

# Banking and Commerce: Tear Down This Wall?

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Many U.S. firms include both commercial and nonbank financial units. For example, General Motors Corporation encompasses not only units that manufacture automobiles but also those, such as General Motors Acceptance Corporation, that gather funding and make loans to individuals and businesses. Firms that handle both commercial and financial activities appear to reap significant benefits that create the appeal of such combinations. One byproduct of a commercial firm's activities may be information about its customers' financial situation. The financial affiliate might then use this information to inexpensively target products to particular customers, benefiting both the financial firm and its customers.

While finance/commerce combinations are widespread, combinations between *banks* and commercial firms are typically prohibited under various U.S. laws. Banks are distinguished from other financial firms by their ability to gather funding by issuing government-insured deposits such as checking and savings deposits. Despite prohibitions of banking/commerce combinations, firms have managed to find loopholes. Until recently the unitary thrift loophole was a popular means of circumventing the banking/commerce wall. The loophole allowed commercial companies to start or buy one, and only one, thrift (i.e., a savings bank or savings and loan association, both of which issue government-insured deposits), using the thrift as a conduit for providing financial services.

The unitary thrift loophole was closed in 1999, but another loophole remains open. Federal banking law allows commercial firms to own industrial loan corporations—essentially banks with somewhat restricted deposit-taking powers. (For additional discussion of the unitary thrift and industrial loan corporation loopholes, see the Appendix.)

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Given the apparent benefits of combinations, why prohibit or restrict them? What hazards result from banking/commerce combinations? Traditionally, discussions of the threats focused on conflicts of interest and diminished competition. More recently, observers have been concerned that combinations might increase deposit insurance claims and expand the universe of economic activities protected by the government safety net. As will be discussed presently, the traditional concerns seem less relevant given the level of competition banks face in today's banking market. Over the last twenty-five years, competition has expanded as restrictions were eliminated on banks' ability to operate across state lines and to offer market rates on deposits. Also, new nonbank firms have arisen offering financial products competitive with most banking products. The concerns over increased deposit insurance claims and expansion of the safety net remain quite relevant. Nevertheless, over the last decade a number of legislators have argued for removal of the banking/commerce wall. I will analyze the threats and suggest some restrictions that would be necessary if the wall were removed.

## **1. THE STATUTES FORMING THE WALL**

The building blocks of the wall between banking and commerce are various federal and state laws. The laws prevent banks from engaging in commercial activities. They also prevent banks from owning subsidiary commercial companies and from being owned by companies conducting commercial activities. Specifically, the building blocks are the National Bank Act of 1864, state banking laws, the Federal Deposit Insurance Corporation Improvement Act of 1991, and the Bank Holding Company Act of 1956. (For a detailed review of these statutes and their motivations see the Appendix.)

The National Bank Act limits the powers of national banks and their subsidiaries. National banks are those chartered and regulated by the U.S. Treasury Department's Office of the Comptroller of the Currency. The Act states that "a national banking association shall . . . have power to . . . exercise . . . all such incidental powers as shall be necessary to carry on the business of banking" (12 U.S.C. 24). While over the years the courts and the Comptroller have wrangled over the meaning of the phrase "business of banking," national banks have been allowed to engage in businesses similar to traditional banking services but not other commercial activities. This restriction of powers extends not only to activities of banks, but to activities conducted by subsidiaries owned by banks.

State banking statutes typically set limits on the nonbank activities of state banks and their subsidiaries, similar to the limits on national banks. Yet, over the years, a number of states have authorized activities well beyond those allowed national banks, some of which typically would be considered commercial powers. Concerns that these new powers might endanger state-chartered

banks, and thereby the taxpayer-backed deposit insurance fund, led Congress to restrict state legislatures' ability to grant powers to state-chartered banks. Specifically, under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), insured state-chartered banks are prohibited from engaging in any activities impermissible for national banks unless the FDIC rules that such activities pose no threat to the deposit insurance fund.

Those who advocate removing the banking/commerce wall typically do not argue for allowing banks to conduct commercial activities or own commercial firms. Instead, they focus on allowing companies that own banks—that is, bank holding companies—to own commercial companies, too. In other words, they do not condone direct bank involvement in commerce but find it acceptable for bank holding companies to own commercial companies, allowing banks to affiliate with commercial companies.

The banking/commerce restrictions in the Bank Holding Company Act of 1956 were based on the view that “bank holding companies ought to confine their activities to the management and control of banks.” The Act restricted bank holding companies such that they “would no longer be authorized to manage or control nonbanking assets unrelated to the banking business” (*U.S. Code: Congressional and Administrative News* [1956, 2482, 2484]).

To enforce this restriction, the Act defines a bank holding company as any company that owns a bank.<sup>1</sup> It prohibits bank holding companies from engaging in nonbanking activities. The Act allows an exception to the nonbanking prohibition in cases in which the Board of Governors of the Federal Reserve System determines the nonbanking activity “to be so closely related to banking as to be a proper incident thereto” (12 U.S.C. 1843c). Typically the Board defines activities closely related to banking as only those activities traditionally performed by banks. Certain additional activities also have been allowed, however, in cases in which they are tied to banking. For example, the Board has determined that a bank holding company may own a data-processing firm if it is primarily engaged in processing financial, banking, or economic data (Spong [2000, 156]).

The Gramm-Leach-Bliley Act, enacted in 1999, added securities underwriting and dealing, as well as insurance, to the list of activities in which banks—through bank-owned subsidiaries—and bank holding companies could engage. Those bank holding companies choosing to engage in securities or insurance activities are called *financial holding companies*. The Act also expanded the activities of bank-owning companies to include most financial activities, those determined by the Board and the Treasury Department to be “financial in nature,” “incidental to a financial activity,” or “complementary to

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<sup>1</sup> The Bank Holding Company Act of 1956 applied only to companies owning two or more banks. Amendments enacted in 1970 extended the Act's provisions to single-bank holding companies.

a financial activity.” Nonetheless, while authorizing a wide range of financial activities, the Act leaves in place the wall between banking and commerce.

Deciding whether an activity is commercial instead of banking or financial and whether it can be conducted by a banking company is often not simple. The decision was difficult under the old Bank Holding Company Act standard of being *closely related* and remains so under the new standard of being *financial in nature, incidental to a financial activity, or complementary to a financial activity*. The placement of an activity on one side or the other of the banking/commerce wall can be controversial and contentious. For example, in December 2000 the Board of Governors of the Federal Reserve System and the Secretary of the Treasury jointly released for comments a proposal to permit bank subsidiaries and financial holding companies to engage in real estate brokerage and management. Real estate industry trade groups quickly objected to the proposal, arguing that it would amount to an illegal mixture of banking and commerce. Banking trade groups argued in favor of the proposal. Beyond the real estate industry’s objections, legislators introduced bills in both the U.S. House of Representatives and the Senate to prohibit these real estate activities in financial holding companies. In April 2002 the Secretary of the Treasury announced plans to put off a decision on the proposal until 2003.

## 2. RATIONALES FOR THE WALL

Three reasons are typically cited for maintaining a wall that prohibits banking/commerce combinations: conflicts of interest, monopoly power, and risk to the taxpayer-backed deposit insurance fund.<sup>2</sup> These three justifications will be examined below. As it turns out, because banking markets appear fairly competitive, the first two seem of relatively minor import. The third remains quite significant.

### Conflicts of Interest

Observers have at times raised concerns over conflicts of interest that might arise if banks and commercial firms are owned by the same firm. They argue that such concerns justify keeping banking and commerce separate. Three conflicts have been described. First, a bank affiliated with a commercial firm would tend to deny loans to the affiliate’s competitors. Second, a bank might use access to insured deposits to provide below-market-rate funding to its affiliates while charging higher interest rates to unaffiliated borrowers. Third, in the legislative history of the Bank Holding Company Act, legislators noted

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<sup>2</sup> For discussions of these three reasons for maintaining the wall, see Krainer (2000, 21–23); Halpert (1988, 490–517); and U.S. GAO (1987, 11–12).

that a bank with a commercial affiliate might deny loans to individuals who do not purchase goods from the affiliate.

It seems natural that removing the banking/commerce wall would allow the first conflict to arise, since a bank with a commercial affiliate, say a restaurant, would not wish to provide funding to competing restaurants. Helping the competitor would tend to lower the profits of the affiliated restaurant. Yet, if competition is reasonably strong, denying loans to competitors only lowers overall profits of the consolidated banking/restaurant firm. If there are alternative lenders over which the affiliated bank has no price advantage, the competing restaurant would get a loan anyway and at the same interest rate the affiliated bank would offer. So, by failing to make the loan, the bank loses any profit it might have made on that loan, hurting the bank. Yet the affiliated restaurant suffers a loss in profits regardless.<sup>3</sup> Therefore, if competition is strong, this potential conflict of interest is unlikely to present a problem and cannot justify maintaining the banking/commerce wall.

But is banking competition strong? Since the 1970s, restrictions on bank-versus-bank competition have been greatly reduced. Restrictions on banks' ability to compete for deposits outside of their local markets, or at least outside of their home states, were severe before the late 1970s. While these restrictions did not apply to bank lending, banks generate a good bit of their lending in the same markets in which they gather loans. Consequently, these restrictions likely limited loan competition as well. Banks' ability to open branches statewide was greatly enhanced in the 1980s as many states removed branching restrictions. Restrictions on operating across state lines began to fall in the mid-1980s and were almost completely removed by the Riegle-Neal Interstate Banking Act of 1994. As a result, banks that had been protected from competition because of branching restrictions became subject to competitive pressure from nonlocal banks by the mid-1980s.

While the elimination of branching restrictions opened local banking markets to greater competition, other market and technological developments have expanded competition further. Consequently, if a bank denies a loan to a business firm because it competes with the bank's affiliate, that firm can find numerous alternative sources of funding in today's more competitive loan markets.

Competition among those who would lend to business borrowers has expanded along several dimensions. For large business borrowers, banks faced growing competition from the debt markets as commercial paper and bond issues increased significantly relative to bank lending over the last twenty-five years. While small businesses cannot issue commercial paper or bonds, today's small businesses have access to loans from a wide range of lenders.

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<sup>3</sup> Owens (1994) makes this argument for bank lending in real estate.

The largest banks aggressively court small business borrowers throughout the country via their Web sites and toll-free phone lines. Further, small businesses enjoy a range of choices of nonbank lenders, including finance companies and leasing companies. Clearly, today's borrowers, both large and small, have a plethora of borrowing opportunities because of the competitive loan market.

If, in spite of these factors, some banking markets remain uncompetitive, policymakers can address the problem directly by removing any remaining barriers to entry. Alternatively, they might tackle monopoly power through antitrust enforcement. Maintaining a wall that separates banking and commerce at best addresses a symptom of an uncompetitive market rather than the lack of competition itself.

Still, using the restaurant example, one might argue that the bank with an affiliated restaurant may for some reason have a cost advantage over its bank competitors that lack such an affiliation. One reason for a cost advantage is that the bank acquires information about the restaurant business through its affiliation. While prohibiting affiliations might eliminate the advantage this bank (and its affiliates) has over competitors, the restriction would diminish economic efficiency because the least costly and most efficient means of producing banking services—through restaurant affiliation—would be denied.

Additionally, if bank/restaurant affiliations are allowed, banks that lack a restaurant affiliate can simply overcome the cost disadvantage by affiliating. This is just what the banking industry did when banks established branches in grocery and discount stores, though they did it through leasing agreements rather than affiliation. After perceiving the advantage gained by the innovative bank that first placed branches in such stores, other banks followed suit to achieve the same advantage. Soon the advantage was dissipated by competition.

Aside from the situation whereby a bank might deny loans to its affiliate's competitors, some observers note a second conflict of interest. They argue that banks may have access to inexpensive funding because of underpriced deposit insurance, and that this funding might be granted to banks' affiliates but not to other borrowers. Such funding would give affiliates an advantage over firms not so affiliated.<sup>4</sup> As long as the banking market is competitive, however, every firm that borrows from a bank gets equivalent access to low-cost funding whether affiliated with a bank or not. Access is equivalent because a bank only hurts itself (i.e., lowers its revenues) by not lending to its affiliate's competitors on equivalent terms to those offered its affiliate. If the bank with an affiliate does not lend to its affiliate's competitors, other banks would take those customers and profit from doing so. Further, Section 23A of the Federal Reserve Act, applicable to all banks, restricts the amount of such affiliate

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<sup>4</sup> For discussions of the argument that access to bank funding could give bank affiliates an advantage, see Board of Governors (1987, 500) and Macey and Miller (1992, 377).

funding to at most 10 percent of the bank's capital. Section 23B of the Act requires such funding be on market terms.

In the legislative history of the Bank Holding Company Act, members of Congress describe a third possible conflict of interest. Specifically, they argue that a bank with a commercial affiliate might deny loans to individuals who do not purchase goods from the affiliate. The Senate Banking Committee's report that analyzes the features of the bill that later became the Bank Holding Company Act describes the concern as follows:

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. (*U.S. Code: Congressional and Administrative News* [1956, 2486], as cited in Halpert [1988, 500])

*Tying* a loan (or other service) to the purchase of another product can only benefit a bank if the bank has monopoly power in its loan market. If it faces competition, denying loans to individuals who are not its affiliate's customers only hurts the bank, and so would not be undertaken. The bank is hurt because it forfeits revenues and helps its bank competitors who would make the loans (Owens [1994]). As noted earlier, when the Bank Holding Company Act was passed in 1956, banking markets were heavily regulated. Entry was restricted and prices were controlled. Monopoly power may have been significant, but most such restrictions have been removed. Additionally, even if banks maintain monopoly power in credit markets, the commercial affiliate must also have market power in order for tying to make consumers worse off. In the case in which the combined firm has market power in the banking and commercial markets, only under limited circumstances are consumers actually made worse off. In other cases consumers are unhurt by tying (Weinberg [1996]). Regardless, current statutes make tying by banking companies illegal.<sup>5</sup>

### **Proliferation of Monopoly**

Some observers argue that, in addition to conflicts of interest, preventing the exercise of monopoly power is another reason for the banking/commerce separation. The legislative history of the Bank Holding Company Act makes it clear that Congress intended the Act to guard against the proliferation of

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<sup>5</sup> See Weinberg (1996) for a review of bank anti-tying statutes and the economics of tying. See Krainer (2000, 22) for a discussion of banks denying credit to their commercial affiliates' competitors. In 1997 the U.S. General Accounting Office analyzed banks for evidence of tying bank loans to securities activities. It found little evidence of any such tying (U.S. GAO [1997]).

monopoly. For example, the Senate Banking Committee report on the conference bill notes that the Act was to provide “safeguards... against undue concentration of control of banking activities. The dangers accompanying monopoly in this field are particularly undesirable in view of the significant part played by banking in our present national economy” (*U.S. Code: Congressional and Administrative News* [1956, 2482–83]). Because such language is vague, it is difficult to determine whether the *undue concentration* discussed refers to horizontal or conglomerate concentration. As a result, it is uncertain whether proliferation of monopoly was behind the Bank Holding Company Act’s banking/commerce restrictions. *Horizontal concentration* means combining a number of banks under one bank holding company such that this holding company controls a high percentage of banks. *Conglomerate concentration* means combining both banks and nonbanks under one holding company so that one conglomerate controls a significant percentage of business firms in banking and a nonbanking industry, or in several nonbanking industries.

Observers since have argued that Congress was indeed concerned with conglomerate concentration. A case in point was a 1974 Federal Reserve’s denial, under the Bank Holding Company Act, of an application by BankAmerica Corporation to form an overseas joint venture with Allstate Insurance. Here the Fed said that “close working relationships abroad between large U.S. banking organizations and large U.S. insurance companies could in time weave a matrix of relationships... that could lead to an *undue concentration* of economic resources in the domestic and foreign commerce of the United States... not... consistent with the purposes of the Bank Holding Company Act.”<sup>6</sup>

Frequently, when advocating the separation of banks from nonbanks on the basis of monopoly, proponents have argued that the combination would allow the monopoly power that banks hold in their product markets to be used by combined firms to raise prices in other areas.<sup>7</sup> But as discussed earlier, while in 1956 concerns about monopoly may have motivated Congress, during the 1970s and 1980s competition expanded greatly, among banks and between banks and nonbanks. Expanded competition significantly reduced any opportunity banks might have had to exercise monopoly power in banking services and to expand it to other businesses with which they might combine. Congress seems to have been cognizant of these changes. When Congress passed the Gramm-Leach-Bliley Act in 1999, it allowed combinations of large banks with large insurance and large securities firms. These were exactly the types

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<sup>6</sup> Board of Governors (1974, 519) (italics added for emphasis). For a similar argument on another application, see Board of Governors (1981, 451), as cited in Halpert (1988).

<sup>7</sup> Halpert (1988, 500–505) discusses the argument that banking monopoly might proliferate into nonbank businesses.



of combinations—that is, large banks with large nonbanks—denied earlier by regulators based on undue concentration language in the Bank Holding Company Act.

### **Safety Net Concerns**

For the reasons discussed above, conflicts of interest and fears of expanding monopoly power alone are probably insufficient reasons to maintain the current wall separating banking and commerce and deny firms the opportunity to benefit from combinations. Nevertheless, there is another set of hazards that could justify the continued presence of the wall separating banking and commerce or at least require that significant precautions be taken if the wall is removed. The hazards come in three forms, discussed in the following paragraphs, and each involves an increased chance of bank failures and a subsequent bailout financed by taxpayers. If bailouts occur, the government safety net, meant to protect bank depositors, could be extended to creditors of commercial companies. If extended, too many resources might flow to bank-affiliated commercial companies, and economic efficiency would be diminished. The threat to the safety net could arise because (1) losses might be shifted to banks to protect a combined firm's reputation with investors, (2) losses might be shifted to banks to take advantage of shareholder limited liability, and (3) the combined firm's riskiest assets might be shifted to the bank. Of the three hazards, the first two could justify continued banking/commerce separation. The third cannot justify separation but is discussed below because it is often mentioned as a hazard of bank/nonbank affiliations.

#### ***Loss Shifts that Protect Reputation***

If banking/commerce combinations are allowed, a combined company can be expected under certain circumstances to withdraw resources from its bank to hide problems in its commercial subsidiary, damaging bank safety. The holding company is likely to choose this course when it can hide commercial subsidiary losses from investors and analysts by shifting commercial subsidiary losses to the bank. The holding company would benefit by hiding the loss, which if revealed would likely be perceived as negative information about the ability of the firm's management and the riskiness of its operations; that is, it would damage the firm's reputation. Such negative information would lead creditors to demand higher interest rates, lowering future profits. Yet, as discussed presently, while shifts to hide losses can be detrimental to banks, they can just as easily be beneficial: holding companies could choose to shift bank losses to commercial subsidiaries. Consequently, a concern that bank holding companies might engage in loss shifts is no reason to prohibit banking/commerce combinations. Instead, if one is to argue that the danger

of shifts can justify the banking/commerce wall, one must believe that loss shifts are more likely to flow toward bank than commercial subsidiaries.

Reputation-protecting shifts that can work to the detriment of bank health are likely to occur when two conditions are met. First, the commercial subsidiary suffers a loss large enough to create its insolvency. Second, the loss, if shifted to the bank subsidiary, would avert the bank's insolvency. The second condition would generally be met if the bank's net worth is considerably larger than that of the commercial subsidiary (before and after the shift). Under these conditions, a shift of a commercial subsidiary's loss to the bank would protect the holding company's reputation. An insolvency is certain to draw negative outsider attention, since it will likely involve either debt renegotiation or bankruptcy. In contrast, a mere loss or perhaps just an increase in the bank's reported expenses can be expected to draw far less attention. Even so, a loss shift necessarily weakens the bank.

Even if the commercial subsidiary experiences a loss that does not lead to its insolvency but is still significant, such a loss could still shift to a larger bank subsidiary. The bank holding company might choose to shift the loss because it might be less noticeable on the books of a large firm than on those of a smaller one. In addition, observers have traditionally argued that banks may have more opaque balance sheets than do commercial firms, so that losses can be better hidden in a bank subsidiary. Some recent research appears to support this view of bank opacity.<sup>8</sup> If banks are indeed more opaque, then losses are more likely to go unnoticed if shifted to the bank.

Nevertheless, the existence of this incentive to shift losses in order to hide them does not imply that commercial and banking firms should be kept separate. Under one set of circumstances already discussed—when the bank's net worth (meaning its capital) is larger than the commercial subsidiary's—a bank holding company can hide the loss by shifting it to the bank. However, under an equally likely set of circumstances—when the commercial subsidiary's capital exceeds the bank's capital—there is no benefit from shifting commercial subsidiary losses to the bank. Instead, if the bank produces losses, the bank holding company can benefit by shifting bank losses into the commercial firm. Therefore, prohibiting banking/commercial affiliations will not necessarily improve bank safety or protect taxpayers and the FDIC from losses.

Further, creditors of banks as well as commercial firms affiliated with banks are likely to be well aware of the incentive to shift losses in order to

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<sup>8</sup> Morgan (2000) finds that banks and insurance companies are inherently more opaque than other firms. Morgan checks for opaqueness of banks and insurance firms versus nonfinancial firms by measuring the frequency of disagreements between the two major ratings agencies in their ratings of banks, insurance companies, and other firms. He finds that the two agencies disagree more frequently over banks (and over insurance companies) than over commercial firms. Morgan contends that the cause of the disagreement is the difficulty of evaluating opaque bank balance sheets.

hide them. By charging higher interest rates, both types of creditors will penalize affiliations that might shift losses to the detriment of their debtor (either commercial firm or bank). For example, a bank's creditors would be likely to view a combination with a risky commercial firm—that is, one that might produce shiftable losses—as dangerous. They would demand the bank pay an increased interest rate if such an affiliation were undertaken. Moreover, if the affiliated commercial firm's riskiness increased, the bank's creditors would impose an additional risk premium to account for the increased risk of a loss shift. If the risk became large, the increased premium might be sufficient to cause the holding company to divest either the commercial firm or the bank. The affiliated commercial firm's creditors would do the same.

Yet there is reason to think that shifts would tend more frequently to deplete bank resources rather than commercial firm resources. While creditors of commercial subsidiaries of bank holding companies would demand higher risk premia for affiliations likely to produce losses that can be shifted to the commercial affiliate, bank creditors have a reduced incentive to do so. Many of a bank's creditors—those holding insured deposits in the bank—would demand no additional compensation when the bank affiliates with a risky commercial firm. If losses are shifted to the bank, weakening it, its government-insured deposits are no less likely to be repaid. Therefore, while the creditors of commercial affiliates penalize risky combinations, those of banks do not. Consequently, combinations that could lead to loss shifts toward banks are likely to be more common than combinations that could produce loss shifts toward commercial firms.

Note that if bank deposit insurance premia were closely tied to individual bank riskiness and accounted for the risk of loss shifts, higher premia would discourage affiliations that could be risky to banks. As discussed in more detail below, observers typically argue that deposit insurance premia are not closely tied to bank risk.

### *Loss Shifts that Take Advantage of Limited Liability*

While the previous section discusses a set of incentives that could lead a bank holding company to shift losses from a less capitalized subsidiary to a more capitalized one, another set of incentives can produce the opposite result. Under certain circumstances, by shifting losses from a more capitalized subsidiary to a less capitalized one, the bank holding company can reduce losses. The strategy, discussed below, is beneficial because of the protections offered shareholders by the principle of limited liability. In some cases it could work to the detriment of the FDIC, and ultimately, to the detriment of taxpayers. As in the case of reputation-protecting shifts, shifts that take advantage of limited liability seem at first to be just as likely to enhance bank safety as diminish it, suggesting that this argument cannot be used as a justification for maintaining the separation between banking and commerce.

On further analysis, however, it is clear that limited liability shifts would more likely work to the detriment of banks and therefore to the detriment of the FDIC and taxpayers. Therefore, maintaining the banking/commerce wall might be justified as a means of preventing these shifts.

The following example shows that with limited liability, a bank holding company can avoid losses if it shifts them. Suppose a holding company—Alpha Conglomerate Inc.—owns two subsidiaries, Bravo Dry Cleaners and Echo National Bank. Bravo has a net worth of \$100 million, while Echo's net worth is \$5 million. Alpha's only assets are its investments in the stock of Bravo and Echo, and it is the sole owner of both. Consequently, Alpha's net worth is \$105 million, the sum of Bravo's and Echo's net worth. If Bravo suffers a \$10 million loss (say it has bankrupt commercial customers to which it has made \$10 million in loans), Bravo's net worth falls to \$90 million. Also as a consequence of Bravo's loss, Alpha's stockholders suffer a \$10 million loss since Alpha's net worth falls to \$95 million (the sum of Bravo's \$90 million net worth and Echo's \$5 million).

Suppose instead that Alpha could arrange to have Echo take the loss. Echo could take the loss by purchasing the loans made to Bravo's bankrupt commercial customers for \$10 million, even though the loans are worthless.<sup>9</sup> The shift of the \$10 million loss to Echo, which had only \$5 million in net worth before the shift, drives it into insolvency. Bravo has a net worth of \$100 million after the shift, and Echo has a net worth of negative \$5 million. Based on the principle of limited liability of shareholders, however, Alpha can suffer a loss of no more than its investment in Echo, or \$5 million. The shift has saved Alpha's shareholders \$5 million. In this case the FDIC, which insures Echo, suffers the remaining \$5 million loss. In summary, a holding company can benefit by shifting a loss when that loss is smaller than the loss-producing subsidiary's capital, but greater than the other subsidiary's capital.

Alpha's incentive to protect its reputation, as discussed in the previous section, will tend to work to prevent it from employing a shift that will produce an insolvency. Echo's insolvency is certain to damage Alpha's reputation and raise its future borrowing costs. Further, such shifts could be illegal. Nevertheless, when the benefit from shifting losses is large, the shift might be undertaken regardless of reputation or legality.

While this incentive to shift losses could endanger bank health, and in fact such a shift led to a bank failure in 1953, holding companies owning bank and commercial affiliates initially seem no more likely to shift losses

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<sup>9</sup>As will be discussed presently, federal law restricts a bank's ability to purchase loans made by its affiliates to a small percentage of the bank's net worth. Purchases of sufficient affiliate loans that lead to the bank's insolvency would be illegal under the restrictions. Nevertheless, in some cases, such purchases have occurred.

into banks than away from them.<sup>10</sup> In other words, combinations of banking and commerce are just as likely to enhance bank safety as reduce it. However, there is a greater chance that shifts will work against banks; for while banks' major creditors—insured depositors—are largely indifferent about the risks that affiliations with nonbanks might impose, commercial affiliates' creditors are very interested. Creditors of commercial affiliates will penalize, with demands of higher interest rates, affiliations that increase the likelihood of an affiliate failure.

Since commercial firm losses tend to be shifted toward banks, undermining bank health, banking/commerce affiliations increase the likelihood of FDIC payouts and ultimately of taxpayer bailouts of the FDIC. Consequently, a limited liability motive for loss shifts could provide a reason to favor prohibiting banking/commerce combinations.

Beyond the cost to the FDIC and perhaps to taxpayers, who provide the backstop for FDIC insurance, there is an additional cost of loss shifts (motivated by limited liability as well as reputation protection). If creditors of bank-affiliated commercial firms believe that these firms' losses can be shifted to banks and ultimately to the FDIC, then creditors will charge bank-affiliated commercial firms lower interest rates than they would absent the perceived ability to shift. As a result of this reduced cost of capital, affiliated firms would regard projects as viable that without this taxpayer-provided subsidy would be unprofitable. In sum, too much investment capital would flow to affiliated firms, and the economy's resources would be wasted.<sup>11</sup> This potential for resource waste may provide further reason to prohibit banking/commerce combinations, or at least to regulate combined firms to discourage shifts.

### ***Risk Shifts***

At first blush there appears to be one additional reason to maintain the separation between banking and commerce: combinations would allow *risky assets* to be shifted from the commercial firm to the bank. Doing so increases the bank's riskiness, putting taxpayer funds at risk. This possibility has caused some observers to raise concerns about affiliations between banks and nonbanks. As a justification for maintaining the banking/commerce separation, however, the argument is unconvincing.

To lower its total funding costs, a bank holding company with a commercial subsidiary can shift the commercial firm's riskiest assets to the bank. The commercial firm must borrow using uninsured debt, while the bank can gather

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<sup>10</sup> See Walter (1996, 22) for a discussion of the case in 1953 in which a bank failure resulted from shifts from a bank holding company's nonbank subsidiary to its bank subsidiary, apparently motivated by an attempt to take advantage of limited liability.

<sup>11</sup> See Walter and Weinberg (2002, 373–75) for a more complete discussion of the economic costs of government subsidization of private firms' borrowing costs.

funds by issuing insured deposits. As a result, funding costs are lowered and holding company profits are increased when the commercial firm's riskiest assets are shifted to the bank. (Note that risk shifts differ from loss shifts, discussed earlier. Loss shifts occur when the bank purchases the assets from the commercial firm at a price that produces a loss for the bank. Risk shifts occur when the bank pays a price that produces no loss for the bank, since it is insensitive to risk.) For banks' costs to be less sensitive, deposit insurance premia and other supervisor-imposed costs must be imperfectly sensitive to bank riskiness. Observers argue that this could be the case for many banks.<sup>12</sup>

*Risk shifts*, however, do not justify the banking/commerce wall because affiliation creates no more incentive to shift risks than would exist without affiliation. If the penalty for holding risky assets is lower for banks than for commercial firms (or, for that matter, for any uninsured firm), then risky assets would flow into banks even if they have no affiliates. Banks would be willing to pay more for risky assets than would other firms and would bid them away from others.

For example, imagine that a commercial firm, Juliet Tool and Die, Inc., is currently paying its creditors 15 percent in annual interest payments to raise \$100,000. It uses this \$100,000 to make trade credit (i.e., a loan from a seller to its customer used by the customer to purchase the seller's goods) available to its customer, Kilo Millwork. Juliet's creditors charge this high rate because they view Kilo as risky, such that Juliet's loan to Kilo heightens the chance that Juliet will itself fail; in other words, the trade credit is a risky asset. Alternatively, Lima National Bank, which pays depositors only 10 percent, can raise the \$100,000 from depositors with which it can provide funds to Kilo. Because of FDIC insurance, its depositors care little about the riskiness of Lima's assets. In such a case, Lima National can be expected to approach Juliet and offer to buy its asset, the trade credit to Kilo. Lima would be willing to pay more than the asset is worth to Juliet since Lima can fund the asset less expensively than can Juliet.<sup>13</sup>

A holding company with a bank subsidiary and a commercial subsidiary may well benefit from having its commercial firm sell its risky assets to the bank subsidiary because of underpriced deposit insurance. But a commercial firm with no affiliated bank would find that banks would want to buy their risky assets just as well. So, if deposit insurance is underpriced, whereby it is less expensive for banks than for commercial firms to hold risky assets, preventing affiliation would not prevent risky assets from being shifted to banks.

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<sup>12</sup> See Walter (1998, 2–9) for a discussion of the means by which banks can receive risk-insensitive funding.

<sup>13</sup> Lima would only be willing to pay more for the loan than it is worth to Juliet if Lima's deposit insurance premia do not completely account for the risk the loan adds. Still, as already noted, for many banks, insurance premia may not accurately reflect their riskiness.

### 3. PROTECTIONS NEEDED IF THE WALL COMES DOWN

The previous section describes the hazard from corporate combinations between banks and commercial firms, and argues that the pertinent hazards arise from (1) loss shifts to protect bank holding company reputation, that is, shifts meant to hide the loss; and (2) loss shifts that take advantage of limited liability, allowing shareholders to avoid the loss by imposing them instead on creditors or on the FDIC. In either case, economic efficiency can be diminished and the loss can end up with taxpayers. One means of addressing the hazards is to prohibit banking/commerce combinations; in other words, maintain the legislative status quo. Alternatively, legislators may decide that the benefits of combinations are worth bearing some danger of loss shifts. If legislators took this latter view, what types of protections could they employ to reduce the frequency of loss shifts into banks and thereby possibly to the FDIC or taxpayers? Already in place are the firewalls established by Sections 23A and 23B of the Federal Reserve Act. These statutory provisions limit transactions between banks and their affiliates. The firewalls are enforced by regular (once every year or year and a half) supervisory examination and by the threat of penalty if violations are discovered.

Beyond these current protections, which apply to any affiliations, including any commercial affiliations that might be allowed in the future, supervisors might wish to mimic the types of limitations uninsured creditors would impose on risky affiliations. As noted earlier, one can expect uninsured creditors to penalize the firm they fund (their debtor) and thereby potentially prevent an affiliation that would tend to lend itself to loss shifts. If supervisors are to mimic creditors' actions, they will restrict the types of firms that banks can affiliate with to those least likely to produce loss shifts in the first place. In other words, supervisors would only allow banks to affiliate with healthy commercial firms possessing strong capital at the time of affiliation.

While at the time of acquisition a new commercial affiliate may be strong, its health could deteriorate or it could take on undue risks. If uninsured creditors find that their debtor's affiliates are suffering losses or assuming risky endeavors, thereby increasing the chance of losses that might be shifted to their debtor, they would demand higher interest payments to compensate for their added risk. So creditors can be expected to monitor carefully the health of their debtor's affiliates. The Federal Reserve mimics private creditors by performing such monitoring (called *umbrella supervision* by the Fed) of holding companies owning a bank and a securities or insurance company, under provisions specified in the Gramm-Leach-Bliley Act of 1999. Umbrella oversight might well be desirable for combinations of banks with commercial firms, but could be more difficult than umbrella oversight of financial firms, for reasons discussed presently. If monitoring reveals that the bank's commercial affiliate has increased its risk, supervisors could impose a monetary cost on the bank through the current mechanism by which insurance premia are set.

Because umbrella oversight of commercial firms may be more difficult than oversight of financial firms, any legislation that might remove the wall could add additional protections beyond those found in the Gramm-Leach-Bliley Act. For example, such legislation could also limit the size of commercial affiliates to those no larger than a fraction of the size of the bank. Such a limit could be beneficial because as noted in an earlier section, shifts large enough to sink the bank are most likely to derive from commercial affiliates that are large relative to the size of the bank affiliate.

### **Firewalls**

The 23A and 23B firewalls are intended to stop exactly those loss shifts that present hazards for bank/commercial firm affiliations. Yet there have been several cases in which shifts have caused bank failures, regardless of firewalls. Additionally, the firewalls have not been tested in a period of widespread affiliations involving nonbanks large enough to produce dangerous losses. Consequently, while in principle firewalls should prevent loss shifts, supervisors will probably wish to take further protective steps if the banking/commerce wall is removed.

Since 1933, banks have been protected against shifts of losses from affiliates by firewalls. Firewalls are found in Sections 23A and 23B of the Federal Reserve Act and apply to all banks.<sup>14</sup> They limit and place controls on transactions between banks and their affiliates.<sup>15</sup> For example, the 23A firewalls limit transactions, such as loans and asset purchases, between a bank and any individual affiliate to 10 percent of the bank's capital, and with all of its affiliates in total to 20 percent of the bank's capital. The firewalls operate only in one direction—they prevent transactions that might shift affiliate losses to the bank, but do not prevent transactions that might shift bank losses to affiliates. For instance, the firewalls prohibit loans to affiliates beyond 10 percent of bank capital, but not the reverse—loans to the bank by affiliates. They also require that purchases of affiliate assets by the bank be on terms at least as favorable to the bank as market terms. In contrast, the nonbank affiliate can purchase assets from the bank on terms unfavorable to the affiliate. Penalties for firewall violations can be quite severe, extending to significant monetary penalties imposed on banks and their managers and directors.

Bank failures caused by the shifts that firewalls were designed to prevent have been infrequent, but there were at least two, one of which was quite large. The 1955 Senate Report on the Bank Holding Company Act noted that “no widespread abuse of this nature [loss shifts] has been brought to the attention

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<sup>14</sup> More specifically, Sections 23A and 23B apply to all insured banks and savings institutions. They are found at 12 U.S.C. 371c and 12 U.S.C. 371c-1, respectively.

<sup>15</sup> See Walter (1996) for a discussion of firewalls.



of [Congress]” (*U.S. Code: Congressional and Administrative News* [1956, 2486]). The House Report on the Act did discuss one case, that of the 1953 failure of First State Bank of Elmwood Park, Illinois, which resulted from shifts of bad loans from a nonbank loan company to its affiliate bank—apparently to take advantage of limited liability protections (U.S. House [1955, 18–19]).<sup>16</sup> Similarly, a 1983 study of the causes of bank failures for the previous ten years found only one case out of 120 failures caused by transactions between a bank and its nonbank affiliates. Still, this case, the failure of Chattanooga-based, \$461 million Hamilton National Bank in 1976, was the third largest in U.S. history up to that time (Walter [1996, 23]).

Historically, then, firewalls have proven less than perfectly impervious. Further, until recently, affiliations were quite limited, offering few opportunities to put the firewalls to the test. Bank holding companies were, for the most part, restricted to owning nonbank financial firms that conducted activities that were similar to banking. Until the Gramm-Leach-Bliley Act was enacted in 1999, banking companies were prohibited from broad securities and insurance powers. Because of the limitations on the types of nonbank firms that bank holding companies could own, nonbanks have typically been much smaller than their bank affiliates. Since they were smaller, they were unlikely to be capable of producing losses large enough to sink affiliated banks.

### **Due Diligence prior to Affiliation**

Since the effectiveness of firewalls is uncertain, care must be taken to ensure that bank holding companies do not acquire especially risky nonbanks. Currently, supervisors evaluate the nonbank’s financial health as part of their review of applications from bank holding companies to acquire nonbanks.<sup>17</sup> They conduct analyses similar to *due diligence* analyses performed by investment companies for unregulated acquirers. Supervisors look for many of the same signals of problems that a creditor would, such as excessive debt and weak earnings performance. Similar analyses would be necessary for bank holding company acquisitions of commercial firms, should the wall come down.

Still, it might seem that such analysis of commercial firms would be expensive for bank supervisors, requiring the development of a very different

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<sup>16</sup> See FDIC (1953, 7–8) for details of the First State Bank case beyond those provided in the House Report.

<sup>17</sup> The Gramm-Leach-Bliley Act of 1999 allows financial holding companies to dispense with applying for supervisors’ approval of many nonbank acquisitions. Financial holding companies simply notify supervisors of the acquisition, within 30 days of the acquisition (Spong [2000, 157]). Therefore, acquisitions of nonbanks by financial holding companies often do not involve a pre-acquisition review of the nonbank’s financial health. For acquisitions by bank holding companies that have not chosen, under rules specified by Gramm-Leach-Bliley, to become financial holding companies, such reviews still occur.

skill set. Bank supervisors who specialize in application review are experienced in examining the health of financial firms, not of commercial firms. Yet other supervisory employees—those who review banks' loans for their repayment prospects—are practiced in analyzing commercial firms, since most large bank loans go to such firms. Today's bank examiners also engage in industrywide analysis as part of their review of syndicated lending to large commercial firms. Therefore, these skills might be brought to bear fairly cheaply.

Under current procedures, if the supervisory review of the firm to be acquired turns up potential risks, the supervisor can deny the application or require that the risk be ameliorated. An application review of acquisitions of commercial firms would likely include the same options.

Beyond these procedures, supervisors might add another requirement, because analyses of commercial firms could be more difficult than analyses of financial firms. Shifts of losses large enough to sink the bank and take advantage of limited liability are most likely to occur when the commercial firm is large relative to its bank affiliate. Consequently, supervisors might also limit the size of commercial firms acquired to a fraction of the size of affiliated banks. Doing so would reduce the chance of bank-sinking or bank-endangering loss shifts. Such a requirement is not unprecedented, as relative size limits were imposed on bank holding company merchant-banking acquisitions under provisions of Gramm-Leach-Bliley.

### **Umbrella Supervision**

While careful analysis of potential affiliates might prevent bank holding companies from purchasing troubled or initially risky commercial firms, problems at a commercial firm could arise well after its acquisition. Because of concern for this possibility, supervisors may wish to maintain ongoing oversight of the health of banks' commercial affiliates. The aim of such oversight is to determine whether the commercial affiliate has suffered losses or is expanding its riskiness. If supervisors find losses or heightened riskiness of commercial affiliates, they could indirectly impose a monetary penalty on the bank by lowering its supervisory rating. All banks are graded by supervisors on their financial health, riskiness, and management expertise. When a bank's grade (supervisory rating) declines, its insurance premiums can rise. Beyond this monetary penalty, when commercial affiliates suffer losses or increases in riskiness, supervisors might also watch more carefully for loss shifts (i.e., fire-wall violations). Further, they might even prohibit all transactions between the bank and its troubled commercial affiliate. In doing so, the supervisor mimics the monitoring that bank creditors would be expected to perform in the absence of deposit insurance.

Oversight of this sort currently occurs under provisions of the Gramm-Leach-Bliley Act, which make the Fed the *umbrella supervisor* of all financial holding companies. In this role, the Fed is to ensure that problems in a securities or insurance affiliate do not endanger the bank. For information on the health of securities and insurance affiliates, the Fed relies on financial reports from the Securities and Exchange Commission and state insurance commissioners. In some cases the Fed will participate in examinations of insurance companies performed by insurance commissioners. One main point of its umbrella oversight is to ensure that bank resources are not being shifted to nonbank affiliates. In the extreme, the Gramm-Leach-Bliley Act gives the Fed the authority to require that nonbank affiliates are divested. Divestiture provides the ultimate prohibition on loss-shifting transactions.

Umbrella oversight of commercial firms may be more difficult than oversight of securities and insurance firms. Securities and insurance firms already face strict regulation by agencies with long-standing experience as supervisors. Moreover, insurance companies receive regular examinations for financial health. Most commercial firms are less regulated and are not subject to examination by governmental supervisors. Developing such processes for commercial firms affiliated with banks could be quite expensive for an umbrella supervisor of combined bank/commercial firms and could impose large regulatory costs on the combined firms themselves.

Nevertheless, public firms—those whose securities trade in public markets—must release a great deal of financial information. Such information could provide much of the data necessary to judge financial health. While publicly available information may be less accurate and complete than that typically available to bank regulators, who have the power to require the release of any additional information they may deem useful, it is the set of information private investors rely upon when deciding whether to invest.<sup>18</sup> Therefore, for unregulated commercial firms, umbrella supervisors could rely upon publicly available information to a significant extent. Additionally, in passing the Sarbanes-Oxley Act, enacted in July 2002, legislators attempted to enhance the reliability of disclosures made by publicly traded companies.

#### 4. CONCLUSION

Clearly, firms benefit from combinations of commercial and financial units, since for years they have chosen to mix them. Yet many experts have maintained that banking and commerce should remain separate. Two predominant reasons for maintaining the separation are concerns with conflicts of interest and the proliferation of monopoly. The most credible reason—indeed, one

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<sup>18</sup> Of course, if private investors believe losses suffered by their bank-affiliated commercial firms can be shifted, then they have less reason to demand accurate accounting information.

that poses a significant hazard from combining banking with commerce—is that such affiliations could provide, at least under certain circumstances, incentives for loss shifts. While it turns out those circumstances are somewhat limited, they are not inconsequential.

Loss shifts can impose costs on taxpayers and waste resources. If losses are shifted from commercial firms to affiliated banks, taxpayer-funded bailouts may result. If creditors become convinced that firms affiliated with banks can shift losses to insured banks, then these firms will enjoy below-market borrowing costs. Below-market funding means that too many resources will flow to bank-affiliated firms. If so, productivity and financial market efficiency are diminished; in other words, scarce resources are wasted.

Nonetheless, since the Gramm-Leach-Bliley Act of 1999 allowed securities and insurance firms to affiliate with banks, potentially producing the same loss shifts that commercial affiliation might engender, why not also allow commercial affiliations? One reason that legislators might prefer not to open that door is that commercial firms are largely unregulated so the demands on supervisory resources are likely greater when protecting against shifts from largely unregulated commercial firms.

On the other hand, if legislators decide that the benefits of banking/commerce combinations could outweigh the hazards, what means of protection might they employ to minimize them? Several come to mind, including (1) careful analysis of the financial condition of commercial firms that bank holding companies wish to acquire, prior to acquisition; (2) the maintenance of firewalls to prevent loss shifts; and (3) umbrella supervision to provide the means of reducing the hazard. In addition to these means, the requirement that commercial firms be significantly smaller than any banks they affiliate with offers further protection. Size limits are likely to be valuable since a commercial firm is unlikely to produce a loss large enough to threaten a much larger bank affiliate.

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## **APPENDIX: BACKGROUND ON THE STATUTES FORMING THE WALL**

### **National Bank Act of 1864**

The National Bank Act restricts the opportunities for national banks to undertake commercial activities. National banks are those chartered and regulated by the U.S. Treasury Department's Office of the Comptroller of the Currency. The Act states that "a national banking association shall... have power to... exercise... all such incidental powers as shall be necessary to carry

on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security” (12 U.S.C. 24). While courts and the Comptroller have, over the years, wrangled over the meaning of the *business of banking* clause, courts have generally taken a fairly conservative view of activities that might qualify. As decided in an influential court ruling, for example, banks are generally limited to conducting businesses that are functionally interchangeable with traditional banking services (*M&M Leasing Corp. v. Seattle First National Bank*, 563 F.2d 1377, 1383 [9th Cir. 1977] as cited by Halpert [1988, 487]). In sum, under the Act courts have allowed national banks to engage in businesses similar to banking but not other commercial activities. This restriction of powers extends not only to activities of banks, but to activities conducted by subsidiaries owned by banks (Halpert [1988, 486]).<sup>19</sup>

### **State Laws and FDICIA**

For state-chartered banks, the banking/commerce wall is constructed of a mix of elements from state laws, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), and the National Bank Act. State banking statutes typically set limits on the nonbank activities of state banks and their subsidiaries similar to the limits on national banks (Spong [2000, 37–41]). Over the years a number of states have authorized activities beyond those allowed national banks. Yet state banks’ opportunity to expand further than the activities allowed under the National Bank Act was largely ruled out by the FDICIA. Specifically, Section 24 of the Federal Deposit Insurance Act as amended by the FDICIA prohibits insured state-chartered banks from engaging in any activities impermissible for national banks unless the FDIC rules that such activities pose no threat to the deposit insurance fund (sec. 303 of Public Law 102-242).

### **Bank Holding Company Act**

Enacted in May 1956, the Bank Holding Company Act was based on the view that “bank holding companies ought to confine their activities to the management and control of banks.” Legislators appear to have been motivated by two concerns. First, that conflicts of interest might arise if one company

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<sup>19</sup> Halpert (1988, 497) argues that it was of minor significance to Congress whether banks engaged in nonbank activities when writing this language of the National Banking Act. He maintains that Congress “never affirmatively required banks to stay out of nonbanking business,” but “[r]ather, subsequent interpretations of the statute by comptrollers of the currency and various courts provided its restrictive cast.”

owned both a bank and a commercial firm. For example, such a conflict arises when a bank receives a request for a loan from one of its commercial affiliate's competitors. Second, though the legislative history is less clear on this point, legislators appear to have also been worried that combinations might lead to the growth of monopoly power.

To address these concerns, the Act restricted bank holding companies such that they "would no longer be authorized to manage and control nonbanking assets unrelated to the banking business" (*U.S. Code: Congressional and Administrative News* [1956, 2484, 2492]). At the time the Act was passed, banking companies were growing rapidly through mergers. In a few cases these companies included nonbanking businesses. The widest-ranging example was found in Transamerica Corporation. It combined in one firm, banking, insurance, and a relatively small amount (as a percentage of Transamerica's total assets) of metals manufacturing and fish processing (Halpert [1988, 498]).

The Act required that companies wishing to purchase a bank first seek approval from the Board of Governors of the Federal Reserve System. Further, the Act prohibited the Board from approving purchases by companies engaged in activities that were not *closely related to banking*, thereby prohibiting commercial companies such as manufacturers from purchasing banks. Commercial firms like Transamerica that owned banks were given several years in which to divest either the bank or alternatively their commercial activities. Through the next forty years the Board developed a list of activities that would be considered closely related, excluding activities most observers would consider commercial.

In 1999, the Gramm-Leach-Bliley Act was enacted. It added securities underwriting and dealing as well as insurance to the list of activities in which banks—through bank-owned subsidiaries—and bank holding companies could engage. Until that time, banks and their subsidiaries and bank holding companies had been prohibited from the securities business by the 1933 Glass-Steagall Act.<sup>20</sup> Insurance activities were likewise highly restricted before Gramm-Leach-Bliley by the Bank Holding Company Act and other laws.

The Glass-Steagall Act's separation of securities activities from banking was driven by legislators' concerns over conflicts of interest, excessive stock market speculation by bank-owned securities firms, and threats to the health of banks from securities activities. Likewise the Bank Holding Company Act's separation of banking and insurance was part of that law's general separation of banking from nonbank activities, driven by concerns over conflicts of interest and monopoly power. By the time the Gramm-Leach-Bliley Act was passed, legislators and other observers had various reasons for removing the walls that separated banks from securities and insurance activities. These reasons

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<sup>20</sup> Bank holding companies began to engage in limited securities activities starting in 1987 through a loophole in Glass-Steagall.

fall into three categories. First, there is little evidence of conflicts of interest or other problems when banks were combined with nonbank firms. Second, market developments, such as growing competition in banking markets, had rendered these problems less important by the 1990s. Third, the concerns could be dealt with effectively by regulating the combined firms.

Ultimately, the Gramm-Leach-Bliley Act specified that only healthy, fairly low-risk bank holding companies were to be allowed to undertake this broader array of financial activities. Those that do so are called *financial holding companies*. Further, the Act allows these new financial holding companies to engage in merchant banking, whereby under certain conditions financial holding companies may purchase the equity of (in other words, become owners of) any type of corporation, commercial or otherwise. Financial holding companies' merchant banking subsidiaries are restricted to holding the equity of firms for a limited period of time and are prohibited from active management of the firms. Beyond securities and insurance, Gramm-Leach-Bliley allows the Board of Governors, in conjunction with the Treasury Department, to also authorize financial holding companies to undertake additional activities that are "financial in nature" or "incidental to financial activities." It also authorizes the Board to approve activities that are "complementary to a financial activity." So the Gramm-Leach-Bliley Act expands the activities of bank-owning companies beyond those previously allowed by the Bank Holding Company Act to include most financial activities, but leaves in place the wall between banking and commerce.

#### ***Loopholes in the Bank Holding Company Act Section of the Wall***

Loopholes have been employed to allow banking/commerce combinations, at least to a limited extent. The *unitary thrift loophole*, closed by the Gramm-Leach-Bliley Act in 1999, was one such opening. Through it, companies owning only one thrift (thus the phrase *unitary thrift*) could also own commercial firms. The loophole existed because thrift institutions (meaning primarily savings and loans, and savings banks) are not covered by the Bank Holding Company Act, which prevents banking/commerce ties. Instead, thrifts are regulated under the Savings and Loan Holding Company Amendments of 1967, which allow commercial activities in unitary thrift holding companies (Seidman [1998, 7]). Gramm-Leach-Bliley closed the loophole though it grandfathered existing unitary thrift holding companies, allowing them to continue to engage in commercial activities.

An additional loophole was partially closed in 1987, but remains open to a limited degree. Before 1987, the Bank Holding Company Act defined a bank as a firm that both offered demand deposits (a type of checking account) and made commercial loans. This definition prevented commercial firms from owning a typical bank, which offers both demand deposits and commercial

loans. Nevertheless, commercial firms could form a bank that did not offer one or the other. By doing so, commercial firms could own banks that did not fall within the Bank Holding Company Act definition of a bank and could circumvent the Act's prohibition of mixing banking and commerce. These banks, known as *nonbank banks*, did not fit the Act's definition of a bank but did offer most banking services. A number of firms established nonbank banks, both as a means of combining banking and commerce and as a means of banking across state lines, which was difficult until the 1990s. In 1987, Congress closed the loophole by tightening the definition, but allowed states with existing laws authorizing the chartering of *industrial loan corporations* (a type of nonbank bank that funds itself with insured deposits but does not offer demand deposits) to continue to charter these ILCs. Several states had such laws as of 1987. This option remains in force as a means of combining banking and commerce in these states.

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