of significant financial risks to the consolidated entity. 75 Less frequently, the Board has been concerned with the effect of a decision on its supervisory or monetary policy functions 76 and, in a small number of cases, the threat of "undue concentration of economic resources" for reasons other than anticompetitive effect. 77 Conversely, in the absence of perceived anticompetitive effect and financial risks, to satisfy the "public benefits" requirement the Board generally has accepted the applicant's claim of economies of scale, economies of scope, enhanced customer convenience, or access to new managerial resources. 78

III. THE HISTORICAL PURPOSES OF SEPARATION

What accounts for the adoption of this peculiar pattern of restrictions on the banking business? The answer is not easy. The hodge-podge of current laws

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71. Id. § 225.25(b)(10).
72. Id. § 225.25(b)(11).
73. Id. § 225.25(b)(7).
75. See M. JESSE & S. SEELIG, BANK HOLDING COMPANIES AND THE PUBLIC INTEREST 63-76 (1977) (providing an empirical analysis of Board decisions relating to applications to engage in nonbanking businesses by bank holding companies over a five and one-half year period).
76. For example, the Board has indicated concern that widespread issuance of large-denomination money orders could make the conduct of monetary policy more problematic. BankAmerica Corporation, supra note 74, at 365.
77. See infra note 152 and accompanying text.
78. M. JESSE & S. SEELIG, supra note 75, at 75.
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developed in three stages: (1) a formative period lasting until sometime after the Civil War during which the states and federal government adopted chartering laws generally understood to preclude banks from engaging in commercial businesses; (2) a brief revisionist epoch in the 1930s during which Congress substantially reformed financial regulation by enacting in very short order a succession of major laws that expanded and reinforced the historical separation, addressing a perceived crisis in capital markets; and (3) an era of regulatory expansion in the three decades following World War II during which the separation was extended to encompass bank affiliates. The reasons for the adoption of various separation-related legislation differ greatly among stages, but none persuasively explains the doctrine's contemporary force.

A. Charter Restrictions on Bank Powers

The first enactment of restrictions on banks' commercial activities in the United States has a simple, if uncompelling explanation: it was the result of the wholesale and uncritical copying of English banking practices. The use of limited-power bank charters in England dates back to the late 17th century. A limited powers clause was first enacted in the 1694 Parliamentary revisions to the proposed royal charter of the Bank of England. The amendment manifested longstanding antagonisms between Parliament and the Crown, rather than any principle or policy regarding the organization of financial markets: Parliament simply was minimizing the charter powers of the bank to limit the value of the royal franchise and to protect the interests of its constituency of small merchants.

Colonial America imported restrictions on commercial activities of banks along with many of the other paraphernalia of English monetary and banking law. The states and federal government uncritically received the English model of a central bank with private ownership, a monopoly franchise, and quasi-public monetary functions, often using language copied from the Charter of the Bank of England to implement the choice. The proscription on trading activities imposed by Parliament on the Bank of England was incorporated substantially verbatim in the charter of the Bank of New York in 1784, the Pennsylvania recharter of the Bank of North America in 1787, and the federal charter of the First Bank of the United States in 1791.

The ready acceptance of the practice of granting only limited banking charters in the United States is better ascribed to simple inertia than replication of relevant English circumstances. Eighteenth century America was primarily an agrarian

79. See Salley, supra note 1, at 196-208 (presenting a sketch of earlier experiences with the separation in continental Europe).
80. Shall, supra note 4, at 259-65. The amendment provided:

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

Id. at 260 (quoting 5 & 6 William & Mary c. 26).
81. See B. Hammond, Banks and Politics in America from the Revolution to the Civil War 63-129 (1957).
82. Id.
society and its debates over banking policies reflected more concerns over the availability of agricultural credit and fears of centralized government than the political and class antagonisms that led to the separation in England.\footnote{These issues largely framed the debate over the first Bank of the United States. See P. STUDENSKI & H. KROOSS, FINANCIAL HISTORY OF THE UNITED STATES 60-61 (2d ed. 1963) (discussing the Hamiltonian view in favor of a National bank and the opposing views of the Jeffersonians).} It may be reasonably inferred, therefore, that the adoption of particular language from the charter of the Bank of England owed less to a conscious policy of protecting small commercial businesses than to a general tendency to accept wholesale British norms of sound banking and commercial practice, at least where no substantial interest opposed them.\footnote{There were, of course, alternative models that could have been adopted. Businesses that integrated banking and commercial functions frequently existed in continental Europe and were not unknown in eighteenth century America. See B. HAMMOND, supra note 81, at 154-55. Nevertheless, reliance on English banking traditions pervaded early American experience. The adoption of the entire panoply of English banking practices without significant revision, including practices emanating from particularities of English life and history, exemplifies a common practice of legal systems in periods of abrupt political or technological transition. Not infrequently, societies undergoing such transitions copy whole bodies of law from extrinsic sources, with fortuities of language or education strongly influencing the choice of sources. See generally A. WATSON, LEGAL TRANSPLANTS 29-30 (1974) (describing the phenomenon of borrowed law).} Similarly, the inclusion of limited powers language in the NBA was due more to its draftsmen's reliance on state precedents than any conscious intention to restrict commercial banking practices.\footnote{Symons, supra note 36, at 698-701. Indeed, Symons contended that Congress intended to induce state banks to convert to federal charter by adopting the broadest powers formulation then existing under statute, the New York Free Banking Act of 1838. Id. at 689-98.}

The casualness with which bank charter restrictions were adopted was mirrored by the casualness with which they were observed. Banks regarded the law as a formality and evaded its restrictions on their powers by conducting ultra vires businesses through state-chartered corporate affiliates.\footnote{See V. CARROSSO, INVESTMENT BANKING IN AMERICA 98 (1970) (describing the affiliate system).} By the early twentieth century, banks had expanded their businesses well beyond traditional limits to include broad investment banking powers including underwriting and dealing in investment securities. Congress abetted this development by conferring trust powers on national banks in 1913\footnote{F. REDLICH, THE MOLDING OF AMERICAN BANKING 392-93 (2d ed. 1968).} and by permitting direct dealings in debt securities in 1927.\footnote{Federal Reserve Act, ch. 6, § 11, 38 Stat. 251, 261-63 (1914) (codified as amended at 12 U.S.C. § 248 (1982)).}

\section*{B. Glass-Steagall and the Divorce of Commercial and Investment Banking}

\subsection*{1. The Enactment of Glass-Steagall}

In contrast to charter restrictions, prohibitions on engagement by commercial banks in investment banking were not adopted fortuitously and have not been
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observed casually. Rather, their enactment was the result of a conscious attempt to grapple with an endemic problem of the United States banking industry: its tendency to incur episodes of bank panic and regional banking collapse. The immediate impetus for the legislation was the series of panics that followed the stock market collapse of 1929. The crisis spurred a congressional inquiry, chaired by Senator Carter Glass of New York, that attributed blame for the market collapse to the bank affiliate system and popularized the notion that bank "conflicts of interests" were chiefly responsible for the recurrent bouts of banking panic. Confirmation of this belief was found readily in the circumstances of the 1930 collapse of the unfortunately named Bank of the United States. The failure of the bank, a major private institution with over $200 million dollars in deposits, was the signal event of the first banking crisis of the Great Depression. The bank’s demise was widely ascribed to abuses in transactions with its securities affiliates. Responding to the perception, Glass engineered the inclusion of a plank favoring the divorce of commercial and investment banking in the 1932 Democratic Party platform and campaigned on behalf of the party ticket with perorations against “insatiable” banks and “their lawless affiliates.” Upon the installation of a new President and Congress in 1933, Glass’ proposal was joined with a bill offered by Representative Henry Steagall to create a federal deposit insurance system. The resulting compromise legislation was cleared quickly by both Houses in June 1933 and signed by President Roosevelt shortly thereafter.

The term “conflicts of interests” has a somewhat unconventional meaning when used to describe the purposes of the Glass-Steagall Act (Glass-Steagall). In its ordinary usage, the term refers to situations where there exists an opportunity for self-dealing at the expense of bank clients, beneficiaries of its trust accounts, or bank creditors. “Conflicts of interests” in this sense are endemic in banking. For example, a bank generally may loan funds to a trust for which it is trustee; it may serve as the trustee for debt securities of an issuer of which it is a creditor; and it may make loans to officers, directors, and affiliated persons. Although some attention is directed at such situations in the federal

94. Id. at 524.
95. See, e.g., FLA. STAT. § 660.38(2) (1985) (empowering Florida banks to lend funds to trust accounts); 12 C.F.R. § 9.12(f) (1987) (permitting national banks to lend funds to a bank trust account where not prohibited by local law).
96. Under federal law, a bank is disqualified as a bond trustee only under specified circumstances, including the ownership of non-voting securities of the issuer. See Trust Indenture Act of 1939, ch. 411, § 310(b), 53 Stat. 1149 (codified at 15 U.S.C. § 77jjj(b) (1982)).
97. See 12 C.F.R. § 31 (1987) (setting forth regulations regarding loans to insiders of national banks); id. § 215 (same regarding Federal Reserve member banks); id. § 337.3 (same regarding state non-member banks).
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statutes, and scattered references in the legislative history of Glass-Steagall indicate they were a concern of the 1933 Congress. Glass-Steagall did not address the broad range of such "conflicts." In practice, control of such abuses, except in connection with distribution of and dealing in securities, was left to the general supervisory powers of regulators, private litigation, and market forces. Rather, in the context of Glass-Steagall, the rubric "conflicts of interest" has been used to allude to a number of inducements inherent in an integrated commercial and investment banking firm to undertake behavior that jeopardizes the solvency of the bank, either by encouraging the bank to misdirect its assets into the securities markets, or by causing a loss of depositor confidence in the bank. This usage encompasses both the "obvious danger" that a bank might be tempted to invest imprudently in its securities affiliates or the customers of its affiliates, and more "subtle hazards" emanating from the bank's interest in maintaining its own reputation of the bank and the economic vitality of related businesses.

2. "Conflicts of Interests" as a Continuing Justification for Limitations on Bank Activities

Whatever the immediate cause of the banking calamities of the early 1930s, "conflicts of interests" hardly were the core problem of United States banking. The divorce of commercial and investment banking alone would not have ameliorated significantly the problem of banking instability. The root cause of episodic banking panics lay in the inherently unstable nature of fractional reserve intermediation, rather than in abusive banking practices. Given the stock market crash of 1929 and the ensuing decline in economic activity, the failure of the Federal Reserve System to accommodate an increased demand for cash balances probably was the decisive factor in causing the banking crises of the early 1930s. Earlier panics had been triggered by other causes not addressed by Glass-Steagall.


100. In Camp, the Supreme Court identified a number of "subtle hazards" that Glass-Steagall sought to remedy: (1) the temptation to a bank to divert resources to support a failing affiliate in order to protect the reputation of the bank; (2) the potential for loss of client goodwill during periods of securities market deflation because of the decline in value of securities previously underwritten by the bank affiliate; (3) the adverse incentive to a bank to undertake imprudent loans in order to finance purchases of securities by the borrower; and (4) the temptation to a bank to unload securities into its trust accounts in violation of its fiduciary responsibilities. Id. at 629-34.

101. The relationship of the supply of high-powered money, deposit inconvertibility, and bank runs was understood by academicians and banking experts before 1930, but not, apparently, by Federal Reserve System officials. Although the Board devoted substantial attention to the problems of the banking system following October 1930, it was preoccupied with the quality of bank management, and devoted little attention to the adequacy of bank liquidity. See M. Friedman & A. Schwartz, supra note 90, at 299-419. Board officials "tended to regard bank failures as regrettable consequences of bad management and bad banking practices, or as inevitable reactions to prior speculative excesses, or as a consequence but hardly a cause of the financial and economic collapse in process." Id. at 358; see also Federal Home Loan Bank Board, Agenda for Reform 31 (1983) (attributing the banking crisis to the failure of the Federal Reserve Board to exercise its discretion properly).
Because, in a fractional reserve system, the claims of depositors ordinarily exceed by many times the cash immediately available to a bank in the absence of external assistance a bank will be able to honor demands for withdrawal of funds as long as new deposits roughly equal or exceed withdrawals. Therefore, whenever the situation appears likely that withdrawals substantially will exceed new deposits in a particular institution, its depositors have a rational incentive to withdraw quickly their own funds before the institution's liquidity is exhausted. Moreover, since the assets of one bank are the liabilities of another, efforts by a bank to augment its cash on hand by liquidating assets are likely to have the effect of spreading illiquidity and inducing depositor runs on other institutions.102 While a perception of imminent illiquidity sufficient to trigger a bank run could result from bank securities transactions, it also could result from changes in the economy of the locality in which a bank operates, the vicissitudes of its credit customers, or the imprudence or bad luck of bank management.

While the Glass-Steagall restrictions on investment banking powers may have reduced marginally the incidence of bank failure, they generally did not resolve the instability of fractional reserve banking. In fact, the end of banking instability in the United States was wrought by the other consequential provision of Glass-Steagall federal deposit insurance. Academic economists never joined in the popular misconception of the relationship between "conflicts of interests" and deposit instability. From its inception, economists regarded the separation of commercial and investment banking as a very subsidiary element of a bill whose centerpiece was deposit insurance.103 Deposit insurance resolved the instability of banking by assuring depositors of the safety and accessibility of their deposits, thereby obviating the necessity of maintaining vigilant attention to bank solvency. By averting depositors' impulse to withdraw funds in anticipation of withdrawal imbalances, deposit insurance ended the potential for bank panics and brought stability to fractional reserve banking.104 By the same token, deposit insurance

102. Banking failures are likely to be correlated in a fractional reserve system for another reason: the total of demand deposits vastly exceeds the total cash, \( M_n \), available in the economy. Any precipitant increase in the desirability of holding cash balances relative to bank deposits that is not accompanied by rapid increases in \( M_n \) necessarily leads to the failure of banking intermediaries. See T. Mayer, J. Dusenberry & R. Aliber, Money, Banking and the Economy 178-90 (1984) (providing an elementary development of the money multiplier associated with fractional reserve banking); see also Council of Economic Advisors, Economic Report of the President 146-47 (Feb. 1984) [hereinafter 1984 CEA Report] (analyzing the disequilibrium nature of fractional reserve banking).

103. See, e.g., Preston, The Banking Act of 1933, 23 Am. Econ. Rev. 585, 597 (1933). Preston exhibited the skepticism, widespread among economists in the 1930s, that deposit insurance could succeed. Id. at 597-600. Preston was the first to identify in print the problem of insurance-induced risk-taking, a concern that has emerged fifty years later as a central issue of banking regulation. See infra text accompanying notes 169-177.

104. During the years 1921 to 1929, an era of generally uninterrupted prosperity, an average of 600 banks per year failed, and from the stock market crash in 1929 to the end of 1933, approximately 9,000 banks closed. In contrast, during the eight years between the initiation of federal deposit insurance and the onset of World War II, only about 400 banks failed, and in the thirty years between 1942 and 1972, only 110 banks failed. Federal Deposit Insurance Corporation, Deposit Insurance in a Changing Environment I-3 to I-6 (1983). Although the number of bank failures has risen in the last few years and risen dramatically in the past two years, only 138 banks failed in 1986. Federal Deposit Insurance Corporation, 1986 Annual Report, Table 122, at 53 [hereinafter FDIC 1986 Annual Report]. Total FDIC losses and expenses
also rendered superfluous concerns relating to the "subtle hazards" of conflicts of interests because they were premised upon the necessity of maintaining the confidence of depositors. Under existing deposit insurance practices, depositors have no rational reason for sensitivity to the reputation of the depository or its affiliates. This fact gives the Glass-Steagall jurisprudence a cabalistic air as courts have struggled to define the scope of the Act's prohibitions according to mechanical tests for the presence of "conflicts of interests" and "subtle hazards," although these tests serve no policy purpose.

C. The Adoption of the Bank Holding Company Act and the Attack on "Undue Concentration" in Banking

1. The Enactment of the Bank Holding Company Act

The success of federal deposit insurance in stabilizing banking did not end the call for further federal regulation of banking. Proposals for bank holding...
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company legislation that included restrictions on engaging in nonbanking businesses were introduced in virtually every Congress from the 1930s onward. The Board, with equal regularity, had endorsed such proposals on the spurious grounds that legislation was necessary to close "gaps" in the separation of banking and nonbanking businesses reasoning that "[t]he fact that Congress has required banks to stay out of nonbanking business but to stay solely in the banking business ... should carry over into the holding company field." The Board's position contravened both history and logic. Congress never had affirmatively required banks to stay out of nonbanking business; the NBA copied, without substantive change, the powers clause from the New York Free Banking Act of 1838, the most liberal contemporaneous state banking statute, thereby giving national banks the broadest powers allowed state banks under state laws. Indeed, the powers clause, to the extent it was given any attention by Congress, "was considered of little significance." Rather, subsequent interpretations of the statute by comptrollers of the currency and various courts provided its restrictive cast. The Board's position also ignored the obvious difference for the potential solvency of the bank between the engagement in nonbanking businesses by a bank or its subsidiaries and by a holding company or its nonbanking subsidiaries. The former necessarily ties the solvency of the bank to the performance of nonbanking businesses; the latter does not.

The ultimate success of proponents of further bank regulation owed little to the force of the Board's arguments. The voluminous hearings that preceded passage of the BHCA focused only infrequently on its nonbanking provisions. The few empirical data provided by the Board in Senate hearings appear to contradict the necessity of extending the separation of banking and commerce to holding companies. Of eighteen bank holding companies for which evidence was presented by the Board, five owned no nonbanking subsidiaries and apparently only one, Transamerica Corporation, was engaged substantially in non-


110. See Symons, supra note 36, at 699.

111. Id.

112. See supra text accompanying notes 30-52.

113. The degree to which the holding company structure insulates banks from the vicissitudes of its nonbanking affiliates is the subject of some controversy. Compare Case & Mingo, The Regulation of Bank Holding Companies, 30 J. FIN. 281 (1971) (arguing that the holding company structure reduces bank risk, since bank income does not depend on affiliate performance and the bank is not legally liable for affiliate's debts) with Eisenbeis, How Should Bank Holding Companies be Regulated?, Fed. Reserve Bank of Atlanta Econ. Rev., Jan. 1983, at 42 (arguing that the insolvencies of affiliates will bring pressure to convert bank assets). The truth, as in most cases, likely lies somewhere between the polar contentions. Whatever the truth, this Article largely ignores the controversy in favor of a broader framing of issues: whether there ought to be a separation and, if so, how it should be defined.
banking businesses.114 Of the approximately $654 million of book value holdings in Transmerica's nonbanking companies, $504 million was accounted for by a family of insurance companies and only $35 million was in two operating nonfinancial companies, a metals manufacturer and a fish processing company.115 Nor was the Board able to identify any actual problem of "conflicts of interests" arising from bank holding company involvement in nonbanking businesses.116

What prompted the revival of holding company legislation, dormant for so many years? In a phrase, congressional passage of the BHCA in 1956 was due to "fear of size."117 The late 1940s and early 1950s saw two "boomlets" of merger activity across a broad spectrum of American industry,118 including banking.119 Public perception of increased economic concentration had earlier spurred the 1950 enactment of the Cellar-Kefauver Act,120 which amended the Clayton Act to restrain more vigorously horizontal and vertical industrial mergers.121

114. 1955 Senate Hearings, supra note 109, at 63-64.
115. Id. at 63.
116. Questioned whether there was a danger that loans would be extended to bank affiliates improvidently, Governor Robertson responded:

I would say that, insofar as the 18 companies which are regulated at the moment are concerned, I cannot think of a single violation of section 23(a) of the Federal Reserve Act which regulates the amount of loans which a bank can make to the holding company and its subsidiaries. They are limited and restricted, and all must be amply secured.

Id. at 64. Pressed by Senator Douglas of Illinois to identify the harm of affiliations between banks and other business, Governor Robertson suggested the possibility that persons seeking credit would be influenced to patronize bank affiliates, leading to the following colloquy:

Senator Douglas: "Is it merely a potential danger or do you think it is an actual practice?"

Mr. Robertson: "I hesitate to make statements I cannot prove. Therefore, I could not state an instance which I would be willing to vouch for."

Senator Douglas: "Do you think Congress should legislate on suspicion?"

Mr. Robertson: "I think Congress should take into consideration the potentialities involved and the fact that you have to have an entirely different sort of attitude in dealing with depositors' funds than your own. The fact that Congress has required banks to stay out of nonbanking business but to stay solely in the banking business, I think, should carry over into the holding company field. If there is no real danger at the moment, you are not hurting anybody by such legislation."

Id. at 65 (emphasis supplied).
118. See G. Benson, CONGLOMERATE MERGERS 5-7 (1980) (presenting in graphical form the volume of mergers between 1895 and 1980).
119. See Alhadef & Alhadef, Recent Bank Mergers, 69 Q. J. Econ. 503 (1955) (presenting data indicative of significant post war bank merger activity).
121. As originally drafted, § 7 of the Clayton Act, Pub. L. No. 81-899, 38 Stat. 731-32 (1914) (codified as amended at 15 U.S.C. § 18 (1982)), the principal statutory weapon against anticompetitive mergers, applied only to transactions effected by stock acquisition and, hence, was circumvented easily by structuring mergers as assets acquisitions. As a result, the statute virtually was a "dead letter." Comment, "Substantially to Lessen Competition . . . " Current Problems of Horizontal Mergers, 68 Yale L.J. 1627, 1629-30 (1959). Between the original enactment of the Clayton Act in 1914 and the mid-1940s, a period during which thousands of mergers took place, the Federal Trade Commission and the Department of Justice together
The Cellar-Kefauver Act, however, generally was regarded as inapplicable to banks and bank holding companies, and bank regulators continued to rely on the largely impotent provisions of earlier legislation to prevent anticompetitive mergers. Public unhappiness with the apparent inability of existing antitrust law to control banking aggregation crystallized with the Board's well-publicized failure in 1953 to dismantle the Transamerica banking empire. The Transamerica Corp. v. Bd. of Governors of the Fed. Reserve System decision spurred Congress to action and resurrected the dormant eighteen-year old bank holding company regulation proposal. Given the circumstances, congressional attention was directed primarily at the provisions of the proposed legislation that regulated bank acquisitions lest unrestrained growth of bank holding companies result, in the words of its framers, in “undue concentration of control of banking activities.” Although


122. The applicability of the original § 7 of the Clayton Act to banks was doubted widely in view of statutory language limiting its reach to corporations “engaged in commerce.” Pub. L. No. 81-899, 38 Stat. 731 (1914) (codified as amended at 15 U.S.C. § 18 (1982)). These doubts apparently were eased during congressional deliberations over the BHCA by the decision of the Third Circuit in Transamerica Corp. v. Bd. of Governors of the Fed. Reserve Sys., 206 F.2d 163 (3d Cir.), cert. denied, 346 U.S. 907 (1953), holding that “commerce” included banking. Id. at 165. Nonetheless, Transamerica Corp. applied only to stock acquisition mergers. Although the Cellar-Kefauver Act had amended § 7 to address asset acquisition transactions, the relevant language was directed only at persons “subject to the jurisdiction of the Federal Trade Commission,” 15 U.S.C. § 18 (1982), a category not including banks. See 15 U.S.C. § 45(a)(2) (1982) (excluding banks from FTC jurisdiction). Not until 1963, with the advent of the Philadelphia Nat'l Bank Supreme Court decision, was the Clayton Act applied definitely to bank mergers not effected by stock acquisitions. Philadelphia Nat'l Bank, 374 U.S. at 343. In the meantime, the BHCA functioned as the primary bank antitrust statute with respect to bank mergers and acquisitions under the authority of § 3(c)(5) of the Act, which required the Board to consider, inter alia, “whether or not the effect of such acquisition or merger or consolidation would be to expand the size or extent of the bank holding company system involved beyond limits consistent with the preservation of competition in the field of banking.” Bank Holding Company Act, Pub. L. No. 84-511, § 3, 70 Stat. 134 (1956). Subsequent to Philadelphia National Bank, § 3(c) was amended to incorporate language borrowed from §§ 1 and 2 of the Sherman Act and § 7 of the Clayton Act, subject to the proviso that competitive concerns be weighed against “the public interest . . . in meeting the convenience and needs of the community to be served.” Bank Holding Company Act, Pub. L. No. 89-485, § 7(c), 80 Stat. 237 (1966) (codified as amended at 12 U.S.C. § 1842(c) (1982)). The 1966 amendments subsequently have been interpreted to incorporate established antitrust jurisprudence under the Clayton and Sherman Acts in the administrative review of proposed bank mergers. Mercantile Texas Corp. v. Bd. of Governors of the Fed. Reserve Sys., 638 F.2d 1255, 1261 (5th Cir. 1981).

123. Transamerica Corporation, the successor to the banking empire of A.P. Giannini, controlled 41% of commercial banking offices, 39% of commercial bank deposits, and 50% of the commercial loans in the five states of California, Oregon, Nevada, Washington, and Arizona. Transamerica Corp., 206 F.2d at 167. Nevertheless, the Third Circuit held that the Board had failed to establish “that the five states constitute a single area of effective competition among commercial banks” or that Transamerica had “moved measurably toward monopoly power” in any appropriately defined commercial banking market. Id. at 169.

124. Id.

an issue promoted by the Board and a nominal element of the statute, concern regarding "conflicts of interests" posed by ownership of nonbanking assets by bank holding companies played only a minimal role in the passage of the BHCA.126 Use of the phrase "undue concentration" in legislative reports accompanying the Act blurred two related but quite different policy goals that continue to underlie contemporary political debate regarding the separation.127 One is the promotion of conventional antitrust objectives: the enhancement of competition in banking markets and allocative efficiency in capital intermediation.128 The other, the discouragement of large banking entities, has nothing to do with competitive efficiency, but rather manifests an ideological antagonism toward massive aggregation of capital irrespective of the competitive structure of the market in which it occurs.129 Although these goals share a common rubric, they differ conceptually and sometimes are antagonistic.130

2. Conventional Antitrust Concerns

The conventional antitrust argument for the separation of banking and commerce is directed against the proliferation of monopoly from banking into nonbanking businesses. The argument usually proceeds from the following premises: (1) some banks have monopoly power—that is, the power to obtain supernormal profits by increasing prices above competitive levels by paying less than competitive rates on deposits or charging more than competitive rates on loans; (2) banks with monopoly power will tend to expand into nonbanking businesses to increase the yield from their monopoly power; and (3) conventional antitrust restraints are inadequate to prevent the spread of such monopolistic abuses.131 Local banking markets in fact are highly concentrated,132 in part because

126. The Senate Report devoted two sentences to a discussion of the conflict of interest issue:

The committee was informed of the danger to a bank within a bank holding company controlling nonbanking assets, should the company unduly favor its nonbanking operations by requiring the bank's customers to make use of such nonbanking enterprises as a condition to doing business with the bank. The bill's divestment provisions should prevent this fear from becoming a reality.

128. Id.
129. Id.
130. For example, restrictions on branch banking diffuse capital by limiting the growth of individual banks, but they also increase concentration in local banking markets by preventing the entry of existing banks into new markets. See 1984 CEA Report, supra note 102, at 158.
131. There is no indication that Congress was concerned by another logical possibility: that a non-banking monopolist would integrate backward into the banking business in order to circumvent restrictions on price discrimination, by tying the purchase of the product to loans from the bank at discriminatory rates. Presumably, this conduct would violate the Sherman Act under conventional antitrust principles.
of restrictive government chartering policies and limitations on branch banking. The other premises of the conventional antitrust justification are less convincing.

Why should a bank that has some degree of market power wish to integrate into a nonbanking business? Casual analysis may suggest two motives with potentially adverse consequences for social welfare: to extract monopoly profits from nonbanking customers and to enhance the bank’s ability to engage in price discrimination and thereby appropriate the consumer surplus of its banking customers. In practice, conglomerate integration would be unlikely to serve either goal. A bank rarely would be able to extend market power from deposit taking and retail banking into nonbanking lines of business, even if the bank refused to lend to competitors of its nonbanking affiliates. Markets for business loans simply are too competitive. Some competitors of the nonbanking business would be financed by other local banks, especially if other banks were not following restrictive lending policies in order to promote monopolies; others would find alternative nonbank sources of capital; and still others could be expected to obtain bank loans from banks outside the locality. The bank’s promoting of its nonbanking businesses by granting credit on favorable terms

reflecting computation of Herfindahl Indexes for each of 248 Standard Metropolitan Statistical Area (SMSAs) and 2470 non-SMSA counties based on 1972 deposits); Rhoades, Concentration in Local and National Markets, Fed. Reserve Bank of Atlanta Econ. Rev., Mar. 1985, at 28 (indicating the stability of high Herfindahl Indexes for SMSAs over time).

The pattern of legal restrictions on branching by state and national banks is complex. The great majority of states place some restrictions on branching, depending on the type of depository institution, location, mode of branching (by acquisition of an existing bank, by automated teller machine, etc.), and other factors. As of June, 1985, 8 states prevented branching in almost all circumstances, 19 states substantially limited branching, and 23 states substantially permitted state-wide banking. See 1 Fed. Banking L. Rep. (CCH) ¶ 3106 (Sept. 12, 1986) (providing a summary of state branch banking laws); see also Ginsburg, supra note 127, at 1152-55 (analyzing branching restrictions). Under the McFadden Amendment to the NBA, the Comptroller is empowered to permit national banks to branch only where state banks would be permitted to branch under state law. 12 U.S.C. § 36(b)(1) (1982).

Of course, a bank may have other motives for expansion into nonbanking businesses which clearly are unobjectionable from an antitrust standpoint, such as exploitation of economies of scale, reduction of nonsystemic business risk by diversification, or reduction of customer transaction costs. See infra notes 218-231 and accompanying text. Vertical expansion to effect price discrimination is assumed to be undesirable for the purpose of constructing this argument, although the economic welfare effects of price discrimination by a monopolist generally are ambiguous. See generally Schmalensee, Output and Welfare Implications of Monopolistic Third-Degree Price Discrimination, 71 AM. ECON. REV. 242 (Mar. 1981) (proving that price discrimination can lead to an increase in economic welfare if it makes profitable sales to markets which could not be served under single price monopoly).

A monopolist may integrate forward into businesses involving low-value uses of its product in order to avoid the dilemma of choosing between setting a low price, to market to low value users, and a high price, to maximize the extraction of surplus from high-value users. Thus, a plastics manufacturer may integrate forward into pipe manufacturing, a low-value use, so that a high market price can be maintained for prosthetics, a high-value use, while still enjoying the benefits of selling to the pipe market.

to bank affiliates and their customers would not make sense either. Every dollar of loan subsidy given an affiliate or its customers would reduce bank income by one dollar. It is no cheaper for a bank to subsidize credit than it is any nonbanking competitor. Assuming the presubsidy market prices in the nonbanking business were at a competitive equilibrium, credit subsidies to the customers of its affiliates could only lose money for the bank.

Furthermore, it is improbable that a bank could improve its ability to price-discriminate among its customers by integrating vertically. A nonbanking firm with some degree of monopoly power may be able to increase its profits by acquiring ownership of its customers, because such forward integration could facilitate price discrimination where it otherwise would be illegal or impractical. Alternatively, such integration could permit the monopolist to distinguish the intensities of demand for its product among its various customers and thereby to exploit more effectively the power to price-discriminate. Unlike industrial companies which effectively are precluded from price-discriminating directly among customers under existing antitrust laws, however, banks are free to charge different customers different interest rates on loans without resort to vertical integration. In addition, it is difficult to identify a plausible scenario in which engagement in nonbanking businesses would provide additional information to a bank that would be useful in identifying customers' demand schedules for borrowed funds.

137. The specter of cross-subsidization of nonbanking businesses by provision of easy credit to customers of the nonbanking business was raised repeatedly in congressional hearings on proposed bank holding company legislation, often by representatives of the Board. See, e.g., 1955 Senate Hearings, supra note 109, at 64 (testimony of J.L. Robertson, member of the Federal Reserve Board). The principal concern was loans to customers of affiliates, since direct loans to affiliates had been regulated since the Banking Act of 1933, ch. 89 § 23A, 48 Stat. 183 (codified as amended at 12 U.S.C. § 371c (1982)).

138. The only time that credit subsidies to customers of the affiliate would increase profits of the aggregate business would be when the affiliate was pricing above the competitive market equilibrium. In such a case, the effect of the credit subsidy would be to lower prices and to improve allocational efficiency by moving the market towards the competitive equilibrium.

139. See supra note 134. The practices enjoined in International Business Machs. Corp. v. United States, 298 U.S. 131 (1936) illustrate the use of vertical restraints to enhance a monopolist's power to price discriminate by distinguishing different demand intensities among its customers. Defendant IBM, one of two manufacturers of automated punch card tabulating equipment, routinely required lessees of such equipment to use only IBM-supplied punch cards. Id. at 133-34. The cards apparently were priced by IBM at a substantial premium. Id. at 136. By requiring the lessees of its machines to use only its cards, IBM was effectively able both to price discriminate and to do so in such a manner that the highest value customers (i.e., those that made the greatest use of the tabulating machines) were charged the highest price. Id. at 135-36.

140. Under § 2 of the Clayton Act, 15 U.S.C. § 13 (1982), as amended by the Robinson-Patman Act of 1936, 15 U.S.C. §§ 13, 13a, 13b, 21a (1982), it is illegal "to discriminate in price between different purchasers of commodities of like grade and quality . . . ." 15 U.S.C. § 13(a) (1982). Even in the absence of the Robinson-Patman restrictions, price discrimination would be impossible, unless the monopolist were able to prevent low-price customers from reselling to high-price customers. However, such restraints on resales may be illegal or impractical to enforce. Bank credit extended to different borrowers never has been regarded as a "commodity of like grade and quality" subject to Robinson-Patman, because the risk characteristics of each borrower are unique and banks are free to prevent resale of their "product" (capital) by imposing terms in the loan agreement inhibiting investment by the borrower in other enterprises. Such agreements are enforced easily because substantial relending would be uncovered in audits made available to the bank-lender.
It may be argued that banks would engage in predatory pricing, cross-subsidizing operations of the nonbanking affiliate even at the cost of sustaining losses, for the purpose of driving competitors out of business and thereby establishing a monopoly. The efficacy of predatory pricing as an anticompetitive strategy is very much in dispute. At a minimum, predatory pricing can work only with industries in which there are significant barriers to entry. Otherwise, the threat of potential entry would inhibit exploitation of the monopoly created by predation. Regardless of its efficacy, banks have no more incentive to undertake predatory pricing than any other owner of a nonbanking business of comparable wealth. Indeed, they may have considerably less incentive, because the low effective marginal tax rate on banks reduces the value of the tax offset to the expenses of subsidization and, therefore, makes the after-tax cost of predatory pricing more expensive for banks than other large businesses.

Even if banks were inclined to expand into nonbanking businesses for anticompetitive purposes, there is no reason to believe that existing antitrust laws would be inadequate to restrain them. Indeed, in two respects, the antitrust laws may be more restrictive with respect to vertical restraints involving banks than nonbanking firms. First, the antitrust standard that applies to applications by bank holding companies or their affiliates to engage in nonbanking activities under section 4 of the BHCA is "whether . . . performance [of the nonbanking function] by an affiliate of a holding company can reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects, such as . . . decreased or unfair competition . . . ." Unlike the analogous provisions in section 3 of the BHCA and in section 1 of the Bank Merger Act that apply to administrative review of bank acquisitions and bank mergers, the language of section 4 does not paraphrase the Sherman and Clayton Acts. The Board, therefore, should be free to apply a more stringent standard of antitrust review to acquisitions of nonbanking interests by a bank holding company than in review of bank acquisitions or in review by other antitrust enforcement agencies in nonbanking contexts.

141. See P. AREEDA, ANTITRUST ANALYSIS: PROBLEMS, TEXT, CASES 190-203, 850-853 (3d. ed. 1981) (presenting a critical introduction to the debate). Evidence that geographically diversified banks have been unsuccessful in discouraging new market entry by competitors indicates that predatory pricing has not been used successfully as an anticompetitive strategy in credit markets. See Curry & Rose, Diversification and Barriers to Entry: Some Evidence from Banking, 29 Antitrust Bull. 759 (1984) (concluding there is no support for the theory that geographically diversified banking organizations impede market entry).

142. See Bailey & Baumol, Deregulation and the Theory of Contestable Markets, 1 YALE J. REG. 111, 112-19 (arguing that supernormal profits cannot be made over the long run if entry and exit from the market are easy).

143. 12 U.S.C. § 1843(c)(8) (1982). Section 7A(c)(8) of the Hart-Scott-Rodino Antitrust Improvements Act, 15 U.S.C. § 18a(c)(8) (1982), provides that all information and documentary material regarding acquisitions subject to approval by the Board be "contemporaneously filed with the Federal Trade Commission and the Assistant Attorney General at least 30 days prior to consummation of the proposed transaction." Id. In practice, the FTC and the Department of Justice rarely or never intervene in BHCA § 4(c)(8) applications.


145. Although in Mercantile Texas the Fifth Circuit loosely referred to acquisitions by bank holding companies in holding that the Board was prohibited from applying a more stringent standard of antitrust review than permitted under the Clayton Act, Mercantile Tex. Corp. v.
Second, the 1970 amendments to the BHCA added provisions considerably more prohibitory than the law applied to nonbanking entities. That specifically forbid tying extensions of credit by a bank to the purchase of its products or services from the bank or from any affiliate of the bank. As with analogous law arising under the Clayton and Sherman Acts, these provisions may be enforced by actions brought by government or private litigants for injunctive relief. Any person "injured in his business or property" is provided an express cause of action for treble damages. Unlike causes of action arising under the Clayton or Sherman Acts, however, a plaintiff relying on the BHCA amendments need not allege or prove either market power of the bank or substantial anticompetitive effects.

Rationalizing either the BHCA section 4(c)(8) antitrust standard or bank antitying laws on the basis of conventional antitrust principles is difficult. In the nonbanking world, horizontal restraints are subjected to more stringent restrictions than vertical or conglomerate arrangements because the adverse welfare implications of the former are more certain. In banking, this hierarchy is reversed: horizontal integration is reviewed under the standards of the Sherman and Clayton Acts, but even then a horizontal integration may be approved notwithstanding violation of the usual standards if offset by the benefits of meeting "the convenience and needs of the community to be served." Non-banking integration either is prohibited directly or subjected to antitrust standards that are more restrictive than those applied to transactions not involving banks or to horizontal bank integration. Whatever the basis for the asymmetry,
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however, the more stringent treatment of vertical restraints involving banks makes less plausible concerns regarding anticompetitive practices as a justification for the separation of banking and commerce.

3. Discouragement of Large Entities

Fear and distrust of banks, in particular large money center banks, has been a continuing theme of American political history. Like the owners of large railroads and armaments manufacturers, bankers have been suspected of pursuing clandestine, antisocial ends and, despite their relatively small numbers, of having wielded enormous political influence. Not surprisingly, these suspicions have been important in shaping banking laws, and they undoubtedly have contributed to legislative support for restrictions on geographical expansion of banks and for the separation of banking and commerce. Presumably, “undue concentration of resources” in the BHCA was, at least to some members of Congress, an allusion to this theme and a code word signaling a populist attack on banking power. In certain cases involving nonbanking acquisitions, the company, primarily because the acquisition “involve[d] the issue of concentration in credit-granting resources . . . .” Id. at 144. This position would have been unsupportable under conventional antitrust standards, because the national “credit-granting” industry probably is too broad a market under standard principles, and the Board performed no analysis of market shares. See Ginsburg, supra note 127, at 1274.

153. See B. HAMMOND, supra note 81, at 53-64 (describing the political debate over the Bank of North America during the period 1785 to 1787 that led to repeal of its charter and subsequent recharter under more restrictive terms); id. at 405-10 (discussing President Jackson’s exploitation of populist ideology to support his veto of the recharter of the Second bank of the United States); id. at 605-30 (outlining the history of antibanking sentiment in the western United States).

154. See L. Brandeis, Other Peoples’ Money passim (1914) (positing a conspiracy by a “Money Trust”).

155. See, e.g., Perkins, supra note 92, at 515-519 (discussing Senator Carter Glass’ “charge of a bankers’ conspiracy” which was used to mobilize popular support for reform proposals eventually incorporated into the Glass-Steagall Act). An interesting variation on this theme appeared at several points in the Senate hearings on proposed bank holding company legislation. Several witnesses, including a United States Congressman, testified that banking aggregation should be discouraged in order to defeat any attempt to establish a totalitarian state. See 1955 Senate Hearings, supra note 109, at 360 (statement of Rep. Multer arguing that the consolidation of banking facilitated Communist takeover of Russian financial industry); id. at 109 (testimony of W. J. Bryan, of the Independent Bankers Association of America, arguing that the consolidation of banking facilitated Nazi takeover of German banking industry).

156. This supposition is buttressed by the legislative history of the 1956 Act which provides some basis for inferring an intention on the part of Congress to enact a prophylactic against bank mergers more stringent than conventional antitrust analysis would justify. During congressional hearings that preceded the Act, the Third Circuit decided Transamerica Corp. v. Bd. of Governors of the Fed. Reserve Sys., 206 F.2d 163 (3d Cir. 1953), holding that § 7 of the Clayton Act applied to bank mergers. Id. at 165. The court also ruled, however, that the relevant market for banking services was local and, therefore, notwithstanding Transamerica’s dominant holdings within the five state region, the Board had failed to demonstrate the “substantially lessened competition” standard required for § 7 relief. Id. at 167. This result received considerable attention in the Senate hearings with a number of witnesses complaining of the insufficiency of then existing law to constrain the growth of such giant concerns. See, e.g., 1955 Senate Hearings, supra note 109, at 125 (testimony of H. Harding, President of the Independent Bankers Association for the 12th Federal Reserve District); id. at 106-07 (testimony of W. J. Bryan, Independent Bankers Association of America); see also id. at 97-98 (presenting the exchange
Board adverts to this meaning. For example, the Board has taken the position that it will deny a BHCA section 4(c)(8) application by a major bank holding company to acquire an interest in a joint venture whenever the proposed co-venturer is itself a substantial enterprise.\(^\text{157}\) The Board’s stated reason for this policy is that “close working relationships between large U.S. banking and nonbanking organizations could lead to an undue concentration of economic resources . . . .”\(^\text{158}\) Although the Board’s rationale is inarticulate and its theoretical underpinnings hazy, this policy surely cannot be grounded in conventional antitrust analysis because, for example, it bypasses the usual predicate question of whether the parties would be likely to enter the market absent the joint venture.

Whether, in fact, this super-antitrust policy has constrained significantly the growth of the largest bank holding companies is questionable. Despite lower population density and more substantial legal impediments to bank expansion and lower population density in the United States, the concentration of commercial bank assets in major bank holding companies in the United States exceeds that in Germany and is not greatly less than in Japan or the United Kingdom.\(^\text{159}\)

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\(^\text{157}\) See Deutsche Bank AG, Order Approving Proposed Bookkeeping and Data Processing Activities and Denying Proposed Finance, Loan Servicing, Leasing and Insurance Activities, 69 Fed. Reserve Bull., No. 5, 449, 451 (May 1981) [hereinafter Deutsche Bank AG]; BankAmerica Corp., Order Denying Investment in Allstate International S.A., Zurich, Switzerland, 60 Fed. Reserve Bull., No. 7, 517, 519 (July 1974). In the former case, the Board disapproved an application to permit a joint venture equally owned by Deutsche Bank, AG, the largest bank holding company in Germany (and the third largest in the world), and Fiat S.P.A., the Italian auto maker and diversified industrial manufacturing company, from expanding de novo into a variety of financial services. Although recognizing that “the introduction of services de novo by a joint venture generally has pro-competitive effects where both joint venturers are not likely entrants into the market . . . . the Board found that the close working relationships between large U.S. banking and nonbanking organizations could lead to an undue concentration of economic resources, and . . . would not be consistent with the purposes of the Bank Holding Company Act, or in the public interest.” Deutsche Bank AG, supra at 451. In the latter case, the Board denied an application by the then largest banking organization in the United States to acquire a 50% interest in a joint venture with Allstate Insurance Company to operate a Swiss insurance underwriter engaged in business only in Europe. The Board justified its decision on the grounds that “[c]lose working relationships abroad between large U.S. banking organizations . . . [or] large U.S. insurance companies could in time weave a matrix of relationships between the joint venturers in the U.S. and abroad that could lead to an undue concentration of economic resources in the domestic and foreign commerce of the United States.” BankAmerica, supra, at 519.

\(^\text{158}\) Deutsche Bank AG, supra note 157, at 451.

\(^\text{159}\) In Germany, the three major credit banks control approximately 13-14% of total “universal” bank assets, while in both Japan and the United Kingdom, the 13 major banks hold approximately 50% of all bank deposits. See Goodman, Cumming & Kumekawa, supra note 8, at 86, 95, 101. In contrast, in 1984, the three largest bank holding companies in the United States controlled somewhat more than 16% of commercial bank assets and the largest 13 companies controlled about 37%. See Bank Scoreboard, Bus. Week, March 22, 1985, at 104; 71 Fed. Reserve Bull., No. 10, Table 1.25, at A18 (Oct. 1985).

The relative insensitivity of concentration to legal structure probably is due in part to the limited economies of scale in banking, which are exhausted at a relatively small scale. See King, Interstate Expansion and Bank Costs, Fed. Reserve Bank of Atlanta Econ. Rev., May 1983, at
In particular, the impact of restrictions on expansion into nonbanking businesses on holding company growth probably is minimal. Economies of scope—reductions in cost that may be attained by joining the production of related goods within a single firm—from joint provision of multiple financial services appear to be small and logically should be no more substantial for most nonfinancial businesses. The limited scale of such economies strongly implies that the banking industry would not, without regulatory controls, experience such extensive conglomeration with nonbanking industries so as to affect aggregate economic concentration. This conclusion is supported by experience prior to the adoption of the BHCA and the current experience with unregulated one-thrift holding companies. In any event, were bank holding company size alone the issue, the goal could be attained much more effectively by direct regulatory restraints on growth than by indirect controls on engagement in collateral lines of business.

Perhaps hostility toward "undue concentration of resources" reflects not mere distaste for large size, but a special concern with the potential political power of large enterprises that encompass both banking and commercial functions. Why concerns regarding political power should result in laws specifically directed at banking conglomerates is unclear. Such large integrated enterprises, businesses with thousands of employees and billions of dollars in committed assets, probably would have significant access to the political process. Nevertheless, in politics, disproportionate influence usually is attained by intense commitment to a narrow set of objectives and, in this respect, large diversified conglomerates may be something less than the sum of their constituent firm parts. Indeed, some of the most successful and socially costly lobbying has been conducted by trade associations on behalf of large industries comprised of small firms with homogeneous interests. Conglomerates that span a range of industries are more likely to internalize both the costs and benefits of interindustry redistributions and, therefore, to oppose especially insignificant programs and to exhibit ambivalence toward particular subsidy proposals. Even where size promotes the

40. King surveyed empirical studies of cost structures for unit and branch banks and for bank holding companies and concluded that "diseconomies of scale exist for institutions of all sorts—branch and unit, affiliate and nonaffiliate—above relatively low levels of overall size." Id. at 44; see also 1984 CEA Report, supra note 102, at 158 (stating that minimum costs for depository institutions to provide traditional banking services are attained by institutions in the $50 million to $100 million asset range). Given this cost structure, the existence of large banking institutions likely is due to the needs of large customers, who may experience economies dealing with a single bank. If this hypothesis is correct, then the growth of very large banks may not have been constrained significantly by geographical market restrictions, since convenient location is relatively unimportant to such customers.


161. Absence of economies of scope is not dispositive of whether extensive conglomeration would occur if permitted. There are other reasons why banks might integrate with nonbanking businesses, including customer economies and reduction of firm-specific business risks. See infra text accompanying notes 218-231. Nevertheless, the structure of costs probably is the single most important determinant of industry structure. It is implausible that substantial aggregation would occur if there were significant diseconomies of scope.

162. See supra text accompanying notes 114-115.

163. The dairy industry and rural electrical cooperatives come to mind.
pursuit of self-interest, there is no evidence that affiliation with a bank is more helpful than affiliation with any other large business.

D. The Bank Holding Company Act Amendments of 1970 and Neutrality in the Allocation of Banking Resources

Although the BHCA, as enacted in 1956, closed one regulatory “gap,” it opened another. The BHCA applied only to holding companies that controlled two or more banks. Independent banks were free to reorganize as one-bank holding companies and to engage in commercial activities through nonbanking subsidiaries free of BHCA restrictions. Just as the Federal Reserve Board had campaigned to close the perceived holding company loophole in 1955, it pressed to end the statutory exception for one-bank holding companies in 1969. The Chairman of the Board of Governors of the Federal Reserve System, William McChesney Martin, Jr., testified before the House Committee on Banking and Currency that the one-bank exception “has become a loophole of such magnitude that unless it is closed there is no possibility of effectively enforcing the [BHCA]'s restrictions on combining nonbanking businesses with banking . . . .”\(^{164}\) Testimony indicated a dramatic increase in the deposits held by one-bank holding companies after 1955 and a significant, but much smaller, growth in nonbanking assets controlled by such companies.\(^{165}\)

Again, the term “conflicts of interests” was used to describe the target of legislative reforms. In 1955, the focus of congressional concern had been primarily on Transamerica Corporation and the apparent inadequacy of conventional antitrust law to constrain the growth of gigantic integrated holding companies. However, in 1969, the fear was directed at “conflicts of interests” in yet another sense: the putative disincentive of integrated banking firms to lend to competitors of their nonbanking affiliates.\(^{166}\) The fear was not of the adverse political and economic effects of size, but of the competitive strangulation of smaller businesses that were unaffiliated with banks because of foreclosure from capital markets.

Although the danger was seen from a different perspective in 1969 than in 1955, it was underpinned by the same naïve belief that a bank’s involvement


\(^{165}\) Between 1955 and 1968, deposits of one-bank holding companies grew from $11.6 billion to $108.2 billion, while assets in manufacturing and mining industries controlled by such banks increased by $47.2 billion. Id. at 352, Table I (statement of Harrison F. Houghton, Chief of Economic Evidence of the Federal Trade Commission).

\(^{166}\) See, e.g., id. at 15 (statement of Professor A. A. Berle); id. at 196-97 (statement of William McChesney Martin). The focus on bank conflicts in this third sense in the 1969 Hearings apparently is consistent with the assertion of some authorities that “economic neutrality” in the allocation of credit should be recognized as a fundamental justification for limitations on the engagements of banks in nonbanking businesses. See E. SYMONS & J. WHITE, supra note 4, at 172-73; Symons, supra note 36, at 714-18. Casting the policy underlying the separation of banking and commerce in the jargon of welfare economics in this way, however, is perverse. “Economic neutrality” requires that government tax and regulatory policies do not discourage allocation of capital to the use which has the highest economic return, appropriately adjusted for non-diversifiable risks. The separation of banking and commerce, by preventing the parties to an investment contract from allocating risk and return between them, distorts behavior, and results in a nonneutral allocation of capital.
with a nonbanking business will tend to result in a distorted investment choice favoring bank-owned businesses. Although statistics presented to Congress showed an increase in the use of the unitary bank holding company structure, no evidence was presented that the phenomenon either hindered access to loans by competitors unaffiliated with banks or promoted allocational inefficiency. This is not surprising because a bank that unreasonably prefers its own affiliates necessarily suffers diminished earnings and because the competitive nature of the commercial loan market makes significant impact on competing commercial businesses unlikely.  

IV. PROHIBITIONS ON ENGAGEMENT IN NONBANKING BUSINESS TO DETER EXCESSIVE RISK-TAKING

Although low failure rates in banking for the half century following enactment of Glass-Steagall temporarily erased bank soundness from the menu of congressional concerns, the dramatic increase in the number of bank failures over the last several years again has made bank solvency a primary focus of bank regulation. Circumstances of the present “crisis”, however, are far different from those of 1933. Following the Great Crash, primary concern justifiably was directed at banking panics and their implications for the banking and monetary system, employment, and output. In contrast, public perceptions of bank solvency no longer threaten the federally insured banking system with the certainty of bank panic and the possibility of banking collapse. Instead, concerns today with respect to bank failure relate to the adequacy of the deposit insurance funds and, much more importantly, to the efficiency with which depositories allocate capital. The former problem, although potentially serious, could be solved relatively easily by a modest increase in deposit insurance premiums.  

The latter problem, however, is more difficult and more important. A significant body of theoretical and empirical evidence has been accumulated indicating that capital intermediation by banks may not be efficient with serious repercussions for economic well-being.

A. Deposit Insurance and Risk-Taking

The primary cause for concern over excess bank risk is widely acknowledged to be the very tonic that cured the banking maladies of 1933—federal deposit insurance. Simply put, because deposit insurance premiums are not risk-re-
lated, a depository institution has an incentive to undertake more risky investments than it would choose in a world without such deposit insurance. This property of deposit insurance is illustrated by graphs drawing on the concepts of portfolio theory.

Figure 1 illustrates the choice of a preferred portfolio of assets for a bank or other depository institution with and without federal deposit insurance. For simplicity, the institution is assumed to be capitalized with equity and deposits in a fixed ratio regardless of insurance status. Curve NN' represents the locus of points in the risk-return space comprising the boundary of the risks and returns to the bank corresponding to all feasible bank investments without federal

170. Under current law, an insured bank pays a premium of one-twelfth of one percent of its "assessment base" (i.e., deposit liabilities subject to certain adjustments) each year and, subsequently, receives a credit equal to 60% of its pro rata share of the amount by which total assessments exceed actual losses and operating costs of the FDIC. 12 U.S.C. § 1817(b), (d) (1982). Analogous provisions govern FSLIC charges to thrifts. Id. § 1727(b) (1982). In addition to the annual insurance premium, the FSLIC has exercised its statutory powers to levy a special annual assessment of one-eighth of one percent to cover current operating losses. Id. § 1727(c) (1982).


172. An insured depository institution will have the incentive to leverage its deposit-capital ratio as high as regulators will permit. While this generally is not true without deposit insurance, the ratio is assumed to be fixed exogenously to simplify the comparison.
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deposit insurance. At point N, the entire bank portfolio would be invested in the least risky asset, presumably government bonds, and the portfolio would yield an expected rate of return on equity in the period \( r \), with an expected standard deviation, \( s \). Holding government bonds is not risk free because, although the default risk is negligible, the net rate of return varies with the difference between interest rates on deposits and bond yields. Point N\(^{'\prime}\) corresponds to complete investment in the riskiest available asset. The return on equity declines between \( E_{RN} \) and N\(^{'\prime}\) because, over this range, marginal increases in the return on progressively riskier portfolios are assumed to be less than the risk premium charged the bank by uninsured depositors. The solid portion of the boundary curve N'E\(_{RN}\) represents the efficient frontier of feasible combinations of investments that are not dominated by portfolios of equal or lesser risk with higher return.\(^{173}\)

The depository institution chooses its portfolio of holdings to maximize its utility from among the portfolios on the efficient frontier. Utility preferences are illustrated by the family of indifference (iso-utility) curves \( I_1 \), \( I_2 \), and \( I_3 \) of successively higher utility. Each indifference curve represents the locus of all points in the risk-return space representing equally desirable bank portfolios. The shape of these indifference curves is generally convex, consistent with the usual assumption that the institution is risk-averse\(^{174}\) and the optimum portfolio is determined uniquely at the point of tangency, \( E_{RA} \). Were the institution risk neutral, the indifference curves would be horizontal lines and the optimum portfolio would be that yielding the highest net return, at point \( E_{RN} \). In the perverse case of risk-seeking behavior, the indifference curves would be concave and the optimum would lie on the portion of the frontier between \( E_{RN} \) and N\(^{'\prime}\).

173. Note that the portfolio representing complete investment in the least risky asset generally is not on the efficient frontier. As long as the correlation of the return on some other assets with the return on the least risky asset is low enough, expected return can be increased and variance simultaneously reduced by portfolio diversification. The gross expected return, \( R_p \), from a multi-asset portfolio is the simple weighted average of the expected returns on its constituent investments:

\[
R_p = \sum_i x_i R_i
\]

where \( R_i \) is the return on the \( i \)th asset and \( x_i \) is the fraction of the total portfolio invested in that asset, so that \( \Sigma x_i = 1 \). \( R_p \) always will rise when a second asset is added to a portfolio comprised of complete investment in the least risky asset. The standard deviation of the multi-asset portfolio is given by the formula:

\[
s = \left( \Sigma_i \Sigma_j x_i x_j C_{ij} \right)^{1/2}
\]

where \( C_{ij} \) is the covariance of the return on the \( i \)th and \( j \)th assets and \( C_{kk} \) is the variance of asset \( k \). As long as there exists an asset whose covariance with the minimum risk asset is sufficiently low, the standard deviation of the portfolio can be reduced by diversification. An uninsured bank will, of course, prefer a portfolio that offers a higher gross return and has lower risk, because its net return on capital will be higher with such a portfolio.

174. See infra text accompanying notes 184-185 (setting forth reasons for business entities' risk-averse behavior).
Under the system of flat-rate federal deposit insurance, the efficient portfolio frontier shifts to $D'D''$. The frontier steepens because of the relative impact of two factors on bank income: the cost of the deposit insurance premium and the savings on interest payments to depositors. For low-risk portfolios, the savings on deposit interest will less than offset the insurance premium and net return on bank equity will be reduced by participation in the insurance system. Conversely, for high-risk portfolios, insurance premiums will be less than the savings in interest payments to depositors and net returns will be increased. The shift in the efficient frontier induces the bank to reform its asset portfolio to assume more risk: a risk-averse management will move to an equilibrium like $E_B$; a risk-neutral or risk-seeking management will shift all the way to $D''$, the highest-risk and highest-return portfolio.\footnote{Intuitively, flat-rate deposit insurance encourages risk-taking for two reasons. First, an insured bank can appropriate all of the increased expected return usually associated with bearing increased risk because, although the insurance fund actually sustains part of the increased risk, it charges nothing for doing so. In effect, low-risk banks cross-subsidize high-risk banks. Second, deposit insurance distorts the bank’s perceptions of the risk and return of various investments, which tends to favor riskier assets. Any increased downside loss exposure from marginal increases in risk is borne by the insurance fund, while the upside always fully accrues to the depository.\cite{175} The distorting effect of deposit insurance increases as bank capital declines.\cite{176} Indeed, in extremis, insured banks with negative net worths may become risk seekers and undertake investments with negative expected returns. While all}
entities develop strong incentives to seek risks near bankruptcy, such behavior
is particularly pronounced in banks because their liquidity facilitates redeployment
of assets in risky ventures, and insured depositors, unlike creditors of other
kinds of institutions, have no incentive to constrain management excesses.

B. The Separation of Banking and Commerce and Risk-Taking

The tendency of insured depository institutions to take superoptimal risks
with their portfolios may be exacerbated by permitting banks to engage in
nonbanking businesses. Engagement in a nonbanking business may be regarded
as an investment in a portfolio asset with an expected rate of return and standard
devation characteristic of other firms in the nonbanking business' industry and
analyzed using the tools of portfolio analysis. In Figure 2, B'B'' represents
the envelope curve of efficient portfolios on the assumption that banks are
permitted to engage in nonbanking businesses. B'B'' dominates A'A'' because
lifting the separation of banking and commerce would permit more potential
allocations of the bank portfolio, for example, by investing in equity securities,
real property, or directly engaging in various businesses.

![Figure 2](image)

As one would expect, permitting banks to engage in nonbanking businesses
generally increases the economic welfare of banks. Fewer restrictions mean more

178. Portfolio analysis first was applied to explain the conglomerate merger wave of the
1960s as a means of reducing the relative variance of intracorporate cash flows. See Lewellen,
a number of scholars have applied portfolio analysis to the analysis of bank holding companies. See
Heggestad, *Riskiness of Investments in Nonbank Activities by Nonbank Holding Companies*,
27 J. Econ. & Bus. 219 (1975); Litan, *supra* note 169, at 10-19; Meinster & Johnson, *Bank
Holding Company Diversification and the Risk of Capital Impairment*, 10 Bell J. Econ. 683
(1979).
opportunities for banks to invest capital more profitably. In Figure 2, the new equilibrium portfolio $E_n$ is preferred to (that is, is on a higher indifference curve than) $E_A$. The questions of whether the new equilibrium will have a higher standard deviation and whether, even if it does have a higher standard deviation, the chances for bank insolvency in the period are greater are theoretically indeterminate. This can be shown graphically by considering the line segments which intercept the Y axis at $-C$, where $C$ is the fraction of shareholders' equity in total institutional assets and the two equilibria, $E_A$ and $E_n$, respectively. The greater the slope of each line segment, the lower the probability of bank failure in the period. Thus, as drawn, expanding the set of portfolio opportunities by permitting banks to engage in nonbanking businesses has resulted in a reduction in the probability of bank failure. Depending on the shapes of the investment possibility frontier and indifference curves, however, elimination of nonbanking restrictions could increase the probability of insolvency. Figure 3 illustrates this relationship.

More formally, the least upper-bound on the probability of failure is proportional to the square of the reciprocal of the slope of the line segment. This follows directly from the theorem of Blair and Heggestad. Blair & Heggestad, Bank Portfolio Regulation and the Probability of Bank Failure, 10 J. MONEY, CREDIT & BANKING 88, 88-91 (1978) (analyzing the restriction of risk exposure in bank asset portfolios). A number of studies addressing risk in banking compare the coefficients of variation of earnings, the ratio of standard deviation to mean earnings, or $s/r$, among various banking organizations as a measure of risk. See Litan, supra note 169, at 11-19. Graphically, the coefficient of variation is the inverse of the slope of a line segment between the origin and the point in the risk-return space corresponding to the institution's performance characteristics. A higher coefficient of variation, i.e., a lower slope, necessarily implies a higher probability of operating losses. It does not necessarily imply however, a greater likelihood of bankruptcy. As long as the depository institution has positive capital, some asset portfolios with a higher coefficient of variance will present a smaller chance of balance sheet insolvency. As long as the institution maintains a sufficient portion of its assets in readily marketable form such that it is able to survive a period of negative cash flow, the coefficient of variation is not the appropriate measure of bank risk. Thus, Litan's conclusion that 16 of 31 bank holding companies have higher aggregate coefficients of variance than their banking subsidiaries, id. at 22-23, does not necessarily imply that a majority of these bank holding companies are in greater risk of bankruptcy than their banking subsidiaries.
The theoretical indeterminacy of the effect of the abolition of the separation of banking and commerce on the probability of bank failure is confirmed generally by empirical studies of holding companies that have diversified within the bounds of existing law. All such studies indicate that diversification has a mixed effect on the riskiness of individual banking institutions. This does not mean however, that the implications of line-of-business diversification on the aggregate rate of bank insolvencies are ambiguous. Historically, the failure rate of depository institutions has been extremely low. A policy change that increases the probability of failure for some institutions and decreases it for others is more likely to increase than to decrease the aggregate failure rate for two reasons.

First, since the current rate is almost at the lower bound of zero, a policy change that increases the dispersion of failure probabilities among individual banks is likely to induce more failures than it prevents. Second, the current low rate of bank failures undoubtedly is due in part to constraints on risk-taking behavior imposed by banking regulators. To the extent that integration of banking and commercial activities would make such regulatory supervision more problematic, it is likely to result in more risk-taking.

C. Welfare Consequences of Risk-Taking Behavior by Banks

Abrogation of the separation of banking and commerce would increase the profitability of banking by increasing the return on bank assets. If it also induced a pattern of bank investment with lower institutional risk, it would be preferable unambiguously to continuing line-of-business prohibitions. The converse is not true for two reasons. First, even if ending the separation increased undesirable risk-taking, the benefit from increasing the return on banking assets, from a welfare standpoint, may outweigh the harm of additional risk. Second, more risk-taking may not necessarily be undesirable. There is good reason to believe that business firms generally exhibit greater aversion to risk-taking than is socially desirable, and adoption of some policies that induce risk-taking may be appropriate.

The reason for excessive risk-aversion among private businesses is the sensitivity of business managers to firm-specific risks. An investor with a well-
diversified portfolio will seek to maximize expected return almost irrespective of the expected variance of individual firms because, in the aggregate, fluctuations of individual firms in the portfolio can be expected approximately to cancel out for reasons uncorrelated to market-wide phenomena. The owners of a closely held business, however, generally are unable to diversify their investments sufficiently to disregard expected volatility in the firm’s earnings. In the absence of actuarially fair insurance against adverse operating results, such owners willingly pay a self-insurance “premium” by trading reductions in expected income for lower variance in the income stream. Likewise, the officers of public corporations frequently exhibit risk-averse behavior. Such officers generally have an “investment” in both human and financial capital — for example, in job skills and stock options — that cannot be diversified easily. Accordingly, although the public stockholders may themselves own diversified portfolios and disregard firm-specific risks, their agents, professional corporate managers, will not. Because monitoring the conduct of corporate officers is costly, the public corporation will exhibit greater risk-aversion than its stockholders desire.\textsuperscript{185} The tendency of both private and public businesses to avoid firm-specific risks leads to lower aggregate national income without any offsetting reduction in volatility.\textsuperscript{186}

The social cost of excessive risk avoidance by individual firms may be substantial. For example, for each one-tenth of one percent annual “premium” paid in reduced earnings on stockholders’ equity to avoid firm-specific risks, aggregate national earnings are reduced by more than $870 million dollars in the manufacturing sector alone.\textsuperscript{187} Some subsidies or regulations with substantial

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in the value of all market securities. Such correlated changes in security values usually are the result of changes in the macroeconomy, for example, changes in interest rates. The systemic risk or “undiversifiable” of a particular investment is characterized by its “beta coefficient” or “beta,” the ratio of the proportional change in the value of the investment, \textit{ceteris paribus}, to a proportional change in general market values. A security with a higher beta is more volatile because, other things being equal, it will exhibit larger price movements as average market values change. “Specific” or “diversifiable” risk is the risk of fluctuations in security values from causes which are particular to a firm or industry in the sense that they are uncorrelated to general market fluctuations. Specific risks may be ignored by risk-averse investors because such risks have minimal impact on a diversified portfolio. See K. Garbade, supra note 171, at 213-34 (presenting a rigorous development of the concepts of “undiversifiable” and “diversifiable” risks).

A risk-seeking insured bank will not distinguish between “systematic” and “specific” risks as long as it does not maintain a diversified portfolio. While the assumption of firm-specific risk generally is restricted by statutes limiting the size of loans that may be extended to individual borrowers and affiliated groups of borrowers, neither federal law nor the law of most states requires interindustry diversification. See 12 U.S.C. § 84 (1982); 12 C.F.R. pt. 32 (1987). State law generally parallels federal law in this regard.


186. Because bankruptcy reorganizations and employment dislocations have real costs, \textit{ceteris paribus}, social welfare is decreased by a higher rate of bankruptcies and, consequently, social preferences are not completely indifferent to firm-specific risks. Nonetheless, the level of social risk-aversion is considerably less than that of the private level because the coefficient of variation in national income associated with such risks is negligible.

187. This result is based on total stockholders’ equity in all manufacturing corporations of $873.8 billion as of Sept. 30, 1985. See Council of Economic Advisors, Economic Report of the President, Table B-87, at 354 (Feb. 1986) [hereinafter 1986 CEA Report].
costs may, therefore, be merited if they materially offset risk-averse behavior.\textsuperscript{188} Thus, the separation cannot be justified on the basis of theory alone.

V. EVALUATING THE SEPARATION AND ITS ALTERNATIVES

I propose that a useful way to think about the separation of banking and commerce is to consider the costs of alternative strategies. An optimal policy for controlling risk taking by banks would minimize the sum of (i) the administrative costs of the policy; (ii) the social costs of excessive bank risk taking; and (iii) the social costs of compliance with the regulations. Collectively, these costs may be referred to as welfare costs. Precise measurement of these welfare costs is impossible and even rough estimation requires some suspension of critical standards. Nevertheless, the attempt to quantify them is useful because it highlights the tradeoffs that inhere in regulatory choices and may point in the direction of desirable regulatory reforms. I begin this exercise by examining the impact of the existing separation of banking and commerce on each category of costs compared to a world without the separation. The conclusions drawn from this section lead to certain proposals for regulatory reforms that are likely to result in reducing total costs.

A. A Comparison of Bank Regulation With and Without the Separation of Banking and Commerce

1. Administrative Costs

One argument made by banking regulators for the separation of banking and commerce is that it reduces the administrative costs of safety and soundness regulation.\textsuperscript{189} This claim may be argued on several bases. First, it may be that restricting bank portfolios to debt reduces the frequency with which they need to be examined and makes examination easier. Second, focusing on the restriction of entry of banks into new lines of business, rather than on regulation of behavior subsequent to entry, arguably avoids both the administrative problem of formulating and applying risk controls to numerous nonbanking businesses and the political problem of attempting to constrain powerful vested interests once they undertake such businesses.\textsuperscript{190} Third, enforcement and litigation costs are asserted to be low.\textsuperscript{191} Violations are relatively easy to detect. The relevant law is complicated and unsettled but, in practice, few banks ever exploit this legal uncertainty by proposing to enter unconventional businesses or by chall-

\textsuperscript{188} Policies such as government-enforced patent monopolies and research and development tax incentives have been defended on this ground. More recently, the Second Circuit has invoked this analysis to rationalize the business judgement rule. See Joy v. North, 692 F.2d 880, 886 (1982), cert. denied, 460 U.S. 1051 (1983).

\textsuperscript{189} See 1984 CEA Report, supra note 102, at 160 (asserting that permitting banks to engage in new lines of business may make regulatory supervision more problematic).

\textsuperscript{190} See Huber, The Old-New Division in Risk Regulation, 69 VA. L. REV. 1025, 1026 (1983) (discussing the difference between “gateway” regulation of new enterprises and supervisory regulation of ongoing businesses in the context of health and safety regulation).

\textsuperscript{191} Id. at 1027.
lenging regulatory interpretations. Last, entry restrictions enjoy the enthusiastic support of nonbanking competitors of regulated depositories who can be expected to share the burdens of enforcement with the regulatory agencies.

While not wholly without merit, these claims are overstated. Restrictions on engagement in nonbanking businesses eliminate certain possible risky assets from bank portfolios; they do not counter the distorting effect of deposit insurance on perceived rates of return. The problem of excessive risk-taking does not arise solely because of managerial imprudence in choosing volatile investments, but because deposit insurance induces banks to seek risk aggressively. Numerous business activities that lie at the core of the traditional "business of banking" and involve neither direct engagement in a nonbanking business nor ownership of corporate equity—including purchasing "junk bonds," financing leveraged buy-outs, and issuing standby letters of credit—can and have been used by banks intent on cultivating portfolio risk. Indeed, given federal deposit insurance, the incentive to load up on risky assets while observing the separation of banking and commerce may result in adoption of an inferior portfolio with increased likelihood of failure. Consequently, the separation of banking and commerce cannot substitute for other regulatory controls on bank risk-taking, primarily bank examinations and restrictions on interaffiliate

192. Given the size of the banking industry and the great complexity of banking law, the volume of regulatory litigation is surprisingly low. As of Dec. 31, 1983, there were a total of 17,939 banks and thrifts in the United States with approximately $3.33 trillion in assets. See Vice President's Task Group Report, supra note 22, at 102. Yet as of October 1987, according to one survey, only 13 suits were pending in all courts involving issues of banking powers, and only seven of these involved Glass-Steagall issues. See Bank Expansion Rep. (Golembe Assocs. Inc.), Oct. 19, 1987, at 21-22 (listing bank-related litigation). Likewise, the administration of entry into new businesses under the BHCA also is a very modest enterprise, with few burdensome decisions to be made. Of the 577 applications to the Board for entry into nonbanking businesses in 1985, 446 routinely were approved by local Federal Reserve banks under authority delegated by the Board. See 1985 Fed. Reserve Ann. Report, supra note 28, at 177. The remaining applications involved proposals referred to the Board as involving matters inappropriate for decision under delegated authority. Of these, only three were denied. Id.

193. The plaintiffs challenging the right of a bank or bank holding company to enter a line of business generally are individual competitors or trade associations of competitors in the new line of business.

194. The portfolio chosen by a bank operating under the constraints of the separation may be inferior in the sense that its true economic variance is higher and expected return lower than that of a portfolio chosen from an unconstrained set of feasible portfolio allocations. Indeed, even if the effect of the separation is to decrease portfolio variance, it may result in a higher risk of insolvency, unless variance is decreased sufficiently to offset the increase in failure probability caused by the reduced return. See supra notes 178-180 and accompanying text.

195. The Comptroller of the Currency has the statutory authority to conduct examinations of national banks. 12 U.S.C. § 481 (1982). The Board has examination powers with respect to state member banks and bank holding companies. Id. §§ 325, 1844(c). The FDIC has examination powers with respect to most insured banks. Id. § 1820(b). In addition, all states provide state regulatory authorities the power to examine state banks. At the federal level, examination policies and the training of examiners is coordinated by the Federal Financial Institutions Examination Council, whose membership consists of the Comptroller of the Office of the Comptroller of the Currency (OCC), a Governor of the Board of Governors of the Federal Reserve System designated by the Chairman (FRB), the Chairman of the Board of Directors of the Federal Deposit Insurance Corporation (FDIC), the Chairman of the Federal Home Loan Bank Board (FHLBB), and the Chairman of the National Credit Union Administration Board (NCUAB).
transactions.196

There is little reason to believe that the application of these other regulatory controls is made less costly by the separation. The frequency with which bank examinations should be conducted is a function not just of the intrinsic volatility of particular holdings, but of the speed with which bank management may shuffle assets among different holdings.197 There also is not much reason to believe it is intrinsically cheaper to value a portfolio restricted to debt securities. Because the value of debt depends on the creditworthiness of the borrower and the market value of collateral, the bank examiner is called on frequently to undertake valuation procedures not unlike those that would be necessary to value equity interests.198

Finally, the willingness of bank competitors to bear the costs of enforcing the prohibition on nonbanking activities hardly signals a social savings, but rather merely a shift of the burden to private persons seeking to protect monopoly rents. Presumably, private litigants enforce the separation to effect a barrier to

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196. Extensions of credit by member banks generally are limited to 10% of bank capital per affiliate and a total of 20% of bank capital to all affiliates. 12 U.S.C. §§ 371c, 1828(j) (1982) (member banks and insured nonmember banks, respectively).

197. The liquidity of bank assets renders them particularly susceptible to conversion or misapplication. According to an FDIC study covering the period from 1960 to 1974, 57% of insured bank failures were due primarily to improper loans to insiders, 32% to defalcation, embezzlement, or manipulation, and only 12% to deficient portfolio supervision. J. Sinkey, Problem and Failed Institutions in the Commercial Banking Industry 17 (1979). The significant role of illegal or improper conduct as a cause of bank failure limits the reliance that may be placed on voluntary regulatory compliance as a substitute for frequent bank examinations. Indeed, were asset volatility the paramount regulatory concern, other regulatory devices would be preferred to the separation. Bank portfolios could be restricted to only the least risky securities—federal obligations and federally guaranteed debt. Alternatively, a simple rule permitting more flexibility would be to place an earnings ceiling on bank income, for example, by taxing returns on the bank portfolio above a specified rate of return at a marginal tax rate of 100%. Under such a constraint, the bank would have an incentive to minimize portfolio variance subject to earning the maximum permitted return, because increasing the variance on the return of a portfolio whose expected rate of return was the maximum permitted would lower, expected returns after tax. The effect would be analogous to the behavior of banks with respect to loan portfolio management when subject to a binding usury ceiling. See Blitz & Long, The Economics of Usury Regulation, 73 J. Pol. Econ. 608 (1965) (analyzing the effect of usury legislation on the bond and physical capital markets). If banks were permitted to own equity as well as fixed interest rate debt, a tax would be preferable to direct regulation because the expected rate of return on equity would not be observable directly ex ante. The tax would have to be levied on unrealized appreciation and, consequently, the proposal probably is practicable only if banks are permitted to own only marketable securities.

198. See Office of the Comptroller of the Currency, Examination Circular 225, June 18, 1986 (presenting an example of the complex procedures necessary to value risky debt). The circular addresses the valuation of problem loans collateralized by oil and gas reserves, supplanting policies adopted by the OCC, FRB, and FDIC in August 1984 that required classification of loans according to the difference between the outstanding loan balance and anticipated future revenues from oil and gas proceeds, calculated in part on prevailing spot market prices. Under the new guidelines, examiners are encouraged to value loans, inter alia, on the basis of long-term oil price scenarios developed with the assistance of in-house or independent petroleum experts.
entry against potential bank competitors.\textsuperscript{199} Expenditures to enforce regulations against competitors are rational only if the regulations protect monopoly rents or inefficiency, because there is no incentive to enter an efficient competitive market.\textsuperscript{200} Thus, the existence of such suits is itself evidence of the social costs of the regulations. Moreover, private litigation, because it has as its objective private gain rather than the public interest, may be inefficient socially in that the litigants will continue spending resources on litigation even when there is no social gain.\textsuperscript{201}

Even if the separation of banking and commerce does make administration of safety and soundness regulation marginally less expensive, the benefit gained is small relative to the other costs associated with the rule and to the size of the banking industry. The four principal federal banking agencies spent approximately $685 million in fiscal year 1985 supervising banks and thrifts, approximately one-fiftieth of one percent of total assets of regulated depository institutions.\textsuperscript{202} This sum covered expenditures on all bank regulatory functions, including chartering, auditing, policy-making, and overhead. The administrative costs of safety and soundness regulation are, presumably, some fraction of this number, perhaps on the order of magnitude of one one-hundredth of one percent of depository assets.\textsuperscript{203} Thus, a one basis point increase in the return on bank capital from the opportunity to own equity and to engage in businesses from which they are currently barred would offset a doubling of the costs of administering safety and soundness regulations.


\textsuperscript{200} The existence of either or both abnormal costs and profits in regulated industries and the symbiotic relationship between regulators and regulatees has been demonstrated in numerous industries. See, e.g., L. Keyes, \textit{Entry in Air Transportation} 307-30 (1951) (airline regulation); Moore, \textit{The Beneficiaries of Trucking Regulation}, 21 J. L. Econ. 327 (1978) (trucking regulation).

\textsuperscript{201} See generally Shavell, \textit{The Social Versus the Private Incentive to Bring Suit in a Costly Legal System}, 11 J. Legal Stud. 333 (1982) (discussing the difference between private and social costs and benefits of litigation).

\textsuperscript{202} Office of Management and Budget, Appendix to the Budget for Fiscal Year 1986, I-R35 to I-R36, I-Y20 to I-Y22, I-Y27 to I-Y34, V 11 to V 12, V-15 to V-16. The total reflects the budget estimates of total administrative expenses for the FDIC, the FHLBB including the FSLIC, the OCC, and the Federal Reserve System comprised of both the Board of Governors and the regional Federal Reserve banks. The total does not include transfer payments to insured depositors or the cost of administering failed institutions.

\textsuperscript{203} The principal expense incurred in safety and soundness regulation is the expense of periodic bank examinations. The seven federal financial regulatory agencies — the OCC, FRB, FDIC, FHLBB, SEC, the NCUA, and the Commodities Futures Trading Commission — spent an aggregate total of $237 million on examinations in 1982, with the three bank regulators spending $73 million of the total. Vice President's Task Group Report, \textit{supra} note 22, at 29 n.16. The latter figure constituted approximately .008% of total bank assets of $1.972 trillion as of Dec. 31, 1982. 69 Fed. Reserve Bull., No. 1, at A18 (Jan. 1983). There is good reason to think that even this amount could be reduced substantially, because commercial banks presently are examined by at least two, and as many as three, government agencies. \textit{See} Vice President's Task Group Report, \textit{supra} note 22, at 29-30. The total excludes costs of complying with regulatory requirements imposed on subject institutions. Since a depository always has the option of refusing to avail itself of any new nonbanking powers, relaxation of the separation cannot make it worse off. That is to say, no bank will undertake any permitted nonbanking activity unless expected gross profits from the activity exceed expected additional regulatory costs from engaging in it.
The second category, the social costs of excessive bank risk-taking, subsumes two very different elements. First, excessive bank risk may raise the direct costs of bank insolvencies. Direct costs include the social costs of the expenditures by the various banking regulators on administering failing and failed institutions and the incremental expenses of bank customers and creditors of conducting their affairs incurred because of the insolvencies, or threatened insolvencies, of regulated banks. For the most part, these costs arise only when a depository fails or comes very close to failure. Second, excessive bank risk taking may impose economic welfare costs because capital may not be allocated to its most socially productive use. This loss ensues as a consequence of deposit insurance-induced behavior regardless of whether any insured depository actually fails. Although they have figured prominently in debates concerning banking policy, the direct costs of bank failures are not large. Few banks fail, and the real costs to the regulatory agencies of administering those banks that do fail are not great. Creditors of failed banks sustain few losses and, in most cases, suffer minimal inconvenience.

Relaxing the separation of banking and commerce would, moreover, not necessarily increase the welfare burden of these expenses. Regulations that impede bank risk-taking increase the return on risky enterprises relative to less risky ones, and thereby induce nonbank investors to undertake greater risk and suffer more bankruptcies. Permitting banks to own equity would reduce the average corporate debt to equity ratio and diminish the corporate failure rate. In any event, like other administrative costs, the expenses attending failing or failed institutions.

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204. Regulators tend not to break out the economic costs of bank failure, but to focus on total budgetary costs to their agencies. See, e.g., Chief Economist Says Small National Banks Performed Well Despite Failures, 47 Wash. Fin. Rep. (BNA) No. 5, at 161 (Aug. 4, 1986) (reporting speech by director of economic and policy analysis for the OCC discussing, inter alia, the costs of commercial bank failures). This perspective distorts the cost-benefit calculus of bank risk-taking by treating transfer payments — subsidies to failing institutions and payments to creditors of insolvent ones — as real costs and by ignoring offsetting changes in the bankruptcy rates of nonbanking persons. Likewise, bank regulators tend to be insensitive to the social gains and losses from changes in the efficiency of bank capital intermediation. Consequently, bank regulators consistently overestimate the social costs of bank failures, and favor a rate of bank failure that is lower than the social optimum.

205. Almost all the liabilities of small and medium sized commercial banks and thrifts are insured deposits. 1984 CEA Report, supra note 102, at 168. Although a significant portion of the liabilities of large depositaries are uninsured, regulators have adopted policies that effectively provide insurance coverage in full for all depositors in such institutions. See supra note 105. Insured depositors have no risk-bearing costs, of course, because there is no risk.

206. Both the FDIC and the FSLIC are required statutorily to pay insured depositors “as soon as possible” on default. 12 U.S.C. §§ 1728 (b), 1821(f) (1982). In practice, the agencies have provided access to the full amount of insured accounts either immediately or very shortly after insolvency.

207. The typical depository reorganization has considerably lower transaction costs than failures of other comparably sized businesses. The reorganization normally is completed in a very short time, and courts have been extremely deferential to the federal insurance funds regarding determinations of insolvency and actions as receivers. See Biscayne Fed. Sav. & Loan Ass’n v. Fed. Home Loan Bank Bd., 720 F.2d 1499, 1502-05 (11th Cir. 1983) (discussing limitations on judicial review of actions of the FHLBB and FSLIC committing a thrift to receivership and becoming a receiver), cert. denied, 467 U.S. 1215 (1984).
depositories are dwarfed by the total pool of bank assets, and marginal increases in such costs from relaxation of the separation of banking and commerce would be more than offset by minuscule increases in the efficiency of invested capital.\textsuperscript{208}

Assessment of the consequences for economic welfare of changes in the riskiness of bank portfolios is more problematic. Various distortions in investment behavior with regard to risk have been identified, but their aggregate effect on the overall allocation of capital has not been demonstrated. Studies of public equity markets, for example, reveal a seemingly inefficient market preference for risk,\textsuperscript{209} while studies of publicly traded debt tend to show excessive risk aversion.\textsuperscript{210} Similarly, although insured depositories are biased toward risk, owners of private businesses and managers of public corporations tend to be overly risk-averse.\textsuperscript{211} Whether relaxation of the separation of banking and commerce would move toward or away from the optimal level of systemic investment risk cannot be predicted theoretically.\textsuperscript{212}

Even if the aggregate distribution of capital were misallocated toward excessive risk-taking, whether relaxation of the separation of banking and commerce would significantly exacerbate the distortion is unclear. Influenced by flat-rate deposit insurance, banks are motivated to increase asset risk, irrespective of whether the additional risk is "systemic" or "specific."\textsuperscript{213} Increases in specific risk do not necessarily diminish social welfare, apart from the impact on the rate of bank failures.\textsuperscript{214} Moreover, current banking regulation seems to favor bank investment in certain risky industries—agriculture, oil and gas drilling, and housing and real estate development\textsuperscript{215}—that have been governmental favorites.

\textsuperscript{208} See supra text accompanying note 187.

\textsuperscript{209} See, e.g., R. Brealey, \textit{An Introduction to Risk and Return from Common Stocks} 47-59 (1st. ed. 1969).

\textsuperscript{210} Between 1974 and 1986, the default rate of publicly traded low-grade debt averaged only 1.5\% annually. Worthy, \textit{The Coming Defaults in Junk Bonds}, Fortune, Mar. 16, 1987, at 25, 29. Even on defaulted issues, investors usually lost only a part of their investment, implying that the yield premium on such securities, which averaged more than 5\% during the period, was far higher than necessary to compensate investors for losses on risky assets. One explanation of this disproportionate return on low-grade debt is that the legal restrictions on the quality of assets that may be held by pension funds and other fiduciaries have distorted the market by overpricing high-quality paper.

\textsuperscript{211} See supra text accompanying notes 183-186.

\textsuperscript{212} This, of course, is another example of the familiar proposition of welfare economics that fulfillment of a competitive condition in one market may not increase well-being as long as other conditions for a competitive equilibrium remain unsatisfied. See Lipsey & Lancaster, \textit{The General Theory of the Second Best}, 24 Rev. Econ. Stud. 11, 12 (1956).

\textsuperscript{213} See supra note 184.

\textsuperscript{214} Consider the risks associated with geographically restricted loan portfolios, for example, the risks of a localized business recession. Such risks are "specific" because they can be eliminated by diversification of the loan portfolio to include borrowers from other regions. A bank that concentrates its loan portfolio within a single locality will have higher variance of asset values than a lender that disperses its loan portfolio over a broader geographical range. Nevertheless, even if every bank undertakes only local loans, the aggregate geographical allocation of capital may be unaffected if banks are dispersed geographically.

\textsuperscript{215} Falling prices in agricultural commodities and oil and gas account for a substantial percentage of current bank insolvencies, and problems with real estate loans and direct engagement in real estate development also have plagued the thrift industry. Since summer 1984, more than one-half of failed commercial banks in every quarter have been agricultural banks as defined by the Board, although such banks comprise only 34\% of all commercial banks. Melicher,
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These industry-specific subsidies tend to offset any risk-reduction effect of the separation.

3. Costs of Regulatory Compliance

The final category of welfare costs, like the second, is comprised of two disparate elements: the out-of-pocket costs to depository institutions of observing regulatory requirements, and the social welfare costs of excluding banks from nonbanking businesses and prohibiting banks from owning corporate equity. The behavior of regulatory authorities regarding these elements manifests a familiar regulatory paradox: the former costs, although relatively insignificant, are internalized wholly by parties to the regulatory process and, consequently, weighed carefully in the formation of regulatory policy; the latter welfare losses, although of much greater significance, are diffused among numerous banking and nonbanking entities and, thus, receive little regulatory attention.216

The out-of-pocket compliance costs of the separation are small because the law is structured as a set of prohibitions with minimal individualized proceedings. Most applications submitted to the Board under the BHCA to engage in a nonbanking business—one of the few aspects of the separation involving case-by-case determinations—were routine filings to engage de novo in activities permitted by the regulations for which only a modest, and cheap, filing was required.217 Even with the expenses of procuring routine legal advice and litigating marginal cases, the total cost remains relatively small.

The costs of allocative inefficiency stemming from the separation appear to be much larger. Enforcement of the separation diminishes economic welfare in at least five ways. First, it limits economies of scale and economies of scope in banking. That is, it prevents banks from achieving cost reductions by spreading fixed costs over a larger volume of enterprises, and inhibits the development of synergies from joint provision of banking and nonbanking services. Second, the separation denies to bank customers certain economies otherwise realizable

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216. But see Executive Order No. 12291, 3 C.F.R. 127, 128 (1982) (requiring, inter alia, that subject regulations “shall not be undertaken unless the potential benefits to society for [sic] the regulation outweigh the potential costs to society . . . .”).

217. See supra note 192.
from consolidation of transactions among suppliers. Third, it restricts bank entry into some noncompetitive nonbanking markets and exacerbates the social costs of monopoly power of firms in these markets. Fourth, the separation inhibits the use of certain mutually advantageous financial contracts—equity investments—and thereby raises the effective cost of capital and reduces aggregate investment. Last, it exacerbates "agency" costs of the separation of ownership and control in the public corporation.

Quantification of these losses is difficult. Empirical studies of the cost of production of banking services do not provide a satisfactory basis for projecting savings from engagement in nonbanking activities that currently are barred by law. Assessments of the impact separation has on monopolistic practices in nonbanking markets, the cost of capital, and agency behavior are speculative at best. Nevertheless, considerable evidence has been accumulated to support the proposition that economic gains from integrating banking and nonbanking businesses would be substantial. The emerging structure of financial markets suggests that integration results in economies to banks and their customers. Competitive markets tend to assume the structure that maximizes economic welfare. The financial services industry has been marked in recent years by

218. This benefit of integration sometimes is overlooked in expositions of the theory of the firm because it is not an economy of production and, indeed, may even induce a pattern of production that is not cost-minimizing within an industry. For example, one sees many nongrocery products sold in supermarkets—cosmetics, hardware, over-the-counter drugs, etc.—that are sold at prices higher than those of specialized competitors. Notwithstanding the higher prices, many supermarket customers purchase these items because of the savings in time and effort in consolidating their patronage in a single store. A regulation that prohibited supermarkets from selling these items would have adverse welfare consequences even though supermarkets are not the low cost purveyors of such products.

There are similar apparent benefits from consolidation of nonbanking businesses within banking entities. For example, information developed for credit-rating purposes also would be useful in pricing business insurance contracts. Yet, insurance underwriters are reluctant to accept bank-supplied information without verification, because banks have an interest in promoting the most favorable public perception of the solvency of their debtors. Verification expenditures of the underwriter would be minimized if the credit and insurance functions were conducted by the same, or related, firms because self-interested behavior would not encourage information distortion. See Bennett, Consumer Demand For Product Deregulation, Fed. Reserve Bank of Atlanta Economic Rev., May 1984, at 28 (suggesting an analysis of the benefits of product integration for a limited category of bank customers).

219. See Phillips, Competition, Confusion, and Commercial Banking, 19 J. FIN. 32 (1964) (analyzing substantial inefficiencies in banking from low failure rates, the large number of firms of less than optimal scale, and uncompetitive pricing practices).

220. Over the last decade, the views of mainstream economists about the competitive significance of industrial aggregation has undergone a sea of change. Influenced by the 1950's work of Joe Bain which purported to demonstrate that economies of scale generally were exhausted at the plant level, many industrial organization economists of that era attributed business consolidations primarily to anticompetitive motives. At the high tide of this view, in the 1960s, economists labored to explain the on going conglomerate merger wave with intricate models of oligopolistic behavior, or they dismissed the phenomenon as the product of imperfect capital markets or deceptive accounting practices. In recent years, a revisionist school, relying on a body of work demonstrating significant multiplant economies and the efficiency of capital markets, has challenged the old orthodoxy with considerable success. There is now a pervasive, if somewhat grudging, acceptance of the view that allocative efficiency plays a significant role in mergers. Compare F. Scherer, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 133-38 (2d ed. 1980) (identifying economic gains from mergers) with F. Scherer, INDUSTRIAL MARKET
evolution towards integrated "financial supermarkets," and by a related trend towards increasing ownership of banks by nonfinancial corporations. Bankers have lobbied vigorously for expanded powers, presumably because they believe engagement in nonbanking businesses would increase bank profitability.

Evidence from markets where bank entry has been permitted corroborates the implications of structural changes in financial markets. Bank competitors have flooded into the discount brokerage business, pushing transaction commissions downward. In New York and Massachusetts, where savings banks may underwrite and sell life insurance, premium rates are consistently among the lowest available. Econometric studies indicate that hundreds of millions

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221. Within the last 15 years, the bank holding company has become the dominant form of financial organization in the United States. Between 1970 and the end of 1983, the number of holding companies increased from 121 to 5395. Vice-President's Task Group Report, supra note 22, at 20-21. Bank holding companies now control more than 80% of commercial bank assets. Id. at 103-04. During the same period, the number of banks controlled by an average holding company has decreased from over 7.4 to less than 1.5, suggesting that this structural change is motivated by the opportunity to expand nonbanking powers rather than to circumvent state branching limitations. Id. at 21. The holding company movement has been complemented by the increasing incidence of entry into financial services by nonbanking firms via acquisition of a nonbank bank or single thrift subsidiary. See Litan, supra note 169, at 31-34 (discussing the financial conglomeration movement).


224. As of 1986, savings bank life insurance was available in three states: Massachusetts, Connecticut, and New York, in amounts of up to $60,000, $30,000, and $250,000, respectively. Of 41 term life insurance policies analyzed by the Consumers Union for ages 25 and 35, and 40 policies analyzed for age 45, New York Savings Bank Life Insurance (NYSBLI) was ranked first, 4th, and 7th in the three age groups, and Massachusetts Savings Bank Life Insurance (MSBLI) was rated 8th, 1st, and 1st. See Life Insurance: How to Protect Your Family, 51 Consumer Rep., at 387-91 (1986) (comparing $50,000 participating policies among various companies). Among 40 whole-life policies analyzed, NYSBLI was ranked first in all six age and gender categories, while MSBLI was ranked 5th, 3rd, and 4th for men, and 5th, 4th, and 3rd for women, in the three age categories. See Life Insurance: Whole-Life, 51 Consumer Rep., at 447, 458-67 (1986) (comparing similar whole-life policies). Connecticut Savings Bank policies were not rated because of the low policy maximums.
of dollars in underwriting fees and interest could be saved annually by permitting banks to underwrite municipal bonds. Experience in states in which state banks have been permitted to underwrite municipal bonds supports this conclusion. Rescinding the prohibition on bank ownership of corporate equity should bolster allocative efficiency for reasons unrelated to economies of production and consumption. Existing law prevents the parties to a loan contract from negotiating mutually preferable terms that permit the lender to exercise the incidents of equity ownership. There are good reasons, however, why the parties might prefer to structure bank financing as equity rather than debt. From a bank's standpoint, becoming a stockholder may be an economical way to control antagonistic interests of the borrower, including the incentive to undertake greater risks than anticipated by the loan agreement. The bank generally will have information about client firms that is superior to other potential stockholders, and it can monitor firm performance more cheaply. These cost savings from superior information are likely to be shared with the issuer. This mutually beneficial arrangement would increase the efficiency of capital intermediation and reduce the cost of capital.

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225. See Hawk, Meaney, Schneider & Schott, Revenue Bond Underwriting by Banks: A Panel Discussion, 2 Ann. Rev. Banking L. 53, 60 (1983) (reporting a survey of 12 econometric studies predicting savings of from $50 million to more than $600 million).

226. A legal decision permitting national banks to deal in certain Georgia municipal bonds stimulated a jump in bond prices, and reduced interest payments by 5%. Horvitz, Stimulating Bank Competition Through Regulatory Action, 20 J. Fin. 1, 11 (1965). Interest payments are a transfer payment, and the interest saved issuers by bank entry into the underwriting business is not itself a measure of welfare loss. Nevertheless, the magnitude of the estimated reduction in interest costs suggests that very substantial welfare gains are possible.

227. The choice of form of the investment relationship—debt or equity—poses the central question of institutional economics: whether, in a world with transactions costs, to organize production by contract or by hierarchy, i.e., within a firm. Extensive literature addresses this question. See Coase, The Nature of the Firm, 4 Economica (n.s.) 386, 390-98 (1937); see also Williamson, Transaction-Cost Economics: The Governance of Contractual Relations, 22 J. L. & Econ. 233, 259-60 (1979) (proposing criteria for distinguishing the preferred relationship).

228. In this respect, the incentives of the borrower are analogous to those of a depository under a flat-rate insurance system: the benefits of increases on the upside of risky ventures accrues to the stockholders as the owners of the residual interest in the corporation. The downside risk is shared with creditors, including the bank lender. See supra text accompanying notes 170-176. A bank loan agreement typically restrains some risk-taking, for example, by limiting debt leveraging by the borrower, but any loan agreement will necessarily provide incomplete protection to the lender, because it cannot anticipate every circumstance that permits additional risk-taking. Where such a noncontractible situation exists, the investor will invest less money than it would if it had held an ownership interest. Cf. Grossman & Hart, The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, 94 J. Pol. Econ. 691 (1986) (“When it is too costly for one party to specify a long list of the particular rights it desires . . . , it may be optimal . . . to purchase all the rights except those specifically mentioned.”). Direct equity ownership offers the bank two advantages over loan contracts: (1) the bank has an interest in the residual profits of the firm, and (2) the bank benefits from the stricter fiduciary obligations owed by corporate management to its stockholders. The former advantage is, in effect, a hedge against wealth transfers from debt-holders to equity holders; the latter may be an efficient method of specifying management responsibilities. Abrogation of the separation also would permit the bank to reduce monitoring costs, by having representatives on the corporate borrower's board of directors.

229. Although the cost of capital also could be reduced by the usual tools of monetary policy—open-market operations of the Federal Reserve or changes in the discount rate—the result would be inferior to a policy change that spurred increased efficiency in capital inter-
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Permitting bank ownership of equity also should reduce the welfare losses associated with agency behavior of corporate managers. The potential for corporate takeover activity by banks would increase the disciplining effect of the "market for corporate control" on corporate agents.\(^{230}\) Even where banks own equity in, but do not control, public corporations, the relative advantage of banks in monitoring corporate behavior would benefit other stockholders. However, the principle works in two directions: permitting nonbanks to own bank equity also would reduce inefficiency in bank management.\(^{231}\)

B. Thinking About Alternative Regulatory Strategies

Analysis of the welfare costs of the separation of banking and commerce suggests several lessons with implications for reform of the bank regulatory system. First, any systematic reform of the laws separating banking and commerce also should revisit the federal deposit insurance system. The principal justification for the separation is that it ameliorates the tendency of federally insured depositories to undertake excessive risks and suffer superoptimal rates of failure. Ultimately, a balance must be struck between the desirability of maintaining the existing deposit insurance system and suffering welfare losses.

Both of the former mechanisms reduce market interest rates, decrease savings, and increase consumption and, therefore, tend to be inflationary. Efficiency gains lead to both increased savings and increased investment, with a disinflationary effect.

According to some authorities, restrictions on bank ownership of equity are an important reason for the much lower cost of capital in Japan than the United States. See W. Ouchi, supra note 8, at 62-90 (attributing lower cost of capital in Japan to close relationships between Japanese banks and their corporate customers); Productivity Lag is Real Trade Barrier, Wall St. J., May 14, 1986, at 30, col. 3 (listing bank ownership of equity in Japan as one reason for Japan's high rate of capital formation). Assessment of this claim is difficult, however, because of the much higher rates of savings in Japan (about 25% of gross domestic product versus less than 5% in the United States), and imperfect international capital flows. Nevertheless, even small differences in the costs of capital can generate staggering differences in wealth over time, and differences in bank regulation undoubtedly have contributed to long-term shifts in relative wealth among countries.

The notion that corporate acquisitions serve to check self-interested and socially costly behavior of corporate officers originated with the seminal work of Henry Manne. Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965) (discussing the economic value of mergers prior to a situation in which bankruptcy or liquidation is imminent). Although Manne's thesis enjoys widespread acceptance among academics, considerable skepticism exists regarding the significance of the role of hostile takeovers as deterrents to careless or abusive management. This skepticism is rooted in the low frequency and high costs of hostile acquisitions. On average, successful tender offerors pay a premium of approximately 50% over prevailing market price for stock of target corporations, in addition to bearing substantial transactional costs. See Separate Statement of Frank H. Easterbrook and Gregg A. Jarrell in Advisory Committee on Tender Offers, Report of Recommendations 109-10 (Securities and Exchange Commission, July 8, 1983). The size of the premium implies that the potential enhancement of corporate value must be very large before a hostile takeover becomes feasible. Presumably, were banks to become active in corporate control markets, the number of hostile acquisitions would increase, with a concomitant increase in the deterrent effect on incumbent managements.

Direct empirical evidence exists for the latter proposition. The operating costs of independent banks are lower in states that permit multibank holding companies, implying that potential bank takeovers constrain agency behavior. See James, An Analysis of the Effect of State Acquisition Laws on Managerial Efficiency: The Case of the Bank Holding Company Acquisitions, 27 J. L. & Econ. 211 (1984) (examining empirically the importance of the outside takeover device as a means of enforcing managerial efficiency).
from policies—the separation or alternatives—that cause some misallocation of bank assets, and that may distort the allocation of income between consumption and investment. Second, bank risk regulation should focus more sharply on the costs and benefits of integration of particular banking and nonbanking businesses.

The separation is an indiscriminate blunderbuss, yet the social costs and benefits of bank entry into new businesses may vary substantially among particular nonbanking businesses. Likewise, particular banks vary considerably in their degree of susceptibility to deposit insurance-induced moral hazard. Publicly owned banks managed by salaried agents and banks with deep capital will exhibit less of a tendency to undertake excessive risk. Modest efforts to distinguish among subject banks and proposed activities offer potentially large returns to economic welfare. Last, a principal goal of any regulatory reform should be to permit greater latitude for market forces to shape the structure and conduct of the banking industry. The capital intermediation process is so significant—both in terms of assets and as a percentage of gross national product (GNP)—that small gains in allocational efficiency are of significant moment to the economy. Conversely, the administrative costs of bank regulation are very small relative to total banking assets. Thus, relatively large increases in administrative expenses are more than offset by tiny improvements in allocational efficiency.

The universe of possible regulatory strategies is large. The tendency of insured banks to undertake superoptimal levels of portfolio risk could be countered with a variety of devices, of which the separation of banking and commerce is one with few apparent virtues. Any regulation that causes a bank's indifference curve, $I_i$, in Figure 1, to become more convex or the umbrella curve of feasible investments, $D'D''$ in Figure 1, to become more concave will shift the bank's optimal portfolio towards less risk.

1. Restrict Deposit Insurance

One reform measure consistent with the observed lesson would be to restrict simultaneously the provision of federal deposit insurance and the scope of nonbanking restraints. If the purpose of deposit insurance is to prevent bank panics, that goal possibly could be achieved by an insurance system limited to funds withdrawable on notice. As of the end of April, 1986, transaction accounts immediately available on demand accounted for less than twenty-two percent of commercial bank assets. Such accounts could be

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232. In a model in which the social costs of restrictions on free allocation of bank capital are balanced against the social costs of bank failure, the first-order conditions for a welfare optimum would require that the marginal welfare gain from permitting entry by a bank into any nonbanking business be equal to the social cost from any resulting increase in the expected probability of the bank's failure. Because, inter alia, the marginal change in the probability of failure depends on a bank's existing portfolio of assets, nonbanking restrictions of general applicability cannot satisfy the first-order condition for a regulatory optimum. See generally Santomero & Watson, Determining an Optimal Capital Standard for the Banking Industry, 32 J. Fin. 1267, 1279-80 (1977) (arguing against the regulation of debt leveraging by banks).

restricted to specialized institutions subject to vigorous controls on excessive risk-taking.\textsuperscript{234} Other depositories financed entirely with equity and uninsured debt would be unregulated. Most intermediation would be freed from the distorting effects of both deposit insurance and the separation of banking and commerce.

Experience with the money market mutual fund industry indicates that deposit insurance may be unnecessary even for depositories accepting demand deposits, if portfolio restrictions on such institutions were sufficiently stringent.\textsuperscript{235} Such restrictions could be enforced privately or publicly. If privately enforced, a vestigial program of deposit insurance could be retained to relieve depositors of the costs of monitoring institutional compliance. Even if omission of deposit insurance caused some shifting of assets into demand accounts, the volume of deposits subject to the separation still would be vastly smaller than under existing law because of the difference in interest paid on demand and other accounts. Uninsured accounts would bear no insurance premium and suffer no portfolio restrictions; intermediaries offering demand accounts would pay the costs of the deposit insurance system and would earn lower rate of returns on their asset portfolios.

2. Introduce Risk-Related Premiums

Alternatively, deposit insurance could be retained, but it could be financed by risk-related premiums, rather than a flat-rate levy. If portfolio risk were assessed accurately and continually, and the insurance were fair actuarially, banks would internalize all of the costs of risk-taking. Accordingly, they would no longer undertake excessive risks, and the need for asset regulation would disappear.\textsuperscript{236} More realistically, operational constraints will limit the regulatory agencies to only the coarsest estimates of risk, and leave great latitude within each category for opportunistic behavior. As a result, the premium differentials among risk classes are likely to be smaller than necessary to eliminate moral hazards.

\textsuperscript{234} There should be no shortage of near riskless assets in which intermediaries offering transactions accounts could invest. In addition to the national debt of more than $2 trillion, the federal government guarantees another $410 billion of private debt. See 1986 CEA Report, supra note 18, at 192.

\textsuperscript{235} See Kareken, Federal Bank Regulatory Policy: A Description and Some Observations, 59 J. Bus. 3 (Jan. 1986) (discussing the development of federal bank regulatory policy and how well the present policies are working). Kareken proposes creation of a category of financial intermediaries subject to two restrictions: (1) that the intermediary offer only transaction accounts and (2) that its accounts be subject to "one hundred percent reserves," i.e., that the intermediary be permitted only to invest in Treasury obligations. Id. at 37-42. Such intermediaries would provide a risk-free transaction account for those who wished to hold their wealth in such a form. Other intermediaries would not offer transaction accounts and would not be subject to deposit runs; consequently they would not need deposit insurance. As an alternative, Kareken points out that restricting the intermediary portfolio to marketable securities and constantly "marking to market" the value of transaction accounts, i.e., constantly revaluing them to a proportionate share of the fair market value of total assets, is a sufficient condition to avoid bank runs. Even in the absence of deposit insurance, there still is no incentive to race to liquidate transaction accounts, because the liquidation value of the account is not enhanced by being first in line to withdraw funds. Id. at 43. The latter proposal would subject transaction accounts to fluctuations in nominal, as well as real, value.

\textsuperscript{236} See supra note 174.
hazard. Politically, risk surcharges may prove difficult to implement since the result necessarily will entail higher premiums for precariously situated banks.

3. Distinguish Well-Capitalized Public Banks

Even if the existing system of flat-rate deposit insurance is continued, the separation should be suspended, in whole or in part, for institutions which either are unlikely to favor excessive risk or, for other reasons, may have particularly low expected probabilities of failure. The social gains, if any, from the separation are less for depositories whose failure rate in the absence of separation would be lower, and the optimal regulatory rule for more secure intermediaries should shift toward greater firm autonomy. For example, relaxed

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237. See 1984 CEA Report, supra note 102, at 166-67. If surcharges for portfolio risk are less than actuarially fair to the insurance fund, low risk banks will continue to cross subsidize high risk banks, albeit to a lesser extent. If undersized enough, risk-neutral insureds will have an incentive to avail themselves of the riskiest possible portfolio. Figure 4 below, adapted from Figure 1, graphically illustrates that the effect of risk surcharges is to rotate DD" towards NN" to a position like SS". If the surcharges actuarially were fair, SS" and NN" would coincide. If the surcharges are too small, S'S" still will continue to rise, and a risk-neutral depository, i.e., one with horizontal indifference curves, will optimize its asset holdings by choosing the portfolio comprised solely of the riskiest asset, represented by point S".

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238. Congress already has demonstrated a propensity to further subsidize failing agriculture and energy banks. See supra note 215.
restrictions clearly are appropriate for depositories with high ratios of equity capital to assets. Such institutions exhibit lower failure rates than more highly leveraged banks for three interrelated reasons: (1) the greater capital provides a cushion which makes it less likely that adverse outcomes will exhaust capital and result in failure;\textsuperscript{239} (2) the return from superoptimal risk is lower for less highly leveraged depositories and, therefore, they have less incentive to behave imprudently; and (3) there is greater margin for regulatory detection and intervention before institutional deterioration leads to collapse.\textsuperscript{240} An obvious improvement on the separation would be to permit a fraction of bank assets that increases with a bank's capital-to-asset ratio to be committed to ownership of equity or nonbanking businesses.\textsuperscript{241} Likewise, agency theory implies that regulatory policy should distinguish between closely held and publicly owned banks, since manager-controlled firms are less likely to take superoptimal risk and less likely to fail.\textsuperscript{242} To the extent that other nonbalance sheet factors,

\textsuperscript{239} The point can be demonstrated graphically using Figure 2. See supra text accompanying note 179. An increase in the capital-asset ratio, C in Figure 2, lowers the intercept \(-C\) and makes the line segments \(-CE_A\) and \(-CE_B\) steeper. The steeper the line segments, the lower the probability of failure.


\textsuperscript{241} Since January, 1986, all four primary federal banking regulators, the FHLBB, the Comptroller, the FDIC, and the Board, have offered plans for risk related capital requirements. See 51 Fed. Reg. 16,550 (May 5, 1986) (FHLBB); Minimum Capital Ratios; Risk-Based Capital Standard for National Banks, 51 Fed. Reg. 10,602 (Mar. 27, 1986) (OCC); Capital Maintenance; Supplemental Adjusted Capital Proposal, 51 Fed. Reg. 6126 (Mar. 27, 1986) (FDIC); Bank Holding Companies and Change in Bank Control; Capital Maintenance; Supplemental Adjusted Capital Measure, 51 Fed. Reg. 3976 (Jan. 31, 1986) (Federal Reserve). Each agency proposes to categorize assets into a small number of classes and to assign arbitrary weights to each class, the weights increasing with assumed riskiness for the purpose of computing total assets for the capital/asset calculation. The Board and FDIC proposals would supplement existing capital requirements, thus increasing capital requirements for "risky" bank holding companies and state banks. The Comptroller would replace existing regulation, thereby permitting additional deposit leveraging by low-risk national banks. The FSLIC would revise radically existing regulation by doubling the required thrift capital-to-asset ratio, but would allow certain "credits" for low risk assets, and impose "incremental" capital requirements for certain high-risk assets. While these proposals demonstrate an admirable, if belated, awareness of the theoretical nexus between capital requirements and risk, they also evidence the regulatory preference for reduction in bank failure rates. Three of the four proposals are necessarily more restrictive than current law, and the fourth is likely to be more restrictive in practice. None of the proposals would relax any of the provisions of the separation, regardless of the degree to which a bank's capital exceeds the statutory minimum.

\textsuperscript{242} See supra text accompanying notes 184-185 (discussing the effects of management control, agency, or risk taking). Professional managers in banking are more likely to exhibit risk-averse behavior than managers in other trades, because of the unusual power of banking regulators to punish them for adverse operating results or especially risky, but legal, conduct. Officers and directors of a failed bank, for example, routinely are required to resign by the FDIC, although the bank may not be liquidated. Forrestal, Bank Safety: Risks and Responsi-
such as competence of management, can be measured or assessed, these factors might figure in the balancing.

4. Substitute Administrative Discretion for Statutory Restrictions

Finally, one can envisage replacing all or part of the current system of line-of-business restrictions with a case-by-case administrative application procedure analogous to existing premerger antitrust review. Financial institutions would apply to regulatory authorities to acquire a business or to purchase a particular equity security. The application would include data regarding the variances of the applicant's existing portfolio and the asset to be acquired, and their covariance. A simple computation would indicate whether the result of the transaction would be to increase or decrease portfolio volatility and the applicant's probability of failure.\footnote{Various criteria can be imagined for administrative review of applications. The most conservative approach would limit approval to transactions that reduce bank portfolio variance or risk of failure. This, at least, would have the virtue of rationalizing the separation by preventing its perverse application in contexts where it promotes bank risk. Alternatively, one could set standards that would permit acquisitions which increase institutional risk. Determination of a risk ceiling should involve some consideration of the relative costs and benefits of enforcement. Finally, banking regulators could weigh the costs and benefits of particular acquisitions. While this is the theoretically preferred approach, the banking regulators' track record raises doubts that they could measure capably externalities or apply impartially such a test.}

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VI. Conclusion

While adoption of the separation of banking and commerce in the United States occurred fortuitously, its subsequent expansion and refinement are due principally to two presumptions: that separation is desirable to prevent financial

\textit{bilities}, Fed. Reserve Bank of Atlanta Econ. Rev., August 1985, at 4, 10 (1985). Even where risk-taking does not lead to insolvency, a reputation for aggressive asset management may subject a professional banking executive to regulatory hostility and the possibility of various career imperilling sanctions. A disfavored bank executive may be foreclosed from employment in newly created banks, because regulatory authorities have the power to disapprove appointment of corporate officers for a period after initial chartering. \textit{See, e.g.}, 12 C.F.R. § 5.20(d)(3)(ii)(C) (1987) (conditioning award of charter on agreement to permit the Comptroller to disapprove appointment of any officer for a period of two years from the time that a national bank initially commences business). Good relations with regulatory officials also are vital where bank operations require discretionary regulatory approval, for example, to branch or to make a bank acquisition. The particular incentive of professional bank managers to avoid conduct perceived as risky by bank regulators may explain the significant negative correlation between bank size and probability of failure, since larger banks are more likely to have diffused stockholdings and to be controlled by professional management. Avery & Hanweck, \textit{supra} note 240, at 386-90.

243. \textit{See supra} note 173. Firm-specific data would be preferable to industry data for these computations, because the latter understates the variance of individual firms, and insured banks otherwise would have the opportunity to seek out firms with uncharacteristic risk patterns that could increase portfolio variance. However, requiring firm-specific data would limit permitted acquisitions to businesses of sufficient age to permit computation of the required statistics.
panics, and that separation constitutes a necessary bulwark against the rise of gigantic economic entities with unacceptable economic and political power. Neither of these presumptions is correct. Federal deposit insurance has defused the tendency of the banking system to experience episodic instability. Even without deposit insurance, some financial intermediaries, such as money market mutual funds, have avoided disequilibrium successfully by adopting restrictive asset policies. Fear that abrogation of the separation would result in dominant integrated firms is equally unfounded. The impetus toward aggregation of financial and nonfinancial firms is less strong, as opposed to stronger, than aggregation of nonfinancial corporations, and integrated organizations are apt to distort political choices less, not more, than nonintegrated firms.

The separation does reduce somewhat the incidence of bank failure. Whether this is a desirable goal is uncertain; it is apparent, however, that bank regulators misperceive the costs and benefits of bank failure, and pursue excessively the goal of bank "safety and soundness." Assuming, arguendo, the appropriateness of the goal, reliance on alternative strategies and reductions in the separation would promote social welfare.