FRBSF Weekly Letter

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Corporate Separateness

The financial services industry is undergoing an important transformation. Once separate financial markets are being integrated and competition is increasing among once distinct types of financial institutions. As a result, pressure to change our outmoded system of financial regulation is mounting. In particular, many argue that the present legal restrictions on the activities of banks and bank holding companies (such as securities underwriting and placement activities) must be reduced or eliminated to enable such organizations to compete effectively.

At the same time, proposals to expand the securities and other financial powers of banking organizations threaten to diminish regulatory control over bank risk taking — a serious concern in light of the incentives to undertake risk that our federal deposit insurance system gives insured institutions. Most proposals that call for expanded powers try to resolve this dilemma by appealing to "corporate separateness." Proponents of corporate separateness argue that banks and the federal insurance funds could be insulated from the risks associated with new activities if such activities were placed in legally separate subsidiaries of bank holding companies and transactions between the banks and their affiliates were restricted.

The feasibility of this approach depends critically on the answers to two questions. First, can separation be maintained in the view of the law? And second, does legal separation necessarily lead to economic separation? This *Letter* argues that although separateness is feasible legally, alone, it is inadequate to insure effective insulation of banks and the federal insurance funds from the risk of new activities. Regulation of the consolidated organization is needed, too.

Legal issues

The legal basis for corporate separateness rests on the long-standing principle of limited legal liability; the owners of corporations are not liable for the debts or actions of the corporations they own and/or control. This principle applies both to individuals and corporations which own other corporations. For example, Citicorp, a corporate bank holding company, is not considered legally liable for the debts of Citibank, its wholly-owned corporate subsidiary bank and primary asset. Nor is Citibank considered legally liable for the debts of Citicorp or any of Citicorp's other subsidiaries.

In some cases, however, the courts have "pierced the corporate veil" and held the owners liable for the debts and other obligations of a bankrupt corporation. These cases are rare and have involved misleading representations and actions, and/or illegal activities on the part of the corporation. Thus, proponents of corporate separateness argue that limited liability can be preserved by following a few basic and sensible rules of business practice and by maintaining corporate distinctions through the use of separate letterheads and separate accounting records, among other things.

Moreover, if the current legal interpretation of limited liability is deemed to offer an inadequate assurance of legal separation in all situations, legislation could be passed to provide stronger safeguards. In sum, the enforceability of limited liability and legal separateness is not an issue of serious dispute.

Economic incentives

Although the law does not *require* a corporation to assume the obligations of an affiliate, neither does the law *preclude* it from doing so. If there are incentives for a corporation to take on the obligations of an affiliate, it will do so. Thus, even though a corporation and its affiliates may be treated as separate by the law, they need not be *economically* separate.

A bank holding company is a corporate veil for the common ownership and management of both bank and non-bank subsidiaries. The owners of the holding company seek to maximize its value by maximizing the sum of the values of each of the holding company's subsidiaries. This means that the owners will transfer resources from one subsidiary to another whenever the benefits to the organization as a whole exceed the costs to the resource-providing subsidiary.

Incentives to transfer resources within a conglomerate-type organization arise because of synergies in the production of goods and services among its subsidiaries. For example, several subsidiaries in a financial conglomerate may be able to use the same information to offer different services to a given customer. It is cheaper for those subsidiaries to share the information and jointly incur the expense of collecting it than for each subsidiary to collect the information.

Likewise, synergies arise in the preservation of reputational capital. Financial troubles at one subsidiary can affect the public's view of the soundness of all of its affiliates. Consequently, the parent has an interest in transferring resources among subsidiaries to preserve the reputational capital of the whole organization. As Walter Wriston, a former chairman of Citicorp put it, ". . . it is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all your capital funds are going to be behind it in the real world."

Restrictions on transactions

Proponents of corporate separateness realize that such synergies induce bank holding companies to operate in ways that do not insulate subsidiary banks from the risks of other subsidiaries. Consequently, they suggest that banks be insulated by restricting dividends and other payments to the parent and by limiting banks' investments in sister affiliates. Some believe that current restrictions on dividend payouts and the restrictions in Sections 23A and 23B of the Federal Reserve Act are sufficient to insulate banks within a holding company framework. Others argue for greater restrictions on transactions between a bank and its affiliates. (Section 23A limits loans and asset purchases to any one affiliate to 10 percent of bank capital and limits such transactions to all affiliates combined to 20 percent of capital. Section 23B requires that permissible interaffiliate transactions be on terms and conditions that are substantially the same as arm's length transactions with nonaffiliated firms. Current dividend payout restrictions require prior regulatory approval for dividend payouts that exceed current earnings.)

Proponents of corporate separateness argue that if restrictions on interaffiliate transactions are enforced, it is necessary only to regulate the bank. Consolidated regulation of the bank holding company and its nonbank subsidiaries would not be required.

An important question remains, though, whether such restrictions *can* be enforced, especially in times of financial stress. In this regard, it is instructive to see whether, in unregulated credit markets, investors view legally separate subsidiaries as economically independent of the strength of their parents.

Evidence from the nonbank sector

In some respects, the risks to the deposit insurance system are the same as those borne by a private long-term bondholder. Both fixed-rate deposit insurance and long-term debt provide incentives to increase risk and earn a higher expected yield than would be possible if the appropriate risk premiums had to be paid to the insurer or the bondholders. The insurance guarantee enables banks to raise funds at a risk-free rate regardless of default risk. Once a corporation has issued long-term debt, a subsequent increase in risk diminishes the value of the long-term bondholders' claim.

In the same way that the bank regulators use dividend restrictions and Sections 23A and B to prevent banks from increasing risk, bondholders use restrictive convenants in the bond indenture to prevent corporations from increasing risk after the debt is issued. These covenants often limit dividend payments and restrict the extent to which a firm can become a claimholder in another business through investments in common stock, bonds, and other extensions of credit. Such restrictions limit the firm's ability to increase default risk by reducing capital or substituting higher risk assets for existing assets.

Since unregulated credit markets require such covenants in private debt contracts, it follows that analogous regulatory restrictions *do* insulate banks and the insurance funds to some extent. However, it also is the case that private credit markets do not rely solely on such insulation.

Rather, the strength of the entire organization is a factor in evaluating the creditworthiness of individual subsidiaries.

Many nonbanking firms have legally separate subsidiaries that issue debt independently of their parent corporations. For example, General Motors and Ford own major finance companies (GMAC and Ford Acceptance Corp.) that issue their own commercial paper. General Electric Corporation also owns a large finance company, General Electric Credit Corporation, which is another major issuer of commercial paper. Yet when Moody's, a private bond rating service, evaluates the soundness of these subsidiaries' debt, a prime consideration is the soundness of the parent corporation, even though the parent may receive a different rating than that of its subsidiary. Apparently, investors see the fortunes of the parent and its subsidiaries as interdependent even though they are legally separate corporations.

An example

One example of the way the market perceives the link between a legally separate subsidiary and its parent is the case of MGIC Investment Corp. and Baldwin-United Corp. Because Baldwin-United's purchase of MGIC, a private mortgage insurer, increased the parent's debt burden dramatically, the Standard & Poors debt rating service downgraded the debt and commercial paper ratings of *both* Baldwin-United and MGIC in 1982. Moreover, in 1983, MGIC temporarily stopped issuing commercial paper because of unfavorable publicity over financial problems at Baldwin-United. Apparently, Baldwin-United had purchased MGIC to generate cash flow and take advantage of tax credits associated with losses in other businesses. Ultimately, Baldwin-United declared bankruptcy, in part because the Wisconsin Insurance Commissioner restricted Baldwin-United's ability to upstream earnings from MGIC.

Thus, in private credit markets, corporate separateness apparently does not fully insulate legally separate affiliates. Of course, it might be possible for regulators to enforce a more stringent standard. But it may not be desirable to do so. Even cross selling and information sharing require allocation of common expenses between the bank and its affiliates. Similarly, for bank holding companies to realize the benefits of filing consolidated tax returns, all the subsidiaries, in effect, assume joint liability for taxes. With perfect insulation, the subsidiaires become passive investments which hinder the realization of such synergies.

Holding company regulation

Some of the proponents of corporate separateness have argued that regulation of the companies that own banks is not necessary. However, a regulatory hands-off approach to bank holding companies requires complete insulation of banks from their affiliates and a resultant loss of synergies among banking and other activities. In a sense, then, we are back to the original problem of finding a way to realize the benefits of expanded powers without increased risk to banks.

Here again, it is instructive to look to private markets for guidance. Investors in unregulated markets evaluate the financial soundness of the parent even when they are purchasing only GMAC or Ford Motors Acceptance Corporation paper. Similarly, the Federal Reserve now evaluates and monitors the soundness of banks *and* their holding companies to determine whether each holding company can be a source of strength for its bank subsidiaries.

The plight of MGIC and Baldwin-United also is instructive. The Wisconsin Insurance Commissioner had the authority only to oversee MGIC, and not its parent. As a result, his task was far more complicated and the ultimate resolution of the Baldwin-United bankruptcy more cumbersome than might have been the case if the insurance commissioner had had some authority to oversee Baldwin-United.

As we have argued in previous *Letters*, the powers of banking organizations can and should be expanded, but stronger regulation, including capital regulation, of banks and their holding companies is needed to protect the insurance system. Corporate separateness alone provides some protection, but needs to be supplemented with regulation of the consolidated organization.

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