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Bank Holding Companies

A Better Structure for Conducting Universal Banking?

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Would bank holding companies be a better structure to conduct universal banking? The device contains some important advantages, but the evidence now is limited and unacceptably high risks for banks could be one result.

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This paper — a product of the Financial Policy and Systems Division, Country Economics Department -- is part of a larger effort in PRE to explore ways to increase the soundness of banking systems. Copies are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Zena Seguis, room N9-005, extension 37665 (24 pages).

Banking systems in many countries have become increasingly unstable in recent years. At the same time, market forces have pushed banks to expand into a variety of universal banking activities, including some that appear to involve higher risks than traditional banking operations.

Talley notes that these trends have prompted questions about whether restructuring banking organizations might permit them to pursue universal banking activities without impairing the stability of the banking system.

The basic bank holding company proposal contains three major elements:

• Any bank that wants to operate as a universal bank must first form a holding company and then conduct all riskier activities in holding company units rather than directly in the bank. The bank would continue to engage in traditional banking activities that involve the usual levels of risk.

• The government would develop laws and regulations designed as safeguards to insulate the bank from any financial problems that might occur in holding company affiliates of the bank.

• Bank regulatory authorities would impose little or no supervision on holding company units. Instead, the marketplace would discipline the financial affairs of these affiliates.

The use of the bank holding company device to conduct universal banking activities can promise important public benefits including: (1) a sounder commercial banking system, (2) less banking regulation, and (3) greater competitive equality between banking and nonbanking units.

One major objective of using holding companies to conduct banking activities is to preserve banking stability. The evidence is inconclusive on whether holding companies could achieve this goal.

The major risk is that policymakers may tend to assume that safeguards protecting banks are invulnerable and allow holding companies to engage in risky activities they would never consider permitting banks to conduct. If holding companies encountered serious problems because of unduly high risks, banks affiliated with them could experience serious damage as a result.

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I. INTRODUCTION

In recent years, banking systems in many countries have been experiencing increasing instability. At the same time, market forces have been pushing banks to expand into various universal banking activities, some of which appear to involve greater risks than traditional banking activities. The combination of these two developments has raised the question whether it might be possible to restructure banking organizations in order to permit them to pursue universal banking activities without impairing the stability of the banking system.

Organizationally, there are three alternative ways in which banking organizations can participate in universal banking activities. First, they can conduct these activities directly in the bank. This appears to be the arrangement that is most widely used. Second, they can conduct these activities in subsidiaries of the bank, an arrangement that appears to be increasing in use. Third, they can conduct these activities in bank holding companies (either in the parent company or in nonbank subsidiaries of the parent). To date, this organizational arrangement has not been widely used, but is being increasingly discussed in banking and public policy circles.

Proponents of bank holding companies argue that conducting universal banking activities in holding company affiliates is clearly superior to conducting these activities either directly in the bank or in subsidiaries of the bank. These advantages include shielding the bank against the risks that universal banking activities may entail, avoiding the spread of bank-type regulation, and promoting a level playing field between banking and nonbanking competitors.

The objective of this paper is to evaluate the bank holding company device as a vehicle for conducting universal banking activities. The paper identifies the major issues involved, reviews the empirical evidence on the use of the holding company structure, and discusses several proposals to make the use of the holding company device more effective from a public policy perspective.

The paper is divided into eight sections. Following this introductory section, the paper briefly reviews the pros and cons of universal banking. In the third section, the basic features of the bank holding company proposal are presented and explained. In the next two sections, the alleged advantages of the bank holding company proposal are presented, followed by various challenges to these alleged advantages. In the sixth section, the empirical evidence on the use of the holding company device for conducting universal banking activities is reviewed. Unfortunately, this empirical evidence is very limited because only one country, the United States, has expressly employed the holding company device on a wide scale to conduct universal banking activities. In the next section, two variants of the basic bank holding company proposal -- the fail-proof bank proposal and the fail-proof parent proposal -- are presented and evaluated. The major conclusions of the paper are presented in the final section.

II. UNIVERSAL BANKING

The term "universal banking" does not appear to have a precise definition. In general, however, the term implies that banking organizations have powers to engage in activities that go significantly beyond traditional banking activities. These broader activities might include lending and investing that involve substantial term transformation, engaging in securities underwriting and dealing, and, in some countries, even holding equity positions in commercial and industrial companies.

As indicated earlier, there has been considerable controversy regarding the merits of universal banking.[1] The proponents of universal banking argue that this form of banking will promote economic growth by making available much needed long-term financing to commerce and industry. Universal banking also will promote efficiency by allowing banks to achieve economies of scale and scope. Moreover, universal banking will foster competition by opening up various areas of finance for entry by banks.

Opponents of universal banking argue that it will distort credit allocation because of an increase in connected lending. Also, universal banking inevitably will lead to a greater concentration of economic resources and political power. Further, universal banking is bound to lead to conflicts of interest -- for example, a bank underwriting securities for a troubled firm where the proceeds of the issue would be used to pay off the bank's own loan to the company. Finally, and perhaps most important, universal banking could involve banks engaging in risky activities that could jeopardize the stability of the banking system.

The difference of views regarding the merits of universal banking is reflected in several World Bank reports over the last decade or so. In the late 1970s, the Bank staff recommended the implementation of universal banking in the Philippines. Shortly thereafter, the staff turned around and argued against universal banking for Brazil and Mexico.[2] The staff's apparent inconsistent approach may simply reflect Maxwell Fry's comment: "There is, therefore, no

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[1] For a detailed review of the pros and cons of universal banking, see Deena R. Khatkhate and Klaus-Walter Riechel, "Multipurpose Banking: Its Nature, Scope and Relevance for Less Developed Countries," International Monetary Fund Staff Papers, September 1980, pp. 478-516.

[2] Millard Long, Review of Financial Sector Work, World Bank, Financial Development Unit, Industry Department, October 1983, p. 40.

universal case for or against universal banking."[3]

I.'. THE BASIC BANK HOLDING COMPANY PROPOSAL

The proposal to use bank holding companies to engage in universal banking activities could take various forms. The form used in this part of the paper is the one that appears most frequently in public policy discussions. This proposal, which will be referred to as the basic bank holding company proposal, contains three major elements.

First, any bank that wants to operate as a universal bank would be required to form a holding company and then conduct all riskier activities in holding company units, rather than directly in the bank. These riskier activities could be conducted either in the holding company itself, or in nonbank subsidiaries of the parent company. The bank would continue to engage in traditional banking activities that involve "bankable" risks.

Second, the government would develop laws and regulations designed to insulate the bank from any financial problems that might occur in holding company affiliates of the bank. At a minimum, these "firewall" provisions would include: (i) strict quantitative limitations on bank loans or other extensions of credit to holding company affiliates, as well as tight limits on bank purchases of securities or other assets from these affiliates; (ii) requirements that all bank transactions with affiliates be on "market terms" -- that is, on terms and conditions that are substantially the same as those on bank transactions with nonaffiliated parties; and (iii) provisions that would prevent the holding company from extracting excessive dividends from the bank that would unduly

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[3] Maxwell J. Fry, Money, Interest and Banking in Economic Development (Baltimore, Md.: John Hopkins University Press, 1988), p. 283.

deplete the bank's capital.

Third, holding company units would be subject to little or no supervision by bank regulatory authorities.[4] Instead, the financial affairs of these affiliates would be disciplined largely or entirely by the marketplace. The rationale for not subjecting holding company affiliates to bank-type regulation is that it is not needed if the bank can be effectively insulated from holding company financial problems.

IV. ALLEGED ADVANTAGES OF THE PROPOSAL

Proponents of the basic bank holding company proposal argue that the proposal would produce substantial public benefits. Most important, the proposal would allow the public to derive the benefits of universal banking without placing the stability of the banking system in jeopardy. The bank holding company proposal also would minimize the spread of bank-type regulation. By conducting risky universal banking activities in holding company affiliates, it would not be necessary to subject these activities to bank-type regulation because the bank is protected by firewalls. By contrast, if these risky activities were conducted directly in the bank, or even subsidiaries of the bank, these activities almost surely would be subject to bank-type regulation. As a result, the movement to universal banking probably would result over time in the spread of bank-type regulation throughout much of the financial system. Moreover, it would tend to result in regulatory duplication in those financial industries (such as securities and insurance) that are probably already subject

[4] Holding company affiliates participating in certain nonbanking activities might be subject to regulation by other government agencies. For example, if an affiliate engages in securities underwriting and dealing, this activity might be supervised by a securities regulatory authority.

to regulation by "functional" regulators.

Another advantage of the bank holding company proposal is that it would place banking and nonbanking competitors on a level playing field. First, both banking and nonbanking rivals would be subject to essentially the same amount of regulation. By contrast, if universal banking activities were conducted directly in the bank, or in subsidiaries of the banks, the bank would be subject to bank-type regulation, whereas its nonbanking rivals wouldn't. Second, the bank holding company proposal would promote competitive equality in the funding of universal banking activities. If these activities were conducted directly in the bank, banks would tend to have a lower cost of funds because banks are protected by the government through such devices as deposit insurance and access to a lender of last resort. Under the bank holding company proposal, however, activities would have to be conducted in holding company affiliates. These affiliates would have to do their own funding in the marketplace or, alternatively, if funded by the bank, would be required to pay market rates. Consequently, holding company affiliates could not gain a funding advantage over their nonbank rivals.

V. CHALLENGES TO THE ALLEGED ADVANTAGES

On first view, the basic bank holding company proposal seems to represent an extremely attractive way to allow banking organizations to engage in universal banking. The proposal holds out the promise that universal banking can be conducted without jeopardizing banking stability or spreading bank-type regulation throughout the financial sector, and also would place banking and nonbanking competitors on a level playing field.

However, these alleged advantages of the bank holding company proposal have been subject to serious challenges. The most important of these challenges is that it may not be possible to insulate banks from holding company problems. If the firewalls develop cracks, most of the alleged advantages of the proposal would disappear. There are three ways that holding company problems might spill over onto banks.

First, if a holding company affiliate fails, creditors of the affiliate might successfully sue the bank to honor the debts of its affiliate. Such a court ruling is referred to as "piercing the corporate veil" and effectively nullifies the technical legal separation of affiliated corporations.

The willingness of courts to pierce the corporate veil could vary considerably from country to country, depending on the laws of the various countries and how courts have chosen to interpret these laws over time. What can be said, however, is that courts in many countries have been willing to pierce the corporate veil under certain circumstances. In particular, courts have permitted piercing in cases where the business affairs of affiliates have been extensively commingled, the affiliates have operated or held themselves out to the public as a single entity, or the policies of the failed affiliate were directed to the interest of surviving affiliates, rather than to its own interests.

Second, holding company problems may be transmitted to banks in the form of adverse transactions. Even with laws designed to prevent such transactions, banking authorities may not be able to prevent them in all cases. One reason is that examiners who would monitor these transactions cannot be entirely sure whether some transactions are on terms that are entirely fair to the bank. For example, it is difficult for an examiner to determine whether the amount of management fees that the bank pays the holding company is appropriate for the services rendered to the bank. Likewise, within a certain range, it is difficult for an examiner to judge whether the tax payment that the bank makes to the holding company to cover the bank's share of the consolidated organization's tax liability is appropriate, or whether the bank's operations have been manipulated in various ways to maximize this tax payment.

In addition to the problems of effectively monitoring intercompany transactions, it is possible that desperate holding company management will knowingly violate banking laws by forcing the bank to bail out a failing holding company affiliate. In banking, the pressures to avoid a failure are great because banking is preeminently a reputation business.

The third way that holding company financial problems could be transmitted to the bank is through a loss of market confidence in the bank. This loss of confidence might occur because depositors closely identify the bank with the holding company. In other words, depositors view the entire bank holding company organization as a single entity, ignoring the fact that the organization actually is composed of a number of legally separate corporate entities.

There are a number of reasons why market participants may view the entire holding company organization as a single entity. One reason is that holding companies often try to project a single entity image through such devices as giving similar names to their various units. This device could capitalize on name recognition and the organization's favorable reputation in the marketplace. Another reason is that holding companies usually operate their organization as a single entity, rather than as a group of unrelated units. Market participants perceive this managerial approach and are influenced by it. Finally, holding companies are likely to do most or all of their financial reporting on a consolidated basis. This practice tends to foster a single entity perception in the marketplace. It also makes it difficult for market participants to evaluate the financial condition of individual units in the holding company, including the bank.

Even if market participants were not conditioned to view bank holding companies as a single entity, they still might commence a run on the bank if an important holding company unit failed. One reason is that major units of holding companies usually are managed by essentially the same group of people. Consequently, if one holding company affiliate has been seriously mismanaged, it is not unreasonable for market participants to assume that other units in the organization, including the bank, may be in trouble too. Moreover, market participants might fear that the bank may be abused in a desperate attempt by holding company management to bail out the troubled affiliate.

As discussed earlier, one of the alleged advantages of the holding company proposal is that it would avoid spreading bank-type regulation throughout much of the financial system. This contention rests on the assumption that banks, in fact, can be effectively insulated. If it is subsequently discovered that insulation does not work, it is probable that the government would subject holding companies to bank-type regulation, thereby spreading this type of regulation to other areas of finance. In addition, if holding companies were subsequently subjected to bank-type regulation, another alleged advantage of the proposal -- the equal regulatory treatment of banking and nonbanking competitors -- would be eliminated.

Finally, it is alleged that the holding company proposal would promote competitive equality by removing banking organization's inherent funding advantage over nonbanking firms. It appears that this contention has been almost universally accepted in public policy discussions. In fact, the argument is seriously flawed. As discussed earlier, the funding advantage would presumably be eliminated because any bank funding of holding company affiliates would have to be on market terms. The crucial implicit assumption in the argument is that these affiliates would then use this regulatory mandated cost of funds as the basis for setting prices for services offered the public. In fact, it is unlikely that the affiliate would use its own cost of funds because this cost merely represents an internal transaction between two units in the same organization. Consequently, this cost figure would have no implications for the consolidated organization and would not be used by a profit maximizing organization to set prices. Instead, the organization would use the bank's "subsidized" cost of funds, because this represents the consolidated organization's external borrowing cost. In final analysis, the only way that a banking organization's funding advantage can be removed is to prohibit the bank from funding affiliates, thereby forcing these affiliates to do their own funding in the marketplace, presumably at "nonsubsidized" market rates.

VI. EMPIRICAL EVIDENCE ON INSULATION

Whether banks can be effectively insulated from financial problems in holding companies is ultimately an empirical question. Unfortunately, there is at present only very limited empirical evidence on this crucial issue. First, there appears to be only one country -- the United States -- where banks have made a concerted effort to convert to the holding company form of organization in order to engage in a broader range of activities than existing laws permit banks to conduct. Second, even though the holding company form of organization is pervasive in the American banking system, there have been very few real tests of the firewalls concept. One reason is that policymakers have placed fairly strict limitations on the universal banking activities of holding companies. Consequently, these nonbank activities often are not large enough to cause serious problems for the consolidated organization. In addition, since the mid 1970s, holding company nonbanking activities have been subjected to close supervision by the Federal Reserve. This supervision has tended to constrain risk taking, and probably has led to fewer financial problems than otherwise would have occurred.

However, there have been two cases in the United States that clearly tested the insulation concept. The first occurred in 1973 and involved a small bank holding company in California named Beverly Hills Bancorp. This holding company owned Beverly Hills National Bank, but also was involved in making commercial real estate loans that were funded by commercial paper. When one of the holding company's large borrowers defaulted, the holding company was unable to pay off its maturing commercial paper and was placed in bankruptcy. The adverse publicity that accompanied the bankruptcy, and the close public identification of the bank with the holding company, resulted in large scale runs on Beverly Hills National Bank. These runs required bank supervisors to merge this illiquid, but solvent, bank into another bank.

The second, and far more important, test occurred in 1975 and involved Hamilton Bankshares. This holding company owned Hamilton National Bank, one of the largest banks in the State of Tennessee. In the early 1970s under new, aggressive management, the holding company set up a mortgage banking company and proceeded to expand the company's operations very rapidly. Within a short period of time, the mortgage company had a large amount of nonperforming loans and was experiencing funding problems. In order to save the mortgage company, management arranged for Hamilton National Bank to buy a large amount of the troubled mortgages. These transactions, which were in clear violation of existing banking laws, subsequently caused the bank to fail. At the time of the failure, Hamilton National Bank was the third largest bank failure in American history.

The Beverly Hills and Hamilton cases understandably have raised some degree of skepticism in the United States regarding the ability to insulate banks from holding company financial problems. Yet, it is important to recognize that both of these cases occurred about 15 years ago, and one involved a relatively insignificant bank. Consequently, while these cases lend some weight against the firewalls concept, they definitely do not constitute conclusive evidence.

There are several other aspects of the American experience with bank holding companies that are worth noting. First, in the two cases where the firewalls were tested, the firewalls cracked for different reasons. In the Beverly Hills case, the spillover effect took the form of a loss of market confidence in the bank. In the Hamilton case, the spillover effect involved massive adverse transactions. So far, there have been no cases where American banks have been "pierced" and forced to honor the debts of holding company affiliates. Moreover, there is almost universal agreement among lawyers, bank regulators and academics that courts in the United States are unlikely to pierce the corporate veil, except in extraordinary cases involving gross commingling of the business affairs of separately incorporated entities.

Second, it is instructive to note how the Federal Reserve, the supervisor of bank holding companies in the United States, reacted to the Beverly Hills and Hamilton failures. Prior to these failures, the Federal Reserve had relied largely on the market to discipline the financial affairs of bank holding companies and their nonbanking affiliates. Shortly after the failures, however, the Federal Reserve changed its policy and began to subject holding companies and their nonbank affiliates to bank-type regulation, including on-site examinations, off-site surveillance and extensive financial reporting (including reports on a wide variety of transactions between holding company units and the bank). Moreover, it appears that the Federal Reserve still does not have great faith in the firewalls concept, because the Federal Reserve has continued to subject bank holding companies to strict bank-type regulation, even though there have been no known spillover problems since the mid 1970s.

Finally, there may be some marginal benefit in reflecting on the following statement relating to the insulation question that was made a few years ago by Walter Wriston, the former Chairman of Citicorp.

> "It is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way."[5]

VII. OTHER PROPOSALS

While the basic bank holding company proposal conceivably could produce important public benefits, these benefits are crucially dependent on the ability to insulate banks from holding company financial problems. As indicated in the last two sections, there are certain reasons, as well as some limited empirical evidence, for doubting that insulation will actually work. Given this skepticism, two other proposals --both variants of the basic proposal -- have been developed. The better known variant is usually referred to as the fail-proof bank (or narrow bank) proposal. The other variant is known as the fail-

[5] Financial Institutions Restructuring and Services Act of 1981, Hearings before the Senate Committee on Banking, Housing and Urban Affairs, 1981, pp. 589-90.

proof parent proposal. Both proposals are designed to make insulation more effective than it would be in the basic bank holding company proposal.

Fail-Proof Bank Proposal

The fail-proof bank proposal is essentially an extreme form of the basic bank holding company proposal previously discussed.[6] The fail-proof bank proposal would force banks to separate their traditional deposit issuing and lending functions. Once the proposal is implemented, banks would be confined to issuing deposits and investing in virtually risk-free assets, such as short-term government securities or perhaps high quality commercial paper. All previous bank activities that involved any meaningful degree of risk would be transferred to holding company affiliates. These affiliates also would do all of the future lending for the banking organization.

Under the proposal, banks would be required to closely match their asset and liability maturities to virtually eliminate interest rate risk. Moreover, banks would be prohibited from engaging in bond trading, foreign exchange trading or conducting various off balance sheet activities. Banks also would be required to have a small amount of capital that would be sufficient to absorb any remaining, unavoidable risks. Any transactions between a fail-proof bank and its holding company affiliates would have to be on market terms, and examiners would closely monitor all intercompany transactions to make sure that the bank was not abused.

Because fail-proof banks would be virtually risk-free, the government could fully insure all bank deposits without exposing the government to any significant

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[6] The fail-proof bank proposal was originally developed by Robert J. Lawrence, and was subsequently elaborated upon by Robert Litan in a Brookings Institution study. See Robert J. Lawrence, "Minimizing Regulation of the Financial Services Industry," Issues in Bank Regulation, (Summer 1985), pp. 22-31; and Robert Litan, What Should Banks Do?, The Brookings Institution, 1987.

losses. From a depositor's perspective, this insurance would constitute a strong second line of defense behind a virtually risk-free bank.

A final feature of the proposal is that holding company affiliates would not be subject to bank-type regulation. Instead, these affiliates would be disciplined solely by the market.

The great virtue of the fail-proof bank proposal is that it would give banks almost perfect insulation against holding company financial problems. First, the proposal would essentially eliminate any possibility that the bank would be pierced. The reason is that the severe restrictions imposed on fail-proof banks would make it virtually impossible for them to commingle their business affairs with those of their affiliates. Second, fail-proof banks would be exposed to only minimal risks of adverse transactions because the banks could not lend to affiliates and could purchase only virtually risk-free assets from affiliates. These two types of transactions are potentially the most dangerous ones that banks can have with affiliates. Third, and most important, fail-proof banks would not be threatened by a loss of market confidence if a holding company affiliate failed. The reason is that depositors would know that the bank was virtually risk-free and that their deposits were fully insured by the government. Moreover, in the extremely unlikely event that depositors ignored these protections, the bank would be in an excellent position to withstand a run. The bank's portfolio would be composed entirely of short-term assets that either would mature within a very short period, or could be sold at very little or no loss. Further, the bank would have access to the lender of last resort and would have a large portfolio of acceptable collateral.

The fail-proof bank proposal would minimize the amount of regulation of the banking system. As stated above, there would be no need to regulate holding company affiliates because banks would be almost perfectly insulated from holding company problems. In addition, the proposal would permit a substantial cutback in the existing regulation of banks. For example, the banking agencies would no longer have to review banks' loan portfolios, a particularly time consuming and expensive affair. Instead, the examination of fail-proof banks would be limited largely to determining whether the banks were in compliance with the special requirements for fail-proof banks, whether any bank transactions with holding company affiliates were on market terms, and whether there had been any misappropriation of bank funds.

The fail-proof bank proposal also would get high marks in promoting competitive equality between banking organizations and their nonbanking rivals. First, by prohibiting banks from lending to affiliates and forcing these affiliates to do their own funding, the proposal would prevent banks from transferring their inherent funding advantage to their affiliates. Second, the proposal would subject holding company affiliates and nonbanking firms to the same degree of regulation. Under the proposal, holding company affiliates would not be subject to bank-type regulation. As a result, in those nonbanking activities that are regulated, these affiliates would be supervised only by the traditional functional regulator, as would their nonbanking rivals. In those nonbanking activities that are not regulated, both holding company affiliates and their nonbanking rivals would be subject only to the discipline of the marketplace.

From the perspective of achieving public benefits from the transfer of risk within a banking organization, the fail-proof bank proposal is clearly superior to the basic bank holding company proposal. The reason is that with the fail-proof bank proposal, public benefits are virtually assured because the effective insulation of banks is basically guaranteed. By contrast, with the basic bank holding company proposal, public benefits are problematic because the effective insulation of banks is in question.

If the fail-proof bank proposal can produce virtually assured, major public benefits, why hasn't it been used? The answer is that its implementation might not be feasible.[7] First, the proposal would require a wrenching change in the structure and operation of the banking and financial system. Under the proposal, banks could continue to hold only a small portion of their existing assets. Consequently, banks either would have to sell most of their assets in the open market or sell them internally to holding company affiliates. Both types of asset sales would produce major problems, particularly since the entire banking system presumably would be selling assets at about the same time. Large asset sales in the open market would drive down market prices, thereby causing banks to incur capital losses. Large asset sales to holding company affiliates would require these affiliates to do a large amount of financing, thereby driving up their cost of funds.

Another problem is that there might not be enough virtually risk-free assets in existence for banks to hold. Indeed, there are probably few, if any, financial systems in the world where the amount of virtually risk-free assets exceeds the amount of bank deposits. In this case, the only way that the proposal could be implemented would be to relax the requirement that banks hold virtually risk-free assets. If this were done, however, the basic character of the proposal changes from a fail-proof bank proposal to a "somewhat less than

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[7] For a detailed discussion of why the fail-proof bank proposal may not be feasible in the United States, see Robert J. Lawrence and Samuel H. Talley, "Implementing a Fail-Proof Banking System," Proceedings of a Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 1988, pp. 344-59.

fail-proof bank" proposal. And with this change, the assurance that banks will be totally insulated and that public benefits will be achieved begins to slip. In sum, the fail-proof bank proposal involves an inevitable trade off between achieving public benefits and the feasibility of implementing the proposal.

Fail-Proof Parent Proposal

The fail-proof parent proposal is another variant of the basic bank holding company proposal, although a considerably less extreme one than the fail-proof bank proposal.[8] Like the basic proposal, the fail-proof parent proposal would require banking organizations to transfer relatively risky activities (but not all activities involving risk) from the bank to the holding company. However, unlike the basic proposal, which would allow these riskier activities to be conducted either in the parent company or nonbank subsidiaries of the parent, the fail-proof parent proposal would require these activities to be conducted only in nonbank affiliates. The reason is to assure that the parent company would not fail as the result of sustaining large operating losses. Another major feature of the proposal is to prohibit the parent company from issuing debt. This provision would assure that the parent would not fail because it could not service its debt obligations.

The proposal also would prohibit banks from engaging in most types of transactions with holding company affiliates, such as lending or the purchase of assets. Only transactions that are essential, such as paying dividends and

[8] The fail-proof parent proposal was originally developed by staff of the Federal Reserve Board in the mid 1970s. The proposal was presented for consideration by the Board in 1975, but was not implemented. For a discussion of the proposal, see Robert J. Lawrence and Samuel H. Talley, "An Alternative Approach to Regulating Bank Holding Companies," Proceedings of a Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, 1978, pp. 1-10. For a more recent discussion, see Robert J. Lawrence, "Holding Companies and Deregulation," Proceedings of a Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, 1983, pp. 39-52.

making tax payments to the parent, would be permitted, and these would be subject to close oversight by bank supervisors to prevent any abuse of the bank.

It should be noted that under the fail-proof parent proposal, nonbank affiliates probably would do most of their own funding. However, the parent company could issue stock and use dividend income to fund these affiliates. Also, the holding company could set up a financing subsidiary that could raise funds for the nonbank affiliates. This procedure could centralize funding for the entire nonbanking part of the holding company organization, thereby exploiting any economies of scale that might be involved.

Under the fail-proof parent proposal, nonbank affiliates would not be regulated and supervised by banking authorities. Instead, these affiliates would be subject only to the discipline of the marketplace.

The crucial assumptions underlying the fail-proof parent proposal are: (i) it makes a difference where risky activities are conducted in the holding company structure; and (ii) it is better for these activities to be conducted in nonbank subsidiaries of the parent than in the parent company itself. The reason is that the failure of a nonbank affiliate is likely to have a significantly less adverse effect on market psychology, and would be less likely to cause a loss of public confidence in the bank, than would the failure of the parent. In a holding company organization, the parent is a particularly important entity. It is the top tier of the organization and, even more important, it is the entity whose stock is held by the public. Given these factors, it is hard to imagine that the failure of the parent would not inflict severe reputation damage on the bank. By contrast, a nonbank affiliate is only a branch in the holding company structure, and its stock is not held by the public. Consequently, the failure of a nonbank affiliate probably would not inflict as much reputation damage on the bank. Moreover, if the parent company is debt free, the failure of a nonbank affiliate would not cause the failure of the parent, and the continued existence of the highly visible parent should help to sustain public confidence in the bank.

In addition to giving banks greater insulation, the fail-proof parent proposal has several other desirable features. First, by not subjecting holding company affiliates to regulation by the banking authorities, it would not spread bank-type regulation throughout the financial sector or result in regulatory duplication. Second, the proposal would promote competitive equality between banking and nonbanking rivals: (i) by subjecting them to similar regulation; and (ii) by removing the inherent funding advantage of banking organizations by prohibiting banks from lending to their nonbank affiliates.

VIII. CONCLUSION

This paper has dealt with the question whether it would be desirable to conduct universal banking activities (or at least those that are relatively risky) in bank holding companies, rather than directly in banks. Stated differently, from a public policy perspective, does it make any sense to encourage or force the transfer of risk among units of a banking organization? The major conclusions of the study are as follows:

1. The use of the bank holding company device for conducting universal banking activities holds out the promise of important public benefits. These benefits include: (i) a sounder commercial banking system; (ii) a reduction in banking regulation; and (iii) greater competitive equality between banking and nonbanking units. However, these benefits are critically dependent on the ability to insulate banks from future problems that might arise in holding

company affiliates. There are three basic ways that holding company problems could be transmitted to banks: (i) through piercing the corporate veil; (ii) through adverse transactions; and (iii) through a loss of market confidence in the bank. The first two spillover effects would inflict losses on the bank and erode the bank's capital. The third would result in the bank experiencing liquidity problems that might force the bank to sell assets at a loss.

2. At present, there is no conclusive empirical evidence on whether banks can be effectively insulated from holding company financial problems. Bank holding companies have been used extensively as a device for conducting universal banking activities in only one country, the United States, and the evidence from that country is very limited. In those two cases where holding company affiliates experienced major financial trouble, the problems did spill over onto the bank and caused the bank to fail.

3. Public policymakers can do much to prevent banks from being pierced by requiring banks not to commingle their business affairs with holding company affiliates. Likewise, policymakers can minimize the likelihood of banks being forced into adverse transactions by: prohibiting all bank transactions with affiliates except those that are essential (such as paying dividends and taxes to the parent company); having bank supervisors closely monitor these essential transactions to assure that the bank is not abused; and imposing stiff penalties for violating rules governing bank transactions with affiliates.

4. It is much harder to prevent a loss of market confidence in a bank if holding company affiliates get into trouble. In this event, depositors are likely to commence a run on the bank because they typically do not have detailed information on the condition of the bank, and they are aware that essentially the same people usually manage both the holding company and the bank. Consequently,

depositors are likely to play it safe and assume that if the holding company is in trouble, the bank may be in trouble too.

5. One way to virtually eliminate the possibility that holding company problems would lead to bank runs is to require banks to be fail-proof. However, the process of converting banks into fail-proof institutions would probably result in unacceptable shocks to the financial system. A less extreme proposal that would reduce, but not eliminate, the prospect of bank runs would require: (i) universal banking activities to be conducted in nonbank subsidiaries of the parent company, rather than directly in the parent; and (ii) the parent company to be debt-free (or at least lowly leveraged). With these requirements, bank runs would be less likely because the highly visible parent company would survive.

6. While a major objective of having universal banking activities conducted in holding companies is to preserve banking stability, it is possible that it could have the opposite effect. The major risk is that policymakers will assume that the firewalls protecting banks are impregnable and allow holding companies to engage in highly risky activities that policymakers would never consider permitting banks to conduct. If holding company affiliates subsequently encountered serious problems and it turns out that the firewalls have cracks, banks could be seriously harmed. It also should be recognized that having universal banking activities in holding companies could concentrate specific types of risks in a number of individual holding company affiliates, rather than having a wide diversification of risks in one unit, the bank.

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