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SUBTLE HAZARDS, FINANCIAL RISKS, AND DIVERSIFIED BANKS: AN ESSAY ON THE PERILS OF REGULATORY REFORM

HELEN A. GARTEN*

INTRODUCTION

Deregulation has put proponents of business regulation on the defensive. Today, economic regulation must be justified by reference to convincing evidence of dysfunction in unregulated markets; otherwise, its interference with competitive market forces is considered unnecessary or even counterproductive.¹ Yet, when regulation has dominated an industry for a long period of time, the case for or against regulation may be difficult to make. Defenders of regulation can point to the hazards that the original regulatory program was designed to address, but, years later, the regulated business may have changed so completely that stories of past abuses by an unregulated industry take on a legendary quality. On the other hand, the consequences of sudden deregulation of an industry that has grown up with and has been shaped by regulation are so unpredictable, and potentially so destabilizing, as to discourage total demolition of existing regulatory structures.² The result often is a compromise,

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1. For this approach to testing regulation, see S. BREYER, *REGULATION AND ITS REFORM* (1982). Some justifications for regulation may seem to have little to do with correcting market failure. For example, regulation requiring banks to serve the credit needs of their local communities would seem to reflect social policy rather than efficiency. Nevertheless, justification of this policy ultimately involves addressing such issues as the competitiveness of the market for financial services and existing incentives for financial institutions to fill this potential gap in service. In other words, most justifications for regulation may be phrased in terms of market failure, depending on one's vision of the efficiency of the market. *Id.* at 32-35.

2. A rare example of radical deregulation, and its sobering consequences, was "Big Bang," the wholesale deregulation of London's securities markets in October 1986. Although the dismantling of the old regulation was accompanied by the creation of alternative regulatory controls, industry problems in adapting to sudden change led to dislocations and business failures. Duffy, *Is the Bloom Off the Rose?*, *Am. Banker*, Dec. 18, 1987, at 5, col. 1. Of course, any regulatory change is likely to have a negative effect on

involving refurbishing of existing regulatory controls, which is unsatisfactory both to proponents and to opponents of deregulation.

This dilemma of regulatory reform is illustrated by recent attempts to deregulate the banking industry, and, in particular, to permit greater bank diversification into nonbanking businesses. Changes in the nature of and demand for banking services have affected the ability of banks and other financial services providers to operate within the confines of traditional regulation that restricts the permissible activities and investments of depository institutions.³ Regulation such as the Glass-Steagall Act,⁴ which prevents banks from engaging in most aspects of the securities business, has few defenders today.⁵ In fact, most observers agree that greater diversification theoretically may result in more profitable banks,⁶

particular groups that acted in reliance on the old regulation. These individual losses generally are dealt with by specific transition rules, such as grandfathering or phase-ins, or by market mechanisms. For an analysis of these kinds of transition policies, see Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509 (1986) (preferring market mechanisms). Cf. Breyer, *Reforming Regulation*, 59 TUL. L. REV. 4 (1984) (preferring government-provided transition relief). The transition problems that are of concern in this Article, however, are not those of compensating victims of changes in regulatory policy, but those of predicting the ability of the new policy to achieve its desired goals. For example, if there is a significant risk that the new regulatory policy may fail to create gains for the very groups that it is designed to benefit, then the case for regulatory change is weakened.

3. For my analysis of these changes in the banking business and their implications for bank regulatory strategy, see Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 FORDHAM L. REV. 501 (1989).

4. The Glass-Steagall Act is the popular name for §§ 16, 20, 21, and 32 of the Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). The Act was adopted in the wake of the banking panic of the late 1920s and early 1930s, when Congress sought to correct abuses within the financial community by creating a "wall" between the investment and commercial banking industries. Banks generally may not invest in or underwrite corporate securities. 12 U.S.C. § 24, seventh (1988). Banks may not affiliate with securities firms. *Id.* § 377. Securities firms may not engage in the business of deposit-taking. *Id.* § 378. Bank directors, officers, and employees may not serve as directors, officers, or employees of securities firms. *Id.* § 78. Portions of the wall created by the Glass-Steagall Act have been scaled from time to time by both the banking and securities industries. See, e.g., *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 839 F.2d 47, 68-69 (2d Cir.) (Glass-Steagall Act does not prohibit bank affiliates from underwriting and dealing in limited amounts of securities), *cert. denied*, 108 S. Ct. 2830 (1988); see also *infra* text accompanying notes 147-160.

5. See, e.g., Trigaux, *Corrigan Endorses Proxmire-Garn Bill*, Am. Banker, Dec. 11, 1987, at 3, col. 2 (President of New York Federal Reserve Bank favors securities powers for banks).

6. Proponents of portfolio theory have suggested that combining banking and securities activities actually may reduce risk within financial institutions. See Note, *Restrictions on Bank Underwriting of Corporate Securities: A Proposal for More Permissive Regulation*, 97 HARV. L. REV. 720, 729 (1984).

more satisfied customers,⁷ and a more competitive financial services industry.⁸

Yet to advocate repeal of the Glass-Steagall Act, or other restrictions on the ability of banks to diversify,⁹ begs the question of the terms on which deregulation should occur. If the theory behind restrictive regulation—that certain hazards are created when depository institutions engage in investment banking or other nonbanking activities¹⁰—is still valid, but the regulatory solution—to bar banks completely from nonbanking businesses—is too broad, then deregulation will require the substitution of more narrowly drawn controls to address those hazards. If both the form and function of existing regulation are faulty, then total regulatory dismantling may proceed without fear of adverse effects that ultimately may require new regulation.

Predicting the likely consequences of deregulation, however, has proved almost impossible. Defenders of restrictions on bank diversification cite the abuses that occurred prior to the adoption of regulation,¹¹ but this type of argument is at best anecdotal. Banks have been subject to extensive regulation of their day-to-day business activities and investments for so long that this regulation actually has shaped their structure, operating policies, and corporate culture.¹² The banking industry of today is so different, due in large part to regulation, that it is impossible to imagine a return to preregulatory days, even if all regulatory restrictions suddenly were removed.

Critics of regulation face the same problem in making their

7. See, e.g., Neustadt, *Big Banks Make Gains Placing Corporate Paper*, Am. Banker, Dec. 6, 1988, at 1, col. 4 (corporations use banks, as well as investment banks, to place their commercial paper to gain access to a different group of investors).

8. See Rosenstein, *Greenspan Urges Expanded Powers to Help US Banks in Global Markets*, Am. Banker, June 15, 1989, at 1, col. 3.

9. For a description of these other restrictions, see *infra* text accompanying notes 19-23.

10. See, e.g., Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137, 144 (1984) (Glass-Steagall Act "responded to the opinion, widely expressed at the time, that much of the financial difficulty experienced by banks could be traced to their involvement in investment-banking activities").

11. Much of modern federal banking regulation dates from the Depression. See Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C. (containing Glass-Steagall Act and Federal Deposit Insurance Act)). Subsequent regulation has extended federal oversight and control over bank investments and activities. See, e.g., Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (1956) (codified as amended at 12 U.S.C. §§ 1841-1850 (1988) (federal regulation of holding companies and affiliates of banks)).

12. See Garten, *supra* note 3, at 509-21.

case. Efforts to measure empirically the consequences of permitting banks to engage in securities, financial, or industrial activities have been frustrated by the absence of recent experience with bank diversification into these businesses. Although some proponents of deregulation rely on portfolio theory to predict the effect of combining banking and nonbanking activities,¹³ portfolio theory can predict only the effect of combining a portfolio of banking and nonbanking stocks, which has little application to actual entry by banks into nonbanking businesses.¹⁴ Moreover, evidence based on experience with diversified nonbank conglomerates suggests that when corporations attempt to reduce risk by diversifying their businesses, they simply are not as successful as individual portfolio investors.¹⁵ These problems in testing the consequences of diversification have stymied attempts to make a definitive case for deregulation.

This Article addresses this dilemma of anticipating the consequences of regulatory change by re-examining the case for deregulation of banking. Part I evaluates the theoretical arguments for and against permitting greater bank diversification. This debate has proved inconclusive because of disagreement over the likely impact of deregulation on the banking industry, consumers, competitors, and the banking system. More generally, simply arguing about whether any hazards will result from deregulation is futile unless some agreement is reached as to why such hazards should be taken seriously in determining the future of bank regulation.

Part II describes three hazards to the banking system that may accompany removal of regulatory restrictions on bank diversification and explains why they should be taken seriously in fashioning regulatory reform. These new subtle hazards¹⁶ of deregulation are the hazard of inefficient diversification, the hazard of inefficient funding, and the hazard of inefficient management. These hazards differ in two respects from the harms that usually are cited to justify

13. See *supra* note 6 and *infra* text accompanying notes 120-125.

14. For a discussion of this point, see *infra* text accompanying notes 126-140.

15. See *infra* text accompanying notes 141-146.

16. The phrase "subtle hazards" has special meaning for bank regulation because it was used by the Supreme Court in *Investment Co. Inst. v. Camp*, 401 U.S. 617, 630 (1971), to characterize the dangers that arise when banks diversify into the securities business. The Court may have adopted the phrase from Senator Bulkley's testimony in support of the Glass-Steagall Act, which stressed the need for banking laws to prevent risks that may be "so subtle as not to be easily recognized." 75 CONG. REC. 9912 (1932). Although the subtle hazards discussed in this Article are somewhat different from those described by the Court and Senator Bulkley, the phrase is descriptive of the harms that may result from the deregulatory process and that may go unrecognized in the haste to detail the defects of existing regulation.

restrictions on bank diversification. First, they involve general problems of organization, structure, and management rather than specific conflicts of interest and other opportunistic behavior on the part of individual bank managers. Second, their impact on the banking system is likely to be far more serious and less easily solved by either legal rules or competitive market forces.

Part III returns to the problem of testing the effects of regulatory change by demonstrating how disagreement over the likely results of bank deregulation is shaping the process of regulatory reform. Most reform proposals reflect an uneasy compromise between advocates of unfettered diversification and those who believe that the combination of banking and nonbanking businesses in a single entity creates the potential for risky or anticompetitive practices. For example, recent legislative and regulatory initiatives permit banks to enter new businesses, but only through separately incorporated affiliates isolated from the bank itself by regulatory "firewalls."¹⁷ In theory, these firewalls prevent interactions between banking and nonbanking operations that may give rise to potential hazards. Inevitably, the lack of consensus as to what these hazards are, and what dangers they pose to the banking system, has led to disagreement over the proper height and breadth of the firewalls.¹⁸ More generally, firewalls do not address the real hazards of organization, funding, and management that are likely to result from bank diversification.

Finally, Part IV proposes a transitional approach to regulatory reform that permits banks to diversify by making minority equity investments in nonbanking firms. Such investments enable banks to take advantage of any risk-reducing effect of diversification while sharing the organizational, funding, and management risks of integrating banking and nonbanking operations. Moreover, unlike firewalls, this approach allows easy transition to full deregulation

17. See, e.g., Financial Modernization Act of 1988, S. 1886, 100th Cong., 2d Sess., 134 CONG. REC. S3369-72 (daily ed. Mar. 30, 1988) (proposing amendment to Bank Holding Company Act to permit banks to own securities affiliates insulated from the bank by firewalls). Although recent attempts to legislate firewalls have been unsuccessful, the federal bank regulators have exercised their discretion to permit banks to commence certain new nonbanking activities conditioned on the building of very similar firewalls. See *infra* text accompanying notes 313-326.

18. Efforts to repeal the Glass-Steagall Act have foundered over disagreement between the Senate and House as to the necessary firewalls. See Depository Institutions Act of 1988, H.R. 5094, 100th Cong., 2d Sess. (1988) (requiring additional firewalls between banks and securities affiliates not contained in Senate bill); see also *infra* text accompanying notes 335-336.

should experience prove today's concerns over the hazards of diversification to have been exaggerated.

I. THE DILEMMA OF REGULATORY REFORM

Perhaps the best known, yet least understood, provisions of modern banking regulation are the restrictions on bank diversification into nonbanking businesses. As with much of bank regulation, restrictions on diversification stem from numerous sources in the banking laws and affect banks in various ways. The Glass-Steagall Act restricts bank entry into many aspects of the securities business, either directly or through affiliation with investment banking firms.¹⁹ The laws of the various bank chartering authorities²⁰ generally bar banks from engaging in commercial activities and even some financial businesses, such as insurance.²¹ The federal Bank Holding Company Act of 1956 restricts the permissible activities of bank holding companies and their nonbank affiliates to activities that are "so closely related to banking or managing or controlling banks as to be a proper incident thereto."²² These activities include deposit-taking and lending and various related activities, but not general commercial, industrial, or nonbank financial businesses.²³

Of course, these restrictions on diversification are not airtight. Some states expressly permit their banks to engage in nonbank activities that are forbidden to national banks and even bank holding company affiliates.²⁴ The Bank Holding Company Act gives the

19. See *supra* note 4.

20. Banks may be chartered by the Comptroller of the Currency, in which case they become subject to the National Bank Act, 12 U.S.C. § 38 (1988), or by the banking authorities in the state in which they are located, in which case they become subject to state banking laws.

21. The National Bank Act specifies the powers of national banks; these powers do not include commercial activities and include only limited insurance activities. *Id.* § 24; *id.* § 92 (limited power to act as insurance agent or broker in communities with 5000 or fewer inhabitants). Although the laws of the various states differ as to permissible banking powers, state banks generally are limited to traditional deposit-taking, lending, and trust activities. A few states permit additional nonbanking activities, such as insurance. See, e.g., Robinson, *California Banks Win Insurance Powers*, *Am. Banker*, Nov. 10, 1988, at 2, col. 2.

22. 12 U.S.C. § 1843(c)(8) (1988).

23. Regulation Y of the Board of Governors of the Federal Reserve System lists activities that are permissible for nonbank affiliates, including consumer and commercial finance, trust functions, investment advice, data processing, and selling some forms of credit life insurance. 12 C.F.R. § 225.25 (1989). Activities that currently are impermissible for nonbank affiliates include general insurance activities, 12 U.S.C. § 1843(c) (1988), management consulting, 12 C.F.R. § 225.126(f) (1989), and oil and gas activities, *Republic National Bank of Dallas*, 59 Fed. Res. Bull. 768, 769 (1973).

24. See *supra* note 21.

Federal Reserve Board discretion to determine what businesses are permissible for nonbank affiliates of banks.²⁵ These businesses are as diverse as discount brokerage and leasing computer time.²⁶ Even the Glass-Steagall Act has been interpreted to permit banks to engage through affiliates in underwriting and dealing in corporate debt and equity securities,²⁷ municipal revenue bonds,²⁸ mortgage-backed securities,²⁹ and commercial paper,³⁰ at least on a limited basis. In fact, the argument may be made that the only remaining barrier to diversification is the need to obtain regulatory approval and defend against the inevitable legal challenges of nonbank competitors.³¹

Still, restrictions on diversification have had a lingering impact on the banking industry. By limiting management's choices with respect to investment in and use of assets, the restrictions have greatly intruded into the day-to-day operations of banks and have profoundly influenced the development of the modern banking indus-

25. 12 U.S.C. § 1843(c)(8) (1988). The Board is precluded by statute from permitting nonbank affiliates to engage in certain insurance activities. *Id.*

26. *See* 12 C.F.R. § 225.125 (1989).

27. *See J.P. Morgan & Co. Inc., Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp and Security Pacific Corp.*, 75 Fed. Res. Bull. 192, 213 (1989) [hereinafter *Bank Underwriting Decision*]. The authority for permitting this and other underwriting is § 20 of the Glass-Steagall Act, which bars banks from affiliating with firms "engaged principally" in the securities business. 12 U.S.C. § 377 (1988). So long as bank securities affiliates limit their underwriting and dealing in corporate debt and equity and other "ineligible securities" (securities that the Glass-Steagall Act does not permit banks themselves to underwrite) to a specific percentage of the affiliate's gross revenues (currently ten percent), the affiliate is not considered by the Federal Reserve Board to be "engaged principally" in impermissible securities activities.

28. *See Citicorp, J.P. Morgan & Co., Inc. and Bankers Trust New York Corp.*, 73 Fed. Res. Bull. 473, 502-03 (1987), *aff'd sub nom. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 839 F.2d 47 (2d Cir. 1988) [hereinafter *Citicorp/Morgan/Bankers Trust*]. The Glass-Steagall Act itself permits banks to underwrite and deal in United States government securities, general obligation bonds issued by states and municipalities, and certain other governmental agency securities. 12 U.S.C. § 24, seventh (1988).

29. *See Citicorp/Morgan/Bankers Trust*, *supra* note 28, at 473.

30. *See id.*

31. The cost of this process is significant. Many recent legal challenges to regulatory approvals of new bank powers have found their way to the Supreme Court. *See, e.g., Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137 (1984) (commercial paper placement); *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207 (1984) (discount brokerage). Moreover, in approving applications to diversify, the bank regulators have placed significant restrictions on operations, including limits on interaffiliate funding and other dealings between bank and nonbank affiliates. *See, e.g., Bank Underwriting Decision*, *supra* note 27, at 206-07 (forbidding bank from extending credit to securities affiliate). In the absence of the Glass-Steagall Act and other legal limits on bank diversification, these restrictions would be more difficult for the regulators to impose and enforce.

try. As regulation has forced banks to serve primarily as lenders of deposits, this has shaped public perception of the bank's proper role and responsibilities. Banks are considered the ultimate source of credit for industry, particularly in times when other sources of credit are unavailable.³² This view of the "proper function" of banks is reflected in various regulatory and governmental policies, such as the Community Reinvestment Act, which makes consideration of a bank's record in meeting the credit needs of its local community a factor in approving applications for expansion.³³ It also has influenced the management philosophy and style of most bankers.³⁴ Thus, the modern commercial banking industry has matured apart from the rest of the financial services industry.³⁵

In addition, despite numerous assaults, remaining restrictions on bank diversification have proved remarkably impervious, particularly to congressional attack. Regulation of bank liabilities, such as ceilings on the rates of interest payable on bank deposits, has been almost completely dismantled.³⁶ Yet attempts to repeal asset restrictions have failed.³⁷ In fact, over the past decade, Congress actually tightened, rather than loosened, restrictions on bank diversification, first, by restricting bank insurance activities,³⁸ and second, by preventing commercial and industrial companies from setting up limited purpose deposit-taking institutions.³⁹

Today, however, the viability of the remaining restrictions on bank diversification is subject to question. Banks have faced serious competitive pressures and have experienced lower earnings in their traditional lending business. The development of active trading

32. For a description of this role of banks as back-up sources of liquidity for the credit markets, see Corrigan, *Are Banks Special?*, FED. RESERVE BANK MINNEAPOLIS ANN. REP. 1, 9-11 (1982).

33. 12 U.S.C. §§ 2901-2905 (1988).

34. See *infra* text accompanying notes 272-276.

35. The impact of the bank's peculiar corporate culture on recent efforts by banks to diversify is explained *infra* text accompanying notes 268-288.

36. See 12 U.S.C. § 3503 (1988) (deregulating rates of interest payable on time deposits).

37. For example, in 1988, Congress again tried—and failed—to repeal the Glass-Steagall Act. See Garsson, *Proxmire: Securities Bill Dead*, Am. Banker, Oct. 21, 1988, at 1, col. 2.

38. See Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1969 (amending 12 U.S.C. § 1843(c)(8)). The amendment restricted the authority of bank holding companies to engage in insurance activities through nonbank affiliates.

39. See Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 101(a), 101 Stat. 552, 554 (1987) (amending 12 U.S.C. § 1841(c) (amending definition of "bank" in Bank Holding Company Act to include insured, limited purpose deposit-taking institutions)).

markets for short-term debt instruments, such as commercial paper, has provided an alternative to bank loans for most corporate borrowers. Banks have experienced the shrinking of their traditional customer base.⁴⁰

Regulatory changes also have made the lending business less attractive. Banks no longer are subject to ceilings on the rates of interest that they may pay on deposits.⁴¹ This deregulation enables banks to compete for funds with high yield investments such as money market mutual funds,⁴² but it also results in narrower spreads between the rates of interest that banks earn on their assets and the rates that they pay on their liabilities. In addition, regulation requiring higher bank capital to asset ratios⁴³ has made lending more expensive. Every additional dollar of loans requires a corresponding increase in capital.

These market and regulatory changes have fueled arguments for permitting greater diversification. So long as the lending business guaranteed high rates of return and relatively little risk, banks had no need or desire to enter other businesses.⁴⁴ The case for diversification recently has become more appealing. The principal advantage of diversification is that, in theory, combining banking and selected nonbanking activities may reduce overall risk. Portfolio theory suggests that a securities investor can reduce portfolio risk by purchasing securities whose returns are negatively correlated. At any given time, poor returns on one investment should be offset by high returns on other investments, reducing the variability of portfolio earnings as a whole.⁴⁵ If a portfolio investor can reduce risk by diversifying investments, the same achievement may be possible for

40. For a discussion of these trends, see Garten, *supra* note 3, at 521-28.

41. See *supra* note 36.

42. For a description of the phenomenal growth of these funds as investment alternatives to bank deposits, see J. AUERBACH & S. HAYES, *INVESTMENT BANKING AND DILIGENCE: WHAT PRICE DEREGULATION?* 92-94 (1986).

43. By the end of 1992, banks must maintain a capital to risk-weighted assets ratio of at least eight percent, of which four percent must consist of equity. See Federal Reserve System Risk-Based Capital Guidelines, 54 Fed. Reg. 4186 (1989) (to be codified at 12 C.F.R. pts. 208, 225).

44. This apparently was the case until the 1970s. See, e.g., Rhoades, *A Comparative Investigation of Risk and Rates of Return in Commercial Banking and Manufacturing Industries*, 25 ANTITRUST BULL. 589 (Fall 1980). Rhoades compared average rates of return on equity and variability in rates of return for the banking and various nonbanking industries in the 1960s. He found that banking was just as profitable as, but less risky than, most nonbanking activities, and concluded that banking organizations would benefit from increasing banking rather than nonbanking assets. *Id.* at 617.

45. See R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 123-26 (2d ed. 1984).

a banking organization by diversifying its businesses. For example, if banking returns negatively correlate with investment banking returns, the risk-reducing effect that is achieved by an investor who buys the stock of Chase and Merrill Lynch may be duplicated by Chase if it conducts a securities business, either by buying Merrill Lynch or starting its own.⁴⁶

This argument for permitting banks to diversify is not new. Prior to the passage of the Glass-Steagall Act, bankers cited the risk-reducing effects of diversification as one reason for their formation of securities affiliates.⁴⁷ Yet Congress decided to limit bank diversification. What then, if anything, did Congress know that the bankers did not?

A. *The Problem With Investment Company Institute v. Camp*

Justifications for regulatory restrictions on bank diversification find their philosophical antecedents in the Supreme Court opinion in *Investment Company Institute v. Camp*.⁴⁸ At first, this reliance on *Camp* seems misplaced. The *Camp* decision involved an interpretation of a particular provision of the Glass-Steagall Act,⁴⁹ and did not address the more general restrictions on bank diversification into commercial activities contained in the Bank Holding Company Act and other banking laws.⁵⁰ Moreover, *Camp* was decided in 1971, almost forty years after passage of the Glass-Steagall Act,⁵¹ in a profoundly different banking and regulatory environment.

46. This argument ignores the possibility that diversification by a business such as Chase is a different and more costly process than portfolio diversification by an individual securities investor. For a discussion of these problems with portfolio theory as applied to conglomerate diversification, see *infra* text accompanying notes 126-146.

47. See, e.g., Wilkinson, *Bank Security Companies*, 119 BANKERS MAG. 927, 929 (1929) (bank entry into investment banking can minimize fluctuations in earning power).

48. 401 U.S. 617 (1971).

49. Specifically, the case involved a challenge to a regulation of the Comptroller of the Currency permitting national banks to operate collective investment funds. *Id.* at 618-19. The Supreme Court interpreted the Glass-Steagall Act's restrictions on bank issuing, underwriting, selling, or distributing securities to cover the operation of such a fund. *Id.* at 639.

50. See *supra* text accompanying notes 20-23.

51. In view of the number of recent cases involving interpretation of Glass-Steagall, it is noteworthy that between 1933, when the statute was enacted, and 1971, the year of the *Camp* decision, the Supreme Court interpreted the Act only once, focusing on the meaning of the phrase "primarily engaged" in securities activities, and did not consider generally the purposes of the Act. Board of Governors of the Fed. Reserve Sys. v. Agnew, 329 U.S. 441, 445-49 (1947). The explanation may be that, prior to the 1970s, the profitability of the traditional banking business removed incentives for banks to test the limits of the statutory restrictions on bank securities activities. See Garten, *supra* note 3, at 518-19.

Nevertheless, for two reasons, the *Camp* analysis has proved extremely influential in setting the perimeters of the debate over bank diversification. First, the hazards identified by *Camp* as resulting from the combination of banking and securities activities may arise when banks engage in nonbanking activities of any sort. The temptation for a bank to utilize its lending facilities to support its nonbanking operations⁵² may be just as strong whether those nonbanking operations are investment banking or shoe sales.⁵³ Thus, consideration of the costs and benefits of bank entry into any new nonbanking activity generally makes reference to the so-called *Camp* subtle hazards.⁵⁴

Second, the *Camp* opinion articulated what now is the classic justification for regulatory interference with competitive market forces. According to *Camp*, the Glass-Steagall Act reflected a legislative determination that "policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the 'hazards' and 'financial dangers' that arise when commercial banks engage in the activities proscribed by the Act."⁵⁵ In fact, this balancing probably was not necessary in 1933, when the Glass-Steagall Act was passed. The decline in the market for new securities issues following the stock market crash and the subsequent regulation of the securities markets led most banks voluntarily to abandon investment banking.⁵⁶

This weighing of the costs of regulatory interference with competitive market forces against the harms produced by an unregulated market had more significance in 1971, when the financial products market was experiencing profound changes. As banks faced serious competition from nonbank providers of financial services and customers began to demand new and better financial products, the effect of restrictive regulation on financial innovation became an issue for the first time in forty years.⁵⁷ Recognition of

52. See *Camp*, 401 U.S. at 631 (describing the "natural temptation [for the bank] to shore up the affiliate through unsound loans or other aid").

53. The motive for such cross-funding, according to *Camp*, is the fear that, because of the close association of the bank and its nonbank affiliate in the public mind, "should the affiliate fare badly, public confidence in the bank might be impaired." *Id.* at 631.

54. See, e.g., *American Soc'y of Travel Agents, Inc. v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 385 F. Supp. 1084, 1091 (N.D. Cal. 1974) (bank entry into travel agency business could create pressures for bank to "prime the pump" of the travel industry by making substandard loans to its travel agency customers).

55. 401 U.S. 617, 630 (1971).

56. See Garten, *supra* note 3, at 514-16.

57. See *supra* text accompanying notes 40-44.

the cost of bank regulation in terms of its interference with beneficial operations of the market is a relatively recent phenomenon.

What hazards did *Camp* say may arise from bank diversification into securities activities? Curiously, the *Camp* decision did not spend much time on the most obvious hazard, that banks may invest depositors' money in risky securities.⁵⁸ Rather, *Camp* identified certain "more subtle hazards" that arise when banks engage in the investment banking business.⁵⁹ For example, since the bank and its securities operations are linked in the public mind, losses in those securities operations may lead to a loss of confidence in the bank itself.⁶⁰ This in turn may tempt the bank to provide funds to shore up its troubled securities operations.⁶¹ Alternatively, the bank may assist its securities operations indirectly by lowering its credit standards to lend to underwriting clients to support their securities issues.⁶²

In addition, bank depositors may blame the bank for losses on securities purchased from its securities operation, thereby damaging the bank's reputation.⁶³ The promotional demands of the investment banking business may cause banks to "lend their reputation for prudence and restraint" to the business of selling securities,⁶⁴ and to let their promotional interest in particular securities color their disinterested investment advice to bank customers.⁶⁵ Banks also may dump unsold securities in their discretionary trust accounts.⁶⁶

Almost all of these so-called "subtle hazards" involve some

58. The specific securities activity at issue in the *Camp* case—operating a collective investment fund—did not involve the direct investment of bank assets in securities. The Supreme Court did note that, prior to the passage of the Glass-Steagall Act, most banks conducted their securities activities through separately incorporated affiliates that did not have access to bank assets. *Camp*, 401 U.S. at 630. Nevertheless, before Glass-Steagall, banks, particularly small banks, were major buyers of securities, often from the securities affiliates of their large correspondent banks. See 75 CONG. REC. 9911 (1932) (statement of Sen. Bulkley) (country's bank correspondents were "overloaded with a mass of investments").

59. 401 U.S. at 630 (Congress focused on the "more subtle hazards that arise when a commercial bank . . . enters the investment banking business").

60. *Id.* at 631.

61. *Id.*

62. The bank's "salesman's interest" in promoting particular securities may "impair its ability to function as an impartial source of credit." *Id.*

63. *Id.*

64. *Id.* at 632. The bank also may be tempted to make imprudent loans to bank customers to finance their purchases of stock. *Id.*

65. *Id.* at 633.

66. *Id.*

form of conflict of interest.⁶⁷ The principal concern raised by these conflicts is not the possibility of unfairness to bank customers, but the likely impact on the bank itself. According to *Camp*, the danger created by these specific abuses is that they lead to public dissatisfaction with and loss of confidence in banks. This loss of confidence presumably may cause depositors to withdraw their funds from the banking system, resulting in the failure of many banks. In fact, bank managers' fear that losses in bank securities operations will cause the public to lose confidence in the bank provides the motive to engage in abusive practices, such as making preferential loans to underwriting clients to support their securities issues and pushing those securities on unsuspecting bank customers.⁶⁸ These practices, if they became known, would only further impair depositors' trust in their banks.

As an accurate statement of the real motives behind the Glass-Steagall Act, the *Camp* subtle hazards are somewhat suspect. Critics of the Glass-Steagall Act have noted the danger of confusing apparent legislative intent with the true motives of Congress in adopting legislation.⁶⁹ These critics argue that the hazards identified in *Camp* as arising from bank involvement in securities activities do not provide an adequate explanation of the Act's complete separation of the banking and investment banking businesses, since conflicts of interest may be prevented by less intrusive regulation.⁷⁰ Thus, the real reason for the Act's separation of banking and securities may have been something quite different. For example, a possible motive for the Glass-Steagall Act may have been the congressional desire in 1933 to protect investment bankers by removing commercial bankers from their turf.⁷¹ In fact, the banks themselves shared in the spoils of Glass-Steagall, since by 1933 they had reason to abandon the securities business voluntarily and return to traditional banking.⁷² For almost three decades thereafter, the commercial

67. See Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 689-90 (1987).

68. *Investment Co. Inst. v. Camp*, 401 U.S. 617, 631-32 (1971).

69. See, e.g., Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1, 2 (1984); see also Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 272 (1982).

70. See Langevoort, *supra* note 67, at 690.

71. See Easterbrook, *Foreword: The Court and the Economic System*, 98 HARV. L. REV. 4, 57 (1984); Macey, *supra* note 69, at 16-19. But see Langevoort, *supra* note 67, at 697 (arguing that real motive was to redirect banking energies to traditional commercial and agricultural lending).

72. See *supra* text accompanying note 56. If banks wanted to cut expenses by terminating employees of their unprofitable securities businesses, the divestiture of securities

banker's protected turf was far more profitable than the investment banker's.⁷³

Although the problem of deciphering the legislative intent of the Glass-Steagall Act is primarily of judicial concern,⁷⁴ the *Camp* hazards also have colored the debate over legislative reform. If *Camp* accurately summarizes the likely consequences of allowing banks to engage in securities and other nonbanking activities, then it provides a starting point for discussion of regulatory policy with respect to bank diversification. Yet the *Camp* hazards have proved unhelpful even for this purpose. *Camp* assumed that losses in bank securities operations cause depositors to lose confidence in their banks and withdraw their funds, leading to liquidity crises and bank failure.⁷⁵ This danger may lead banks to make imprudent loans and take other steps to ensure the success of their securities operations. Risky loans and other questionable practices may themselves result in losses for the bank and impair public confidence. Thus, bank securities activities are of regulatory concern because they may lead to loss of depositor confidence in banks, bank runs, and bank failures.⁷⁶

This justification for regulatory intervention seems unconvincing today. Since 1933, public confidence in the banking system has been sustained not by the Glass-Steagall Act, but by the deposit insurance system, which was created by the same comprehensive banking legislation that produced the Glass-Steagall Act.⁷⁷ The existence of deposit insurance makes the scenario suggested in *Camp*, that losses in bank securities activities will lead to large scale deposit outflows, more difficult to accept. Most fully insured depositors have little reason to expend much time or money to monitor the performance of their bank's securities division. Even if losses in

operations forced by the Glass-Steagall Act allowed banks to justify their firing of employees during the Depression. In 1933, Chase terminated over 1000 employees of its securities affiliate. See Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483, 523-24 (1971).

73. See *supra* text accompanying note 44.

74. For an analysis of how recent reviewing courts have dealt with the Glass-Steagall Act, see Langevoort, *supra* note 67, at 698-719.

75. 401 U.S. 617, 631 (1971).

76. The Court did identify other reasons for concern over bank securities activities, including their contribution to feeding the speculative fever of the late 1920s. *Id.* When *Camp* was decided in 1971, however, this particular danger was no longer a serious threat. On the other hand, maintaining public confidence in the banking system is an ongoing problem.

77. See Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

securities operations lead to bank failure, the deposit insurance fund will reimburse these depositors in full.⁷⁸ Although uninsured depositors may have more reason to be concerned whether securities losses lead to the failure of their bank, they may be indifferent to or actually welcome some of the conflicts of interest predicted by *Camp* if these conflicts give their bank a competitive advantage.⁷⁹

Moreover, the kinds of abuses identified by *Camp* are amenable to treatment by special conflict of interest rules. Such rules are relied upon to prevent conflicts of interest in diversified nonbank financial firms.⁸⁰ If similar rules are workable for diversified banking firms, then the justification given by *Camp* for the Glass-Steagall Act begins to fall apart. Post-*Camp* judicial construction of the Glass-Steagall Act has struggled with this logical inconsistency created by *Camp*. If the only reason for the Act is to prevent the hazards identified in *Camp*, yet these hazards can be dealt with by more narrowly drawn rules, then there is no reason to interpret the Act broadly to prohibit particular bank securities activities. Thus, most judicial decisions that rely on *Camp* to interpret the Glass-Steagall Act have tended to narrow the reach of the statute.⁸¹

78. Many insured and even some uninsured depositors maintain accounts in particular banks because of convenience, availability of other services, or other reasons that have little to do with risk and return. Such depositors are less sensitive than typical securities investors to changes in risk at their banks. See Garten, *Banking On the Market: Relying On Depositors to Control Bank Risks*, 4 YALE J. ON REG. 129, 134-37 (1986).

79. Such practices as dumping unsold securities in bank trust accounts may enhance the profitability of bank securities operations. Although any resulting dissatisfaction on the part of trust customers could result in the loss of their business, the effect will not be so sudden or so devastating as to result in the failure of the bank and loss of depositors' funds. Depositors would have ample opportunity to switch to another bank should any problems arise. In fact, there is very little evidence that, when and if such abuses did occur, they caused the failure of a substantial number of banks. The practices of the bank securities affiliates in the 1920s may have led to the bankruptcy of the affiliates' customers, but not their affiliated banks. See Fischel, Rosenfield & Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 323 n.72 (1987) (suspecting that bank failures in the 1920s and 1930s were unrelated to investment banking affiliates); Garten, *supra* note 3, at 512 n.52. The failure of the Bank of the United States in 1930, although often blamed on its affiliate system, was caused by insider fraud on the part of its president. See Perkins, *supra* note 72, at 496-97.

80. See, e.g., Lipton & Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459 (1975). Some of the abuses identified in *Camp*, such as dumping securities issued by bank clients into trust accounts, already can occur in undiversified commercial banks. See Hunsicker, *Conflicts of Interest, Economic Distortions, and the Separation of Trust and Commercial Banking Functions*, 50 S. CAL. L. REV. 611, 654-55 (1977).

81. See, e.g., *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207 (1984). In deciding that discount brokerage was not an impermissible securities activity under the Act, the Supreme Court determined that discount brokerage

This does not mean that the *Camp* hazards are irrelevant. The connection between bank securities activities and public confidence may be more complex than the *Camp* opinion suggested. *Camp* itself quoted extensively from a lengthy statement as to the purposes of the Glass-Steagall Act made by Senator Bulkley on the Senate floor in 1932.⁸² Senator Bulkley argued that losses in a bank securities affiliate, even if not severe enough to bring about the failure of the bank, could so discredit the bank as to impair the confidence of its depositors.⁸³ Yet he also was concerned about public confidence in the securities markets, which in his view had been overdeveloped because of the activities of bank securities affiliates. Once the banks had developed extensive retail distribution networks for securities, they had to recoup their costs by insuring a continuous flow of new issues.⁸⁴ This in turn led banks to pressure their underwriting clients to issue vast quantities of new securities and to create a market for these securities by lending to securities purchasers and encouraging depositors and correspondent banks to invest.⁸⁵ Removing banks from the securities business would improve the quality of the securities markets by ensuring that advice on new issues would be untainted by the banker's stake in promoting an active securities market.⁸⁶

Senator Bulkley's attempt to blame the excesses of securities speculation entirely on the commercial banks obviously was overstated.⁸⁷ Nevertheless, the Senator's goal of creating entirely separate markets and corporate cultures for commercial banks and investment banks in fact has been the most significant achievement

would not create the kind of pressures on the bank that would cause it to engage in the abusive practices described in *Camp*. *Id.* at 220 & n.23.

82. See 75 CONG. REC. 9909 (1932). It is unclear if Senator Bulkley's statement accurately reflected the views of either the drafters of the Act or the Congress that subsequently passed it. Senator Bulkley indicated that he represented the views of the subcommittee that had worked on the Glass bill, and at least one fellow senator found his argument "absolutely invincible." *Id.* at 9913 (statement of Sen. Vandenberg). Nevertheless, the real reasons for passage of the Act are probably unknowable. See Langevoort, *supra* note 67, at 692.

83. 75 CONG. REC. 9912 (1932).

84. *Id.* at 9911.

85. *Id.*

86. "If . . . the business of originating and underwriting investment securities is confined to houses not engaged in deposit banking, then the extent and the desirability of new issues will be subjected to an independent and impartial check. This should tend to restore public confidence." *Id.* at 9912.

87. In fact, it may give credence to the argument that the motive of Congress in adopting Glass-Steagall was to assist the traditional investment banks in eliminating their new, aggressive bank competitors. See *supra* text accompanying notes 69-71.

of the Glass-Steagall Act. As a result of Glass-Steagall, generations of corporate customers and bankers have viewed issuing corporate debt and obtaining a bank loan as entirely separate means of financing, obtained from different financial institutions with very different attitudes toward pricing of services, client relationships, and credit analysis.⁸⁸

Moreover, Senator Bulkley's view of the potential hazards of bank securities activities offers two significant lessons for recent debate over bank diversification. First, the problems identified by Senator Bulkley are problems of organization and management of diverse enterprises. For example, Senator Bulkley argued that the substantial investment required to set up a securities distribution network itself can provide incentives for a banking organization to support its securities operations.⁸⁹ Whether or not this particular hazard is a threat today, it is clear that any organizational or managerial inefficiencies resulting from bank diversification are likely to be more lasting, and potentially more dangerous, than the specific abuses identified in *Camp*.

Second, unlike the *Camp* hazards, Senator Bulkley's complaints cannot be easily addressed by rules that prevent conflicts of interest and other misconduct in diversified firms. This may provide an answer to the nagging question raised by *Camp*: Why does bank diversification create any greater problems than diversification by any other financial or nonfinancial company?

B. *The Problem with Empirical Testing*

Relying on the *Camp* hazards to make the case for regulation is insufficient without further demonstration that these hazards, or other hazards resulting from bank diversification, should be taken seriously in today's banking market. Proponents of deregulation face the same problem of proof in arguing for repeal of restrictive regulation. Proponents of deregulation have not substantiated their claim that bank diversification will produce a safer banking system, or at least will not lead to a more dangerous one. Their problem is that, without any evidence based on real experience, the consequences of bank diversification are impossible to predict. Thus, attempts to test empirically the effects of deregulation have foundered.

88. One observer has noted that the division between commercial and investment banking "is a matter of education, training, motivation, and philosophy." Note, *Glass-Steagall: Lest We Forget*, 11 FLA. ST. U.L. REV. 163, 194 (1983).

89. 75 CONG. REC. 9911 (1932).

Most studies of bank diversification have attempted to predict the consequences of allowing banks to enter nonbanking businesses by creating simulated portfolios of banking and nonbanking companies and looking at the relative returns on these portfolios.⁹⁰ These studies have found that the returns on certain nonbanking activities are negatively correlated with banking returns.⁹¹ They then conclude that some diversification may reduce risk in banking organizations.⁹²

These studies hardly provide a realistic picture of corporate diversification. Portfolio studies treat banking and nonbanking activities as entirely separate investments. When banks actually diversify, they will be unlikely to treat each new business as a passive investment in a portfolio of securities. Portfolio studies cannot take into account individual operating policies, funds allocation, and other management decisions that may affect the returns on one or more operations in a diversified banking organization.⁹³ Further, reliance by most studies on industry-wide data in determining the returns on banking and nonbanking activities⁹⁴ obscures the significance of individual management decisions.⁹⁵ For example, if independent mortgage banking companies in general outperform mortgage banking companies that are affiliated with bank (or nonbank) conglomerates,⁹⁶ then use of average industry-wide data may not reflect special managerial problems that are unique to conglomerate enterprises.

Other tests of the probable effects of bank diversification also are subject to criticism. Because banks already may diversify through nonbank affiliates into activities approved by the Federal

90. For two such studies, see Eisemann, *Diversification and the Congeneric Bank Holding Company*, 7 J. BANK RES. 68 (1976) (comparing stock price and dividend data for selected banks and nonbanks), and Heggstad, *Riskiness of Investments in Nonbank Activities by Bank Holding Companies*, 27 J. ECON. & BUS. 219 (1975) (comparing profitability of banking and nonbanking industries).

91. See, e.g., Heggstad, *supra* note 90, at 223 (finding lowest correlation between banking and real estate returns).

92. See *id.* at 222-23; Eisemann, *supra* note 90, at 73-75.

93. For a more detailed explanation of this point, see *infra* text accompanying notes 261-290.

94. See, e.g., Eisemann, *supra* note 90, at 70 (using industry-wide data).

95. See, e.g., Heggstad, *supra* note 90, at 223 (admitting this problem in using industry-wide data).

96. At least one study of bank-affiliated mortgage banking companies has found that the affiliated companies were less profitable than the industry as a whole. Talley, *Bank Holding Company Performance in Consumer Finance and Mortgage Banking*, 52 MAG. BANK ADMIN. 42, 44 (1976).

Reserve Board,⁹⁷ studies can measure the actual performance of diversified bank holding companies.⁹⁸ Alternatively, studies can measure investors' reactions to announcements of bank holding company acquisitions of new nonbank entities.⁹⁹ These studies, however, have proved inconclusive.¹⁰⁰ This may mean that diversification has little or no effect on bank risk. But it also may mean that, either because of regulation or management choice, banks have not diversified in a way that leads to risk reduction.¹⁰¹ In any case, these studies cast no light on the possible effects of diversification into currently forbidden activities.

On the other hand, there is some evidence that diversification by banks will not be as effective in reducing risk as portfolio diversification by individual shareholders. Studies of bank holding company performance in permissible nonbanking activities have found that nonbank affiliates generally have been less profitable than either their independent competitors or their sister banks.¹⁰² Likewise, the recent performance of diversified nonbank conglomerates casts doubt on the beneficial effects of corporate diversification.¹⁰³ Thus, the unequivocal benefits of diversification cannot simply be assumed. Again, consideration of the merits of deregulation stumbles against the troubling question of how the consequences of regulatory change can be measured.

C. *Measuring Subtle Hazards*

The previous discussion noted the difficulty of proving the case for or against deregulation. Regulation has restricted bank activities

97. See *supra* note 25.

98. See, e.g., M. JESSEE & S. SEELIG, *BANK HOLDING COMPANIES AND THE PUBLIC INTEREST* 77-129 (1977) (comparing a sample of holding company banks with a sample of independent banks); see also Meinster & Johnson, *Bank Holding Company Diversification and the Risk of Capital Impairment*, 10 BELL J. ECON. 683, 684-88 (1979) (analyzing cash flows of diversified operations of two bank holding companies).

99. See Wall & Eisenbeis, *Risk Considerations in Deregulating Bank Activities*, FED. RESERVE BANK OF ATLANTA ECON. REV., May 1984, at 6, 16.

100. For example, a study of bond price movements for 11 banking and nonbanking firms following their acquisition of a discount broker or other financial services company found no significant abnormal returns. *Id.* at 16-17.

101. See Eisemann, *supra* note 90, at 77 (concluding that bank holding companies have not been diversifying efficiently). For an explanation of why bank management may not be effective at efficient diversification, see *infra* text accompanying notes 120-215.

102. See Talley, *supra* note 96, at 44 (bank holding company consumer finance and mortgage banking affiliates).

103. See *infra* text accompanying notes 144-146. See generally Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 52-60 (1986) (describing recent trend toward "bust-up" takeovers of huge diversified conglomerates).

for so long that there is no way to demonstrate the likely effect of permitting bank diversification. Proponents and opponents of deregulation end up making contradictory, yet undemonstrable, assumptions about the consequences of bank entry into nonbanking activities.

Thus, the primary hazard created by deregulation may be the unpredictability of the consequences of regulatory change. Nevertheless, some assessment of the risks and returns of deregulation is possible. Although opponents of deregulation have identified many evils that may follow bank diversification, not every hazard is necessarily of concern to bank regulation. For example, if banks enter the securities business, some may be unsuccessful and incur losses. These losses may injure bank stockholders, but shareholders' losses do not justify continued regulation of bank securities activities. Guaranteeing returns to bank shareholders is not a goal of bank regulation. Nevertheless, if as a result of securities activities, half of the nation's banks fail, these failures would be of regulatory concern. Depositors' claims would bankrupt the insurance fund, threatening depositor confidence in the remaining healthy banks, and necessitating government intervention. Thus, the connection, if any, between bank securities activities and failure deserves consideration.

The mere possibility that bank securities activities might lead to bank failure does not prove that such failure is very likely to occur. Although the impossibility of prediction means that no risk can be ruled out entirely, not all hazards to the banking system require the intervention of special bank regulation. There is always a risk that half of the banks (or nonbanks) in the country suddenly may become insolvent, creating serious consequences for the economy. But there are mechanisms that lessen this risk in the majority of cases. Competitive market forces pressure management to enter new activities cautiously.¹⁰⁴ Conflict of interest rules discourage insider abuses that lead to failure. If these alternative controls exist and influence how banks diversify, special bank regulation may not be necessary.

This suggests the need to re-evaluate the hazards of bank diversification by reference to two guiding principles. First, assessing the hazards requires consideration of how any particular evil resulting from diversification interferes with important bank regulatory goals.

104. Theoretically, managers who cause their banks to suffer losses risk losing their current jobs as well as the chance of being offered better jobs at other firms. Cf. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980) (significance of the managerial labor market in disciplining management performance).

This analysis necessarily is complicated by current disagreement over the exact goals of bank regulation. For example, bank entry into securities and other nonbanking activities could lead to the formation of huge financial and industrial conglomerates.¹⁰⁵ Fear of concentration of financial power certainly has motivated some bank regulation.¹⁰⁶ Yet as banks today face competition from giant diversified foreign competitors, it is debatable whether keeping banks small is a desirable regulatory goal.¹⁰⁷

Because of this danger of defining the regulatory interest too broadly, this Article proposes a more narrow view of regulatory goals. At a minimum, the goal of bank regulation is to safeguard the banking system from systemic crises.¹⁰⁸ Because achievement of this goal requires maintenance of some form of federal "safety net," which today includes deposit insurance,¹⁰⁹ central bank lending to banks experiencing liquidity problems,¹¹⁰ and, most controversial, government intervention to handle failed banks,¹¹¹ protection of this safety net is a second important goal of regulation.¹¹² If the regulatory interest is defined in this way, then the hazards with which bank regulation should be concerned are those that threaten

105. This has been the case in countries that do not restrict bank diversification. See generally Daskin & Marquardt, *The Separation of Banking from Commerce in the United Kingdom, West Germany and Japan*, 7 ISSUES BANK REG. 16 (1983).

106. The Bank Holding Company Act's restrictions on diversification were responsive to this concern. See, e.g., Halpert, *The Separation of Banking and Commerce Reconsidered*, 13 J. CORP. L. 481, 505-08 (1988).

107. See Rosenstein, *supra* note 8, at 1, col. 3 (Federal Reserve Board Chairman urges Congress to allow banks to diversify to compete effectively with huge diversified foreign banking organizations).

108. Systemic bank failure could have several undesirable effects. Massive bank failures could impair the operation of the payments system. They could deprive the credit markets of liquidity, leading to failures of nonbanking businesses. They could eliminate the investments of small savers. These dangers have led to general agreement that government must play some role in preventing system-wide bank failure. See generally Corri-gan, *supra* note 32 (describing unique functions of banks).

109. Federal deposit insurance currently covers deposits in insured banks up to \$100,000 per depositor. 12 U.S.C. § 1813(m)(1) (1988).

110. For a description of this function, and some examples of Federal Reserve lending to defuse threatened liquidity crises, see W. MELTON, *INSIDE THE FED: MAKING MONETARY POLICY* 153-70 (1985).

111. Regulatory practices such as providing direct financial assistance to troubled banks and arranging mergers of failed banks with healthy banks are intended to avoid the relatively greater cost to the insurance fund of liquidating failed banks and paying off their insured depositors. For a description of current regulatory policy for handling bank failures, see Bovenzi & Murton, *Resolution Costs of Bank Failures*, 1 FDIC BANKING REV. 1 (Fall 1988).

112. Even critics of bank regulation tend to agree on the need for preservation of at least some aspects of the safety net, particularly some form of deposit insurance. See Fischel, Rosenfield & Stillman, *supra* note 79, at 313.

the safety of the banking system or the continued viability of the safety net.¹¹³

As many potential hazards arguably pose this threat, a second test is warranted to narrow the potential field. Assessment of the hazards also should consider whether any potential harm can be prevented through means other than special bank regulation, including competitive market forces, existing legal rules, or common-law remedies such as private litigation. For example, a common argument against permitting banks to sell nonbank financial products such as insurance is the possibility of customer abuses such as tying banking and insurance products.¹¹⁴ The effect of these abuses on bank solvency is indirect: such abuses, if widespread, could undermine confidence in the banking system.

Even if this possibility is real, existing control mechanisms should be sufficient to discourage customer abuses. Banks already are subject to the antitrust laws, as well as special antitying rules applicable to banking organizations.¹¹⁵ Bank entry into the insurance business is not likely to lead to abuses of such a different quality or magnitude that they cannot be handled by existing rules.¹¹⁶ Moreover, since the markets for both bank credit and insurance are competitive, dissatisfied customers can find alternative suppliers who do not insist on tying products.¹¹⁷ Finally, deposit insurance

113. These two threats tend to be linked. Although the failure of a single large bank leaves numerous healthy banks to handle credit needs, the failure could bankrupt the insurance fund. This in turn could result in a loss of depositor confidence in other banks and a system-wide banking crisis.

114. Tie-ins occur when the bank conditions obtaining one product, such as a loan, on the customer's purchasing a second product from the bank, such as credit insurance. See *Alabama Ass'n of Ins. Agents v. Board of Governors of the Fed. Reserve Sys.*, 533 F.2d 224, 249-51 (5th Cir. 1976), *vacated in part*, 558 F.2d 729 (5th Cir. 1977), *cert. denied*, 435 U.S. 904 (1978). The seriousness and frequency of tying arrangements is subject to question. See, e.g., Edwards, *Economics of 'Tying' Arrangements: Some Proposed Guidelines for Bank Holding-Company Regulation*, 6 ANTITRUST L. & ECON. REV. 87, 88-89 (1973).

115. See 12 U.S.C. § 1972 (1988).

116. From an administrative perspective, it may be easier to forbid banks from selling insurance products than to monitor bank behavior to catch tie-ins. Lax enforcement of the antitying rules may allow violations to occur that are not possible when banks are forbidden to sell insurance. Nevertheless, administrative convenience does not justify retaining barriers to bank diversification, particularly if increasing the competitiveness of the banking and insurance markets itself may help to discourage anticompetitive practices like tie-ins. Moreover, similar abuses already can occur within banks that engage in lending and other traditional bank activities, such as trust services. See Hunsicker, *supra* note 80, at 650-54.

117. Most economists agree that, to maintain tie-ins, the seller must possess some monopoly power over the tying product to foreclose competition in the tied product market. See, e.g., Edwards, *supra* note 114, at 89-92.

helps to maintain public confidence in banks generally even if individual bank customers become disillusioned with their own banks.

In sum, the significant hazards created by deregulation are those that, first, pose a serious threat to the banking system and the bank safety net, and second, cannot adequately be controlled by alternative legal or market mechanisms. Such hazards are potentially serious enough to warrant continued regulatory concern even if their occurrence cannot be predicted with certainty. Section II identifies several such new "subtle hazards" and demonstrates why they should be taken seriously when fashioning future bank regulatory policy on diversification.

II. THE NEW SUBTLE HAZARDS

This Section refocuses the ongoing debate over subtle hazards and the risks of deregulation by taking a fresh look at the consequences of bank diversification. The real concerns raised by diversification are not specific abuses by individual bankers, but problems of organization and management that arise when banks enter new businesses. These new subtle hazards are far more serious, and less easily solved, than the subtle hazards identified by *Camp*.¹¹⁸

These new hazards are not necessarily unique to diversified banks. Similar problems affect nonbank diversified conglomerates.¹¹⁹ Yet, for several reasons, these hazards pose a particularly serious threat to banking. The nature of the banking business encourages diversification strategies that increase, rather than decrease, firm risk. Moreover, the presence of a bank within a diversified conglomerate pressures management to make inefficient funding decisions. Finally, combining banking with nonbanking activities creates special problems of integration and control.

A. *The Hazard of Inefficient Diversification*

The most common argument for permitting greater bank diver-

118. These hazards are new only in the sense that, because of the influence of *Camp*, they have not always been appreciated in the debate over deregulation. Although specific hazards, such as the hazard of inefficient funding, may seem similar to the problems identified by *Camp*, this Article suggests a very different explanation for these practices. See *infra* text accompanying notes 216-263.

119. The leading exposition of the benefits of the conglomerate form of organization is O. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* 155-75 (1975). Recently, however, there has been a trend toward the breakup of large diversified conglomerates as a result of market pressure, including "bust-up" takeovers. For a description and explanation of this trend, see Coffee, *supra* note 103, at 15-60.

sification is that diversification can reduce risk.¹²⁰ Like a securities investor, a bank may be able to reduce the variability of its earnings by entering activities whose returns negatively correlate with the returns on traditional banking businesses. Studies of diversification have identified several such activities, including real estate and insurance.¹²¹

Arguments for diversification based on portfolio theory raise two puzzling questions. First, it is curious that proponents of bank diversification do not simply suggest that banks should be permitted to take some of the money that they otherwise would invest in loans or government securities and buy stock in real estate and insurance companies.¹²² Instead, they assume that the risk-reducing effect of investing in a diversified securities portfolio can be duplicated by a bank that acquires and operates different businesses. But diversification by a conglomerate is a very different and more costly process than portfolio diversification by an individual securities investor.

Second, as a practical matter, it is unclear why banks are not efficiently diversified already.¹²³ Diversification does not require investment in a hundred different enterprises. The judicious selection of ten different securities may suffice.¹²⁴ Banks already engage in a variety of nonbanking activities, including numerous securities activities.¹²⁵ The returns of at least some of these activities must negatively correlate with banking. Yet evidence suggests that banks have diversified in an inefficient fashion, apparently choosing their new activities for reasons that have little to do with efficient portfolios. This past experience with diversification may be of use in evaluating how and why banks are likely to diversify if they obtain additional powers.

1. *Can Banks Diversify as Efficiently as Portfolio Investors?*—Developments in the securities markets have made diversification relatively easy for the individual investor. If an investor wants to diversify her securities portfolio to reduce risk, she can choose

120. See *supra* text accompanying note 45.

121. See Heggstad, *supra* note 90, at 222.

122. This Article ultimately proposes a version of this strategy by suggesting that banks should diversify by making minority investments in nonbanking enterprises. See *infra* text accompanying note 347.

123. Diversification is efficient if, for any given level of risk, expected return is as high as possible and, for any given level of expected return, risk is as low as possible. See H. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS 19-26 (1959); see also W. SHARPE, PORTFOLIO THEORY AND CAPITAL MARKETS 130, 178 (1970).

124. See R. BREALEY & S. MYERS, *supra* note 45, at 123.

125. See *supra* text accompanying notes 24-30.

among hundreds of publicly traded stocks and bonds. The liquidity afforded by the trading markets and the availability of public information enable the investor to make portfolio decisions rapidly and at little cost. If the investor has neither the expertise nor the inclination to monitor the risk-return relationships of her investments, she can put her money in a diversified mutual fund, where professionals will diversify for her.

Diversification by a banking organization or other business firm is a very different process. Suppose that a bank decides that insurance is a good portfolio mix with banking. In order to enter this business, the bank must incur substantial start-up costs to train personnel, build a client base, and establish a reputation. Although the bank can draw on its existing customers, these customers may not necessarily prefer the bank to their own insurance company.¹²⁶ Moreover, the bank's customer base may not be large enough to make the new business viable. So the bank will have to invest in advertising, promotions, and other techniques to obtain a foothold in the new business.¹²⁷

Alternatively, the bank can enter the business by purchasing an established insurance company. Such an acquisition may require payment of a substantial premium to the firm's owners. At any time, there may not be many desirable insurance firms for sale, so competition among buyers may be fierce.¹²⁸ Moreover, in buying an established company, the bank may be forced to acquire not just the insurance business, but other businesses, such as consumer finance, that do not fit the bank's ideal portfolio.¹²⁹ The bank then will have to go through the process of divesting or terminating unwanted operations.¹³⁰

126. Banks have discovered that the attractiveness to consumers of so-called "one-stop shopping" for financial products may be outweighed by other considerations, such as quality of service or perceived expertise. For example, banks still are experiencing difficulty convincing their depositors to buy mutual funds from banks rather than from securities firms. See Brenner, *Buyers Unmoved by Bank Mutual Funds*, Am. Banker, Oct. 13, 1988, at 2, col. 1.

127. One thing the bank cannot do is attempt to tie its new insurance products to bank loans. See *supra* text accompanying notes 114-117.

128. For example, when banks began to enter the discount brokerage business in the early 1980s, established brokers were able to demand high premiums to sell their franchises to banks. In 1982, Chase reportedly paid seven times earnings to acquire Rose & Co., at the time one of the leading discount brokerage firms. Horowitz, *Chase May Sell Discount Brokerage Subsidiary*, Am. Banker, Nov. 8, 1988, at 3, col. 2.

129. See *infra* text accompanying note 182 (consumer finance returns positively correlate with those of banking).

130. See Johnson, *The Rationale for Acquisition of Finance Companies by Bank Holding Com-*

More generally, integrating a formerly independent company into the bank's organizational structure often proves costly. Senior management of the insurance company may leave, creating a void that must be filled. Altering the acquired firm's salary structure and benefits, accounting procedures, and management controls to fit the bank's requirements may present additional problems. The bank may have to reassure customers of the acquired firm that the change in ownership will not affect existing services.¹³¹

Once the bank enters a new business, subsequent portfolio adjustments may prove even more difficult than the initial effort to diversify. Proper portfolio management demands that the mix of investments be re-evaluated should risk-return relationships among investments change. For individual investors or a mutual fund, the liquidity of the securities market allows adjustment of portfolio holdings at very little cost. For a business, altering investments is much more difficult. Diversified organizations have been very reluctant to sell or spin off assets. In many cases, deconglomeration has occurred only as a result of a takeover, or the threat of a takeover that forced management to restructure.¹³²

This reluctance of conglomerate management voluntarily to terminate operations may reflect a preference for asset growth.¹³³ Alternatively, at least in the case of banking organizations, selling or terminating activities may impose special costs on the bank. Banks have reason to fear any negative publicity that results from decisions to reduce or terminate operations and employees.¹³⁴ Such decisions often are read by the market as a sign of financial difficulties at the bank rather than efficient portfolio adjustment. This is particularly true when a bank has made a substantial investment to enter a

panies, 92 *BANKING L.J.* 304, 310 (1975) (businesses, unlike individual securities investors, must make "lumpy" investments).

131. The cost of diversification is further increased by bank regulation. Banks may have to obtain approval of one or more bank regulatory agencies to acquire new businesses. *See, e.g.*, 12 U.S.C. § 1843(c)(8) (1988) (Federal Reserve approval required for bank holding company acquisitions of nonbank companies). This cost will not be entirely eliminated by deregulation of banking activities. For example, insurance regulation still may require special regulatory approvals of changes in control of insurance companies.

132. *See* Coffee, *supra* note 103, at 52-60.

133. For a discussion of this explanation of managerial motive, *see id.* at 28-31; *see also* Jessup, *Portfolio Strategies for Bank Holding Companies*, 152 *BANKERS MAG.* 78, 81-82 (1969) (arguing that preference of bank holding company managers for growth may explain bank regulation designed to prevent acquisitions).

134. *See, e.g.*, Duffy, *Citicorp Cuts Trading Staff in UK by 85*, *Am. Banker*, Jan. 13, 1988, at 2, col. 1 (Citicorp denies that serious trading losses suffered in October 1987 stock market crash forced staff layoffs).

new field. Recent cutbacks in fledgling bank securities operations have been viewed as evidence that banks cannot make a success of the securities business.¹³⁵ This type of publicity could adversely affect banks' quest for additional securities powers.

Other factors may account for the reluctance of banks to terminate operations. If a particular business has become unprofitable because of industry-wide conditions, the bank may want to terminate the operation and enter another business. But the bank may not be able to sell the business at a price that recoups the substantial acquisition premium that it originally paid.¹³⁶ Further, the bank may have integrated its new operations so successfully with its existing banking business that they now are almost impossible to separate.¹³⁷ Thus, divestitures by banks are likely to be very expensive.¹³⁸

In any case, efficient diversification may be impossible for many banks. An efficiently diversified portfolio should not be overinvested in any single security. If an investor puts ninety percent of her money in one stock and only ten percent in another, she will not obtain the optimal risk-reducing effect of diversification. Studies of bank diversification have found the most efficient portfolios to be those in which banking and nonbanking assets are equally weighted.¹³⁹

135. See, e.g., Horowitz, *supra* note 128, at 3, col. 3 (Chase's recent decision to get out of the discount brokerage business will "reinforce securities industry arguments that banks don't have the stomach for the volatile retail brokerage business").

136. This may be the case in the discount brokerage business. In the early 1980s, when banks sought and won permission to enter the field, discount brokerage was very profitable. Banks had to pay large premiums to acquire established firms. Since the October 1987 stock market crash, the discount brokerage business has suffered. In 1986, the industry's return on equity was 50%; in the first half of 1988, return on equity was only 5.7%. See Horowitz, *Manufacturers Hanover Slashes Brokerage Staff*, Am. Banker, Oct. 5, 1988, at 2, col. 1. As banks attempt to sell their brokerage businesses, it is very unlikely that they will make a profit, or even recoup their investments. See Horowitz, *supra* note 128, at 3, col. 4 (speculation that Chase will sell its brokerage subsidiary back to its former owner at a discount price).

137. For explanation of why such integration is likely, see *infra* text accompanying notes 251-260.

138. In some cases, regulation itself may force portfolio adjustment. For example, Manufacturers Hanover Corporation made the decision to sell its profitable consumer finance division to improve its capital position in response to regulatory capital requirements. Horowitz, *Hanover Puts Consumer Unit Up for Sale*, Am. Banker, Mar. 4, 1988, at 1, col. 4. Although this decision may have been an efficient portfolio adjustment, it did cost the banking organization a valuable national distribution network. *Id.* at 14, col. 4.

139. See Johnson & Meinster, *Bank Holding Companies: Diversification Opportunities in Non-bank Activities*, 1 E. ECON. J. 316, 322 (1974) (equally weighted portfolios of banking and 12 other activities outperformed portfolios weighted according to industry asset size).

Thus, a little bit of insurance, or securities underwriting, will not have much of an effect on bank risk. Banks should diversify by buying nonbanking assets roughly equal in size to their banking assets. This could present difficulties, especially for large money center banks. A bank such as Chase would have to buy Prudential, or Merrill Lynch, before significant risk-reducing effects would be realized. Yet such a combination would raise antitrust concerns as well as more general public opposition.¹⁴⁰

Bank diversification may be superior to individual diversification in one respect. Because of its superior monitoring ability, a conglomerate should be better than outside investors at assessing the risk-return relationships of its own businesses.¹⁴¹ This should benefit the conglomerate in two ways. First, subject to the limitations already suggested, the conglomerate should be relatively efficient in its choice of investments.¹⁴² Second, investors should be attracted to diversified conglomerates as a way to achieve diversification for themselves.

Nevertheless, recent literature suggests that, in general, conglomerates are not necessarily more successful at diversification than individuals.¹⁴³ One reason may be that monitoring by individual investors has improved, due to the availability of more reliable information about securities investments and the growing importance of sophisticated investors.¹⁴⁴ In addition, in the case of banking organizations, special management problems may interfere with efficient monitoring.¹⁴⁵ In any event, the superiority of conglomerate monitoring seemingly does not justify the substantial premiums that banks must pay to diversify. This is confirmed by the lack of

140. See *supra* text accompanying notes 105-106 (historical concern over concentration of financial power). Legislative proposals to permit bank entry into securities activities have included specific provisions forbidding mergers between the largest banks and securities firms. See Financial Modernization Act of 1988, S. 1886, 100th Cong., 2d Sess., 134 CONG. REC. S3360-62 (daily ed. Mar. 30, 1988) (forbidding affiliations between banking organizations with assets of more than \$30 billion and securities organizations with assets of more than \$15 billion).

141. See O. WILLIAMSON, *supra* note 119, at 132-54.

142. Professor Williamson concedes that the conglomerate is more limited than an individual investor in its ability to diversify by acquiring and divesting assets. *Id.* at 148. Nevertheless, because of its superior monitoring ability, the conglomerate firm can "trade off breadth for depth." *Id.*

143. See, e.g., Coffee, *supra* note 103, at 33 n.88 (citing evidence that diversification at shareholder level has outperformed conglomerate firms); Johnson, *supra* note 130, at 309-10 (individual can "self-diversify" more efficiently than a bank holding company).

144. See Coffee, *supra* note 103, at 34.

145. See *infra* text accompanying notes 264-296.

popularity of conglomerate stocks among investors generally.¹⁴⁶

2. *Are Banks Already Efficiently Diversified?*—Another puzzling question raised by portfolio theory is why banks are not already experiencing the risk-reducing effects of diversification. Despite regulation, banking organizations already can engage in a variety of financial and even some nonfinancial activities. Banks or their affiliates can sell data processing services,¹⁴⁷ lease property,¹⁴⁸ provide courier services for financial documents,¹⁴⁹ operate a credit bureau,¹⁵⁰ privately place corporate securities,¹⁵¹ provide advice on mergers and acquisitions,¹⁵² arrange full service brokerage¹⁵³ and interest rate swaps,¹⁵⁴ and, on a limited basis, even underwrite corporate debt,¹⁵⁵ equity,¹⁵⁶ commercial paper,¹⁵⁷ municipal bonds,¹⁵⁸ asset-backed securities,¹⁵⁹ and consumer-receivable-related securi-

146. See Coffee, *supra* note 103, at 52-60.

147. 12 C.F.R. § 225.25(b)(7) (1989) (nonbank affiliates). Performance of these activities by nonbank affiliates will not reduce risk in the bank itself. But if diversification reduces risk in the banking organization as a whole, the parent holding company should have greater capacity to provide financial support to its banking operations.

148. 12 U.S.C. § 24, seventh (1988) (national banks); 12 C.F.R. § 225.25(b)(5) (1989) (nonbank affiliates).

149. 12 C.F.R. § 225.25(b)(10) (1989).

150. *Id.* § 225.25(b)(24).

151. See COMPTROLLER OF THE CURRENCY, FEDERAL DEPOSIT INSURANCE CORPORATION & FEDERAL RESERVE BOARD, COMMERCIAL BANK PRIVATE PLACEMENT ACTIVITIES 12 (1978) (privately placing securities does not constitute underwriting or dealing in securities prohibited by Glass-Steagall).

152. See *Bank of Nova Scotia*, 74 Fed. Res. Bull. 249, 249-51 (1988); *Signet Banking Corp.*, 73 Fed. Res. Bull. 59, 59-61 (1987).

153. See *Bank of New England Corp.*, 74 Fed. Res. Bull. 700, 700-04 (1988) (allowing bank affiliate to provide investment advice and brokerage in tandem to retail customers).

154. See *Signet Banking Corp.*, *supra* note 152, at 59-61.

155. See *Bank Underwriting Decision*, *supra* note 27, at 195-96 (interpreting § 20 of the Glass-Steagall Act, which forbids affiliations between banks and companies "engaged principally" in underwriting and dealing in securities, to permit a limited amount of underwriting of corporate debt securities by nonbank affiliates of banks). Outside the United States, bank affiliates may underwrite unlimited quantities of corporate debt. 12 C.F.R. § 211.5(d)(13) (1989).

156. See *Bank Underwriting Decision*, *supra* note 27, at 195-96 (§ 20 of the Glass-Steagall Act does not bar limited underwriting of equity securities by nonbank affiliates). Overseas, bank affiliates may underwrite and deal in equity securities subject to limitations of two million dollars per issue per affiliate. 12 C.F.R. § 211.5(d)(13) (1989).

157. See *Citicorp/Morgan/Bankers Trust*, *supra* note 28, at 502.

158. 12 U.S.C. § 24, seventh (1988) (government obligations); see also *Citicorp/Morgan/Bankers Trust*, *supra* note 28, at 502 (industrial revenue bonds).

159. See *Citicorp/Morgan/Bankers Trust*, *supra* note 28, at 502.

ties.¹⁶⁰ Some state-chartered banks may engage in real estate¹⁶¹ and insurance activities.¹⁶²

Presumably, at least some of these nonbanking activities should be a good portfolio mix with banking. Studies have found that portfolios of banking and real estate, data processing, or securities brokerage are more efficient than portfolios of banking alone.¹⁶³ This suggests that banking organizations already should be able to achieve the risk-reducing effects of diversification. Why have banks apparently been so bad at efficient diversification?

One explanation may be that, until quite recently, a bank's choice of permissible nonbanking investments was limited. Banks have received permission to enter activities such as securities underwriting and dealing only in the last few years.¹⁶⁴ Entry into these activities has required banks to go through a lengthy regulatory application process and often a judicial determination of the legality of regulatory approvals.¹⁶⁵ Moreover, permission to engage in new activities has been subject to regulatory restrictions, such as limits on the total amount of permissible nonbanking business¹⁶⁶ and other operating conditions.¹⁶⁷ These conditions, which are intended to conform to existing legislative restrictions on bank securities activi-

160. See *Chemical New York Corp., Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, Manufacturers Hanover Corp. and Security Pacific Corp.*, 73 Fed. Res. Bull. 731, 731-35 (1987).

161. See, e.g., N.Y. BANKING LAW § 98 (McKinney 1971 & Supp. 1989).

162. See *supra* note 21.

163. See, e.g., Eisemann, *supra* note 90, at 73-75. Eisemann concluded that, given the range of permissible nonbanking activities, bank regulation did not prevent banks from diversifying efficiently. *Id.* at 77. *But cf.* Stover, *A Re-Examination of Bank Holding Company Acquisitions*, 13 J. BANK RES. 101, 106 (1982) (regulatory restrictions have constrained bank holding company diversification). Both of these studies were conducted before the recent regulatory interpretations of the Glass-Steagall Act that have permitted at least limited bank entry into virtually every type of securities activity. See *supra* text accompanying notes 151-160.

164. For the dates of such regulatory approvals, see *supra* notes 151-160.

165. See *supra* text accompanying note 31.

166. See, e.g., *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 839 F.2d 44, 66-67 (2d Cir.) (upholding regulatory limitations on revenues from underwriting ineligible securities to 5-10% of underwriting affiliate's gross revenues over a 2-year period), *cert. denied*, 108 S. Ct. 2830 (1988).

167. See, e.g., *Bank Underwriting Decision*, *supra* note 27, at 206-07 (forbidding extensions of credit from bank to underwriting affiliates); see also *infra* text accompanying notes 313-326.

ties¹⁶⁸ or to prevent conflicts of interest,¹⁶⁹ may limit the ability of the bank to achieve the full benefits of diversification.

But even prior to the adoption of regulation limiting bank diversification, banking organizations never were as diversified as such classic conglomerates as ITT or Gulf & Western. Before passage of the Bank Holding Company Act in 1956, very few bank holding companies had substantial nonbanking operations.¹⁷⁰ At least one bank holding company, Transamerica Corporation, had substantial nonbanking interests, but these consisted almost exclusively of insurance operations.¹⁷¹ This experience suggests that banks are unlikely to diversify generally into commercial businesses such as aerospace or manufacturing, even if, for a portfolio investor, the combination of such investments with banking reduces risk.

The reluctance of banking organizations to diversify broadly may indicate that the banking business simply does not mix well with general commercial activities. Most bank holding company managers tend to be bankers rather than experienced conglomerate managers.¹⁷² This may reflect, and perhaps perpetuate, the hands-on management style of most bank holding companies with respect to their subsidiary banks.¹⁷³ The tendency for holding company managers to be bankers is also encouraged by bank regulation. Regulatory policy demands that managers exercise careful supervisory authority over their banks. Bank holding company managers may be held personally liable or even replaced for mismanagement of subsidiary banks.¹⁷⁴ Moreover, should a subsidiary bank fail, bank holding company managers generally lose their jobs.¹⁷⁵ If

168. See *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 839 F.2d at 65 (gross revenue limitation on ineligible securities underwriting is designed to comply with Glass-Steagall Act's requirement that banks not affiliate with companies "engaged principally" in impermissible securities activities).

169. See *infra* text accompanying note 328.

170. See Halpert, *supra* note 106, at 497. Many bank holding companies originally were formed by industrial companies that chose to enter banking not to diversify their businesses, but to ensure a source of credit for themselves or their employees. See Lerner, *Three Financial Problems Facing Bank Holding Companies*, 4 J. MONEY, CREDIT & BANKING 445, 445-46 (1972).

171. See Halpert, *supra* note 106, at 497.

172. This may be changing. One head of Citicorp's consumer banking division was a former mass marketing executive at General Foods Corporation. See Bartlett, *John Reed Bumps into Reality*, N.Y. Times, Feb. 5, 1989, § 3, at 1, col. 2.

173. See *infra* text accompanying notes 272-276.

174. See 12 U.S.C. §§ 1818(b), (i), 1847(b)(1) (1988).

175. If the bank is the holding company's principal asset, failure of the bank usually will result in the bankruptcy of the holding company. In addition, in arranging dispositions of failed banks, the bank regulators recently have tried to ensure that holding com-

bank holding company managers face personal responsibility for problems at subsidiary banks, they have an incentive to monitor banking operations closely. These managers may be less expert at running nonfinancial companies or at operating a fully diversified conglomerate.

Further, public perception of banks and bankers may contribute to the reluctance to diversify too broadly. In banking, as well as other financial businesses that service retail customers, reputation is extraordinarily important. Most consumers view their banks differently from providers of other retail products, such as soap or magazines. Consumers may be reluctant to buy banking products from the same merchant or in the same store from which they purchase lawnmowers or toothpaste. This reluctance may explain the difficulties that companies like K mart have had selling banking services in conjunction with consumer products.¹⁷⁶ Consumers simply have trouble thinking of a major retailer like K mart as a banker like Morgan or Citibank.¹⁷⁷ Experience in countries in which major financial and industrial concerns are linked indicates that this public perception can be altered.¹⁷⁸ Yet the strength of this perception can lead to serious marketing difficulties when a bank is simply a single part of a larger diversified conglomerate.¹⁷⁹

pany managers are replaced. *See, e.g., FDIC Agrees to Assistance Plan for Texas Bank Holding Company Subsidiary Banks*, [1987-1988 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,067 (Sept. 9, 1987) [hereinafter *First City Rescue*] (open bank assistance to First City's troubled subsidiary banks conditioned on removal of incumbent management).

176. A widely publicized program by First Nationwide Bank to sell banking services at convenience branches in K mart stores recently was terminated, as the companies admitted that there was no "natural affinity" between the retail store and the consumer-oriented financial services company. *See Robinson, Attention K mart Shoppers: Banking Hours Are Over*, *Am. Banker*, Feb. 13, 1989, at 3, col. 1.

177. Some diversified conglomerates that have decided to concentrate on financial services have changed their names to erase their non-bank images. First Nationwide Bank, K mart's partner in the venture described *supra* note 176, is now owned by Ford Motor Company, but keeps its old name. *See id.*

178. *See supra* note 105 and accompanying text. If there also are government links with the financial and industrial conglomerates, public perception of the safety and soundness of the bank may be maintained regardless of its association with nonfinancial interests.

179. The experience of commercial companies with the so-called "nonbank banks" provides a telling example. Prior to 1987, many industrial companies took advantage of a loophole in the Bank Holding Company Act to set up limited purpose banks that, because they took deposits but did not make commercial loans, were not "banks" subject to the Act's restrictions on bank affiliation with commercial firms. *See supra* note 39. Yet these deposit-taking entities never became major competitors in the market for deposits. Nonbanking companies, such as Household Finance, found it both difficult and expensive to attract retail deposits to their new banks. *See Gross, Financial Companies Follow Spectrum of Strategies in Era of Deregulation*, *Am. Banker*, May 26, 1987, at 32, col. 1.

Thus, when banks diversify, they are more likely to enter other financial businesses, such as finance, securities, or insurance, than general commercial activities.¹⁸⁰ These financial conglomerates obviously are very different from the classic diversified conglomerate that combines businesses that service very different customers with very different technologies.¹⁸¹ Nevertheless, even within the financial services industry, some activities are a better fit with banking than others. Studies have found that insurance activities are a better portfolio mix with banking than mortgage banking or consumer finance.¹⁸²

Nevertheless, although prior to 1982, bank holding companies were permitted to engage in a number of insurance activities,¹⁸³ consumer finance was a far more popular activity for bank holding companies looking to enter nonbanking businesses.¹⁸⁴ The banks' rationale for acquiring a finance company was not to achieve an efficiently diversified portfolio. Rather, banks saw finance as complementary to their existing businesses in terms of customer base, marketing technique, and technology. Because banks already engaged in mortgage lending, receivables lending, and other finance company activities, acquisition of a finance company allowed banks to offer a full package of complementary credit services to existing bank and finance company customers. Thus, the ability to offer one-stop shopping to financial customers was the principal motive for finance company acquisitions.¹⁸⁵

Gulf & Western (now Paramount Communications Inc.), which also bought a "nonbank bank," eventually made the decision to concentrate on entertainment, and sold its financial services operations. Gulf & Western's decision may represent the general move to deconglomeration that recently has been evident among industrial firms. It also may suggest that financial services companies do not fit well into huge diversified industrial or commercial conglomerates.

180. This also has been the diversification strategy of nonbank providers of financial services, such as Prudential-Bache (insurance and securities) and American Express (international banking, consumer financial services, investment banking, and insurance).

181. Financial services companies are more likely to make concentric acquisitions of companies with common customers or technologies than true conglomerate acquisitions of companies with different customers and technologies from their own. See Kitching, *Why Do Mergers Miscarry?*, HARV. BUS. REV., Nov.-Dec. 1967, at 84-85 (contrasting these types of mergers).

182. See Eisemann, *supra* note 90, at 73.

183. See *supra* note 38.

184. This was particularly true in the 1970s, as bank holding companies first moved into nonbanking activities in large numbers. See Eisemann, *supra* note 90, at 76; Talley, *supra* note 96, at 42.

185. See Johnson, *supra* note 130, at 317-19. According to Johnson, banks may have overestimated the potential for synergy in offering complementary financial services, particularly as some of the products that banks proposed to offer through their new

More recent bank diversification reflects a similar strategy. Initial bank forays into the securities business focused on private placements, securities brokerage, and underwriting commercial paper, municipal revenue bonds and asset-backed securities, each of which activities permitted relatively easy bank entry. Customers for bank private placement and commercial paper underwriting services tend to be drawn from the bank's own customer base of corporate borrowers.¹⁸⁶ A convincing argument made by the banks in requesting permission to place commercial paper was their need to service these traditional bank customers.¹⁸⁷ Likewise, because banks already bought and sold securities for trust accounts and underwrote certain government securities,¹⁸⁸ offering brokerage services to other bank customers and underwriting other kinds of municipal bonds were natural extensions of banks' existing activities.¹⁸⁹

This experience with bank diversification suggests that when banks enter new activities, they are likely to choose their businesses with an eye not to their covariance, but to their coordination with traditional banking activities. This diversification strategy is explained by the nature of the financial services industry. Success in financial services largely depends on achieving a reputation for expertise. Establishing that reputation in turn requires some experience in the financial markets. Companies seeking to issue securities look for an underwriter with the ability to place their securities effi-

finance companies had been abandoned by independent finance companies as unprofitable. *Id.* at 318-19. At least one study of bank holding company performance in consumer finance and mortgage banking in the early 1970s found that the bank-affiliated finance companies were less profitable than their independent competitors. See Talley, *supra* note 96, at 44. This suggests that banks may have miscalculated the appeal to customers of "one-stop shopping" for financial services. Nevertheless, banks would not necessarily have been more successful in their early attempts at diversification had they followed a strategy designed to combine businesses with negatively correlated returns. See *infra* text accompanying notes 192-194.

186. Despite this natural customer base, bank entry into the private placement market has been relatively slow. In 1984, commercial banks had a 12.3% share of the private placement market; in 1987, their share had risen to 26%. See Neustadt, *Banks Encroach on Wall Street's Turf*, *Am. Banker*, Apr. 4, 1988, at 1, col. 1.

187. See, e.g., *Citicorp/Morgan/Bankers Trust*, *supra* note 28, at 490 (bank holding companies will be able to offer their borrowers an additional service and means of financing that may be more economical).

188. These limited securities activities always were permissible under the Glass-Steagall Act. See 12 U.S.C. § 24, seventh (1988).

189. See, e.g., *National Westminster Bank PLC*, 72 Fed. Res. Bull. 584, 586-87 (1986), *aff'd sub nom.* Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 108 S. Ct. 697 (1988); see also Rehm, *Banks Put New Powers to Use*, *Am. Banker*, Aug. 25, 1988, at 1, col. 2 (banks focus on municipal revenue bonds).

ciently and quickly. Such an underwriter must have in place some form of securities distribution network, which can be established through a presence in the secondary trading market.¹⁹⁰ Likewise, leadership in underwriting may be advertised as evidence of skill in corporate finance and used to attract other business, such as advising on mergers and acquisitions. Thus, most financial services are not separate businesses, but interdependent activities.¹⁹¹

The complementary nature of financial products can both help and hinder banks in their efforts to enter new businesses. Some activities, such as arranging interest rate swaps and securitizing assets, are natural extensions of the bank's own business. Banks not only can draw on their existing customer base, but already have expertise in the underlying technology.¹⁹² Banks may have more trouble entering other new businesses. Inexperience in equity trading and underwriting impeded most banks' efforts to enter the business of advising on mergers and acquisitions, which often involves structuring equity deals.¹⁹³ Likewise, banks have been unable to demonstrate to retail customers why they are better sellers of mutual funds than traditional brokers.¹⁹⁴

Further evidence that bank diversification aims for complementary expansion rather than risk reduction is the willingness of banks to enter businesses that may not contribute to bank earnings. Recently, discount brokerage and commercial paper underwriting have been unprofitable both for securities firms¹⁹⁵ and for the new bank entrants.¹⁹⁶ That banks still are entering these activities suggests

190. See Hayes, *Investment Banking: Commercial Banks Inroads*, FED. RESERVE BANK OF ATLANTA ECON. REV., May 1984, at 56, 57.

191. See *id.* at 56.

192. Banks can compete on an equal basis with securities firms in both fields. See Weiner, *Firms Favor Banks for Asset Sales*, Am. Banker, Sept. 12, 1988, at 1, col. 2; Weiner, *Bankers Cite Edge over Rivals in Competitive Swaps Market*, Am. Banker, Apr. 6, 1988, at 1, col. 2.

193. See Horowitz, *Banks Garner Few Domestic Merger Deals*, Am. Banker, Apr. 7, 1988, at 1, col. 2 (in 1987, banks captured only 7.4% of the market as mergers and acquisitions advisers). Banks' role in leveraged buyout lending helped some banks to break into this business. The bank typically arranged the senior credit facility as well as served as adviser to the buyout group. See Horowitz, *Morgan Guaranty Surges on Deal List, Gets Lead Role in Smith-Kline Merger*, Am. Banker, Apr. 14, 1989, at 1, col. 2. Recent problems in the leveraged debt markets have made this business less profitable for banks and their nonbank competitors.

194. See Brenner, *supra* note 126, at 2, col. 1.

195. See Horowitz, *There's Life After Glass-Steagall for Wall Street, Report Says*, Am. Banker, Dec. 2, 1987, at 3, col. 2 (reporting Salomon's termination of its municipal bond and commercial paper underwriting businesses).

196. See Horowitz, *Bankers Trust Cuts Money Market Sales Force*, Am. Banker, Nov. 1,

that banks value these businesses more as a way to expand their client base or to cross-sell financial products to existing customers than for their inherent profitability.¹⁹⁷ In addition, banks may be using these activities to gain experience in the securities business before moving on to more profitable activities, such as underwriting corporate debt and equity.¹⁹⁸

The complementary nature of most financial products and the need to establish a reputation for expertise to gain entry into the financial services business suggest that a strategy of efficient diversification aimed solely at risk reduction may be counterproductive. Choosing a new activity simply because its returns theoretically are negatively correlated with banking returns does not reduce risk if the bank has insufficient reputation, expertise, and contacts to establish a foothold in the new business. Moreover, although banks eventually will gain sufficient experience to compete in virtually any securities, insurance, or other financial business, they still may not enter and exit businesses with an eye to their covariance with banking. Banks may prefer to protect their reputations—and to satisfy customers—by continuing to offer some services even if they are no longer profitable or a good portfolio mix with banking.

The complementary nature of most financial services itself casts some doubt on the ability of banks to reduce risk by entering the securities business or other financial businesses. One reason to allow banks to underwrite corporate securities is that, from the perspective of both the borrower and the bank, corporate lending and underwriting are very much alike. From the borrower's point of view, bank loans and issuances of debt securities are alternative means of obtaining financing.¹⁹⁹ The borrower's choice generally depends on the rates that it must pay on the loan or the securities. Yet, today, these rates are determined largely by the same forces. When interest rates rise, both the lending and securities markets are affected. Corporations seeking to save on rates will consider such

1988, at 2, col. 2; Horowitz, *Manufacturers Hanover Slashes Brokerage Staff*, *Am. Banker*, Oct. 5, 1988, at 2, col. 1.

197. Of course, as in the case of finance company acquisitions, banks may be overestimating the synergy to be gained from combining these businesses with banking. See *supra* note 185.

198. The Federal Reserve Board has concluded that banks' prior experience in private placements and other securities activities should facilitate entry into corporate securities underwriting. See *Bank Underwriting Decision*, *supra* note 27, at 198-99.

199. This is particularly true since the development of the commercial paper market, which allows corporations to obtain short-term funding by selling debt securities without registration under the Securities Act of 1933. See 15 U.S.C. § 77c(a)(3) (1988).

alternatives as borrowing in the foreign rather than in the domestic markets, or going short- or long-term.²⁰⁰

Likewise, from the bank's point of view, making a loan and underwriting securities do not create radically different risks. Both activities require the bank to undertake a credit analysis of its corporate customer to determine the bank's potential risk and to set the rate at which the corporation can obtain funds. Moreover, the bank can sell the loan almost as easily as it sells an issue of corporate securities, either by offering pieces to other banks or "securitizing" its entire portfolio.²⁰¹ Today, an increasing percentage of many banks' earnings is coming from fee income derived from trust services, investment advice, private placements, and other services offered by both banks and traditional securities firms.

Thus, even without radical deregulation, developments in the financial markets are leading to more similarities than differences among financial institutions. The demand for liquidity²⁰² encourages uniformity in financial products, whether offered by banks, securities firms, insurance companies, or other financial institutions. If one financial institution "invents" a new financial product for a corporate customer, it will soon be copied by other financial institutions, which, although adding their own twists in response to regulatory demands or customer needs, will try to keep their product as close to the original as possible.²⁰³ This cloning facilitates the product's acceptance by the market and permits secondary trading in it

200. Historically, bank lending rates have readjusted more slowly than rates on short-term debt securities that are keyed to money market yields. Thus, changes in the business cycle have affected the choice between borrowing from a bank or borrowing from the securities markets. Companies borrowed from banks in periods of rising interest rates and from the debt markets in periods of falling rates. See Hurley, *The Commercial Paper Market*, 63 Fed. Res. Bull. 525, 530-31 (1977). Recently, creative loan pricing, such as basing interest rates on the commercial paper rate, has allowed loan and debt interest rates to move in tandem. Today, the spread between these rates is more likely to reflect the higher administrative expenses associated with bank lending and the credit rating of the individual borrower than any systemic factors.

201. For a description of the process by which banks are packaging and selling interests in pools of their loans, see Roderer, *Securitization of Bank Assets*, 4 REV. FIN. SERVICES REC. 29 (1988).

202. Liquidity in the financial markets means the ability to dispose of financial instruments rapidly without causing a substantial decline in their price. See W. MELTON, *supra* note 110, at 154. This liquidity is facilitated when a new financial instrument is fungible with instruments offered by other issuers.

203. As one banker stated, "One of the great traditions of Wall Street is plagiarism and reciprocity." See Yacik, *Asset-Backed Paper Gains Popularity*, Am. Banker, Oct. 25, 1988, at 22, col. 2 (quoting Richard Gerwitz, manager of Security Pacific's structured finance department).

and similar products.²⁰⁴

If banks, securities firms, and insurance companies already offer the same or similar products, it is unclear how these different businesses really are diverse. Giving banks full securities powers will not grant them entry into an entirely new business, but will enable them to add the few remaining pieces of the puzzle that are needed to participate fully in today's financial markets. The most important remaining difference between banking and other financial businesses may be regulation itself. For example, bank holding companies often choose to use nonbank affiliates to engage in activities such as finance that already are permissible for banks. Their motive is not to enter new businesses, but to avoid restrictive regulation applicable to banks, such as limits on interstate banking,²⁰⁵ interaffiliate funds transfers²⁰⁶ and payment of dividends,²⁰⁷ reserve requirements,²⁰⁸ and deposit insurance premiums.²⁰⁹ In contrast, nonbank financial firms want to set up banks to obtain the advantages provided by bank regulation, such as the deposit insurance guarantee against a liquidity crisis.

If regulation provides the real difference between a bank and a nonbank financial firm, it is unclear why there will be any risk-reducing effect in combining banking and nonbanking financial activities. In fact, such a combination may increase risk for the bank and its

204. An example of a financial market in which many different types of financial institutions are participating is the asset-backed securities market. The bundling of assets into marketable securities, originally used to sell interests in pools of mortgages, was adopted by banks as a way to package and sell their own loans in order to remove them from their balance sheets, thus freeing up capital. See *supra* note 201. Banks and securities firms now offer the same service to corporate clients to enable them to securitize their trade receivables, credit card receivables, and other assets. See, e.g., Miller, *Continental to Launch Fund to Sell LBO-Backed Securities*, Am. Banker, Nov. 2, 1988, at 2, col. 2. As a result, the market for asset-backed securities has grown, enabling more financial firms to enter the business.

205. Nonbank affiliates of bank holding companies are not subject to the Bank Holding Company Act's restrictions on interstate ownership of banks. See 12 U.S.C. § 1842(d) (1988). Recent changes in state law are permitting full interstate banking. See King, Tschinkel & Whitehead, *Interstate Banking Developments in the 1980s*, FED. RESERVE BANK ATLANTA ECON. REV., May-June 1989, at 32. Historically, an important justification for acquiring nonbank affiliates was to establish an interstate network of offices that would be in place when interstate banking became a reality. See Johnson, *supra* note 130, at 330-31.

206. Section 23A of the Federal Reserve Act limits loans and other extensions of credit by banks to their nonbank affiliates. 12 U.S.C. § 371c (1988).

207. See, e.g., *id.* § 60(b) (national banks need regulatory approval to pay dividends in excess of net profits plus retained earnings for two preceding years).

208. See 12 C.F.R. § 204.3 (1989) (banks must maintain reserves against their deposits and Eurocurrency liabilities).

209. See 12 U.S.C. § 1817(b) (1988).

investors. As deregulation proceeds, any remaining regulatory distinctions between banking and nonbanking financial activities will vanish. In particular, the special regulatory protections currently afforded banks, as opposed to nonbanks, will be impossible to maintain.²¹⁰

If the quid pro quo for allowing banks to diversify is some cut-back in the special subsidies that banks now receive, then diversification will impose significant costs on banking organizations. In this respect, it is revealing to note the reaction of the market for bank stocks to greater bank diversification. Today, most publicly owned banking organizations are organized as bank holding companies which already are somewhat diversified. Thus, when they buy bank holding company stock, investors are buying an interest not only in one or more banks, but also in various nonbank affiliates. Yet, over the past few years, the market has tended to discount bank holding company stocks, particularly those of the largest and most diversified banks.²¹¹ Perhaps market participants believe that, whether because of bad management or regulatory constraints, bank holding companies have not diversified as effectively as they might.²¹² Alternatively, investors in banking organizations may not place a great value on conglomerate diversification, preferring to diversify for themselves.²¹³

Nevertheless, evidence suggests that the market may value the bank charter and the regulatory protection that charter provides. Although some banking organizations could conduct most or all of their current operations without a bank charter and thereby avoid costly regulation, banks are very reluctant to relinquish their charters for fear of a severe negative market reaction.²¹⁴ This suggests that, in the view of investors in bank stocks, the potential benefits of diversification may not outweigh the potential costs of losing the

210. The regulators already are responding to greater diversification by banking organizations by distinguishing more carefully between debtholders of the bank and of the bank holding company in working out entitlements to regulatory assistance to troubled banks. Moreover, the cost of handling the failure of huge diversified banking organizations is forcing some reappraisal of deposit insurance coverage. See *infra* text accompanying notes 299-311.

211. See, e.g., Matthews, *Money Center Stocks Weaken, Analysts Find*, Am. Banker, Dec. 15, 1987, at 25, col. 1.

212. Shareholders also may be reacting to these banks' large international exposures. These loan concentrations also are a sign of insufficient diversification.

213. See *supra* text accompanying notes 143-146 (investors' preference for self-diversification over investing in conglomerates).

214. See, e.g., Horowitz, *Chase Backs Off Threat to Drop Bank Charter*, Am. Banker, June 2, 1988, at 1, col. 2.

special subsidies that regulated banks now enjoy.²¹⁵

B. The Hazard of Inefficient Funding

If the risk-reducing effect of diversification is the chief weapon of defenders of deregulation, the danger of inefficient funds transfers is the main string in the bow of its opponents. The risk that banks will use their resources to support their nonbanking operations is one of the subtle hazards identified in *Investment Company Institute v. Camp*.²¹⁶ Why such cross-funding is so dangerous is not explained in *Camp*. *Camp* does suggest that loans to a nonbank affiliate may be unsound, creating a risk of default and losses for the bank.²¹⁷ But regulatory concern over cross-funding reflects more than the possibility that a bank may pour money into its failing nonbank affiliate. Bank regulation has sought to limit any extension of credit or other financial transactions between banks and their nonbank affiliates.²¹⁸

Is the danger of cross-funding still a significant hazard of bank diversification? Critics of regulation argue that a bank has no incentive to subsidize financially troubled operations in ways that threaten the solvency of the bank itself.²¹⁹ Moreover, existing regulation of interaffiliate transactions should suffice to prevent inefficient transfers that may occur as a result of fraud or mismanagement on the part of individual bankers. Nevertheless, these arguments are belied by numerous instances in which, despite regulation, banks have diverted funds to troubled nonbank affiliates. Banks have purchased bad loans from nonbank affiliates, although such transactions violated bank regulation and led to the bank's failure.²²⁰ Banks have made loans to bail out failing nonbank operations, occasionally even with the encouragement of the regulators, as in the case of the real estate investment trusts in the 1970s.²²¹ Most recently, Continental ignored lending limits to rescue its op-

215. This conclusion has not been tested empirically, primarily because no major banks have chosen to give up their bank charters in order to diversify.

216. 401 U.S. 617, 631-32 (1971); see *supra* text accompanying notes 59-62.

217. 401 U.S. at 631.

218. Section 23A of the Federal Reserve Act generally limits financial transactions between a bank and each nonbank affiliate to 10% of the bank's capital and surplus and between a bank and all of its nonbank affiliates to 20% of the bank's capital and surplus. 12 U.S.C. § 371c (1988). These limits do not distinguish between loans to failing and to healthy affiliates.

219. See Fischel, Rosenfield & Stillman, *supra* note 79, at 326-27.

220. See J. SINKEY, PROBLEM AND FAILED INSTITUTIONS IN THE COMMERCIAL BANKING INDUSTRY 202 (1979) (Hamilton National Bank).

221. See *id.* at 237-55.

tions trading subsidiary following the October 1987 stock market crash.²²²

This suggests the need for a closer look at interaffiliate transactions and other funding questions that arise in a diversified banking institution.²²³ Two points may be made about this particular hazard of diversification. First, not all funds transfers from bank to non-bank operations are likely to cause the failure of the bank. Nevertheless, such transfers may defeat the goal of efficient portfolio diversification. Second, in diversified banks, there are incentives for banks to make inefficient funds transfers from banking to nonbanking operations that may result in losses or even failure of the diversified organization.

1. Diversification and Cross-Subsidization.—In a diversified conglomerate, cross-funding among affiliates or operations is not necessarily bad. A frequently cited advantage of the conglomerate form of organization is the conglomerate's ability to engage in efficient funds allocation among its various enterprises.²²⁴ Because of their superior ability to monitor the performance of their own businesses, conglomerate managers theoretically can allocate cash flows to the highest yielding operations more efficiently than a private investor seeking to divide her money among alternative investment securities.²²⁵

In addition, conglomerate managers may allocate funds in ways that private investors would be unlikely to choose, such as taking funds from healthy operations to offset temporary losses in another business.²²⁶ Management's superior knowledge of its operations may permit it to take a longer view of overall funds allocation decisions than the average investor. For example, in a diversified bank, if banking operations are profiting while securities operations are

222. Continental's loan was intended to keep its subsidiary in compliance with its own regulatory and exchange capital requirements following losses suffered as a result of the stock market crash. See Ringer, *First Options' Luster Was Tarnished in Hard Week at Futures Exchange*, Am. Banker, Oct. 28, 1987, at 1, col. 2.

223. Although regulatory limits on cross-funding are directed to transactions between banks and their nonbank affiliates or subsidiaries, funding issues also arise when non-banking activities are located within the bank itself. Because resource allocation within a single company is almost impossible to police, bank regulation has required the location of nonbank activities in separately incorporated affiliates. See *infra* text accompanying notes 314-316.

224. For the most cogent exposition of this thesis, see O. WILLIAMSON, *supra* note 119, at 147-48.

225. *Id.*

226. *Id.* at 164-65.

experiencing cash flow difficulties, management may decide to use bank profits to shore up securities operations. The securities division may be on the verge of launching a "new" security that will garner new business, but the division needs funds now to pay its lawyers.

In the short run, however, this funding strategy may interfere with the risk-reducing aim of diversification. If the banking organization has diversified into nonbanking activities whose returns are negatively correlated with those of banking, then presumably the nonbanking business will fare badly, and require additional funding, under economic conditions in which the traditional banking business is prospering.²²⁷ When conditions are favorable for a particular business, even management mistakes are easy to hide or correct. When industry conditions are poor, the same mistakes may lead to a financial crisis. Thus, in an efficiently diversified banking organization, nonbank operations are likely to require financial assistance from the bank at times when business conditions are good for banking but not good for the nonbanking business.

When business conditions are good for banking, however, the diversified bank could use its profits to invest in additional high return banking ventures or even to increase dividends. If, instead, bank profits are diverted to support troubled nonbanking operations, the diversified bank may be at a competitive disadvantage with respect to undiversified banks. Shareholders looking for short-term profits may disfavor the diversified bank. Yet, if the bank does not support its nonbanking operations, then a significant advantage of conglomeration, and a justification for the high premium that the bank paid to acquire its nonbanking operations, are lost.²²⁸

Thus, the short-term aim of risk reduction through diversification and the long-term advantages of conglomeration may be somewhat at odds. As individual portfolio investors are likely to take a short-term view of risk and return, they may have reason to avoid conglomerates that take the longer view at the expense of immediate earnings. This may be another reason why securities investors prefer to undertake their own diversification rather than to buy conglomerate stock.²²⁹

227. See *supra* text accompanying note 45.

228. See Johnson, *supra* note 130, at 312.

229. See *supra* text accompanying note 146. The affiliate's debtholders may welcome the additional guarantee provided by cross-funding. Holding company debtholders should react negatively to any diversion of resources to benefit creditors of a subsidiary at their expense. See *infra* note 296.

In the case of diversified banking organizations, however, the incentives to engage in cross-funding may outweigh concerns over the equity market's reaction. In a diversified bank holding company, the bank generally is able to raise funds at lower rates than either its nonbank affiliates or its holding company. This may be true even during periods of low profitability for the banking business. Banks always have access to core deposits that pay below-market rates of interest and are not overly sensitive to changes in financial condition at individual banks.²³⁰ In addition, the protection afforded deposits by deposit insurance gives banks a natural funding advantage.

In contrast, to the extent that the nonbank affiliate ever raised funds directly from the capital markets, its access to these markets is affected by changes in its financial condition. At the very time that the affiliate is in need of funding, its ability to raise capital may be impaired.²³¹ The holding company's cost of funds also may be negatively affected by problems at its affiliate. But the bank's access to the deposit market may not be affected at all.²³² In any case, the bank can weather a temporary liquidity crisis by borrowing from the

230. These deposits include noninterest or low interest-bearing transaction accounts, escrow accounts and payroll accounts, which may be costly or inconvenient to move to another bank. See *supra* note 78. There may be occasions when the bank's cost of funds exceeds that of its holding company. This may occur if the bank is relying excessively on wholesale deposits such as jumbo certificates of deposit rather than core deposits and the bank is experiencing financial difficulties, causing wholesale depositors to demand a premium to invest. For example, First Nationwide, a thrift owned by Ford Motor Company, replaced three billion dollars of its high yielding wholesale deposits with advances from its parent company, which could issue commercial paper at lower rates than the thrift could borrow. Robinson, *First Nationwide Reduced Deposits by 17% in Month*, Am. Banker, Feb. 27, 1989, at 1, col. 3. Nevertheless, in most cases, such a difference in funding costs is likely to be short-lived. The inability of a bank to obtain cheap deposits generally is a sign of weakness at the bank (although, in First Nationwide's case, it may have reflected more general problems in the savings and loan industry). Problems at the bank generally begin to affect the holding company's funding costs relatively quickly. In the case of First Nationwide, the size and strength of its parent proved an exception. In most cases, the identity and credit standing of the bank holding company is tied closely to the fortunes of its bank affiliate.

231. Likewise, it may find it costly or impossible to borrow from an unaffiliated bank.

232. The existence of deposit insurance may reassure depositors that the failure of an affiliate will not affect their investments in the bank. Regulation requiring banking organizations to place their nonbanking activities in separate affiliates from the bank is intended to reinforce the notion that the bank will not be affected by failure of a nonbank affiliate. Occasionally, however, depositors may disagree. When Beverly Hills Bancorporation defaulted on its commercial paper, a deposit run began at its subsidiary bank, Beverly Hills National Bank, by depositors who could not distinguish the bank from its holding company. Mayne, *New Directions in Bank Holding Company Supervision*, 95 BANKING L.J. 729, 731 (1978). To avoid any confusion, bank regulators occasionally have required nonbank affiliates to have a different name from their affiliated bank. See, e.g., *National Westminster Bank PLC*, *supra* note 189, at 588.

central bank. Bank holding company management has a strong incentive to use funds from the bank to support nonbank operations.²³³

Thus, bank funding of nonbanking operations has particular advantages in a diversified banking organization.²³⁴ Such funding may not result in short-term profits, but may be in the long-term interest of the entire organization. This assumes that management's funding decisions are efficient and will not jeopardize banking operations. Yet, as will be shown, there may be strong incentives for management to make inefficient funds transfers as well.

2. *Management's Incentives to Make Inefficient Transfers.*—Why would any management make interaffiliate funds transfers that jeopardize healthy operations? Competent and honest managers presumably have no reason to make transfers that could threaten their entire organization. This argument, however, assumes that managers of diversified organizations always make correct assessments of appropriate funding needs and uses.

No management is infallible. Occasionally, most if not all managers make the wrong funding choices. Managers of diversified organizations may feel particular pressure when one or more of their operations is about to fail. The pressure to avoid failure at any cost, even by risking healthy operations to bail out unhealthy ones, may cause managers to make inefficient funding decisions. This pressure is especially strong in banking and other financial services industries. Moreover, as this pressure is created by diversification itself, existing market and legal controls may not be sufficient to offer adequate counterincentives.

a. *Management's Incentive to Resist Failure.*—Most managers of diversified banking organizations will not deliberately choose to cause their bank to fail by diverting bank funds to shore up failing nonbank operations. Nevertheless, most managers will not anticipate the failure of part or all of their business. In order to reach the decision not to support an ailing nonbank operation, managers must admit that the business is beyond saving and that their own mismanagement or lack of skill led to its demise. These conclusions

233. This discussion assumes a holding company structure. When banking and nonbanking activities are combined in a single entity, management may also prefer to use cheap deposits, rather than the more expensive funds that are raised by selling new equity or debt, to fund nonbanking operations.

234. In contrast, management has less incentive to draw upon nonbank operations to fund troubled banking operations. *Cf. infra* text accompanying notes 290-296.

are very hard for most managers to accept. It is easier to believe that the problems are temporary and can be solved by a little funding from the bank.

This resistance to the inevitability of failure may continue even as new funds are squandered and the bank begins to feel the strain. Scholars have noted the importance of "groupthink" in explaining seemingly irrational and inefficient management behavior.²³⁵ The tendency of a management group to suppress information that is contrary to its interests or expectations may lead it to underestimate the severity of a problem.²³⁶ The temptation to minimize problems may be especially strong for banking organizations as they enter new nonbanking businesses. Failure in any of these new activities may lead to public pressure to stop further deregulation on the theory that if banks cannot handle even limited new powers, they certainly should not be given further opportunities for diversification.²³⁷

Therefore, management may underestimate both the extent of the financial problems in nonbank operations and the effect of diverting funds from the bank. Management may even feel justified in flouting legal barriers to interaffiliate lending if it believes that the situation is temporary and that the bank will be reimbursed. Moreover, management's misjudgment is unlikely to be disciplined by market forces. Given the ease and rapidity of funds transfers within a corporation, many investors, particularly depositors, will not be aware of the inefficient allocation of resources until it is too late.²³⁸ If more sophisticated investors, such as bank holding company shareholders and debtholders, do learn of the funds transfers, these investors can react by refusing to supply additional funds to the bank holding company. This, however, actually may increase man-

235. See, e.g., Roe, *Corporate Strategic Reaction to Mass Tort*, 72 VA. L. REV. 1, 14-17 (1986) (explaining tendency of corporate management to underestimate severity of mass tort threat).

236. *Id.* at 15.

237. For example, recent losses and staff cutbacks in the fledgling securities operations of major banks may be read by competitors and the public as an admission of failure in the securities business. See *supra* text accompanying note 135. The problems that banks experienced in their London securities operations in 1986 and 1987 also have been cited by opponents of deregulation as a reason to restrict domestic securities underwriting by banks. The Federal Reserve, however, rejected this argument as a reason to deny new underwriting powers to banks. *Bank Underwriting Decision*, *supra* note 27, at 212.

238. Many depositors simply do not monitor a bank's condition on an ongoing basis, and will not react to any problem until and unless a crisis occurs, such as the bank's imminent collapse. See *supra* note 78.

agement's incentive to rely on bank deposits, particularly core deposits, which remain available to the bank. Thus, any market reaction may exacerbate the problem, hastening the bank's failure.²³⁹

b. *Management's Incentive to Protect Its Reputation.*—From the perspective of a diversified portfolio investor, losses from the failure of any one investment may be offset adequately by profits from successful investments. Management cannot afford to take the same view. Even in a diversified organization, the failure of any single operation is likely to have a significant effect on management's reputation. Shareholders in the diversified organization may doubt the ability of management to operate the remaining businesses.²⁴⁰ The organization as a whole may experience difficulty in obtaining new financing either from the securities markets or from bank lenders, who may distrust management's ability. These risks may lead management to make inefficient funding decisions, such as diverting funds from healthy enterprises, to avoid failure at all costs.

The reputational effects of business failure are particularly acute in the case of banking organizations. The banking business depends heavily on reputation to attract and retain customers. The ideal banker's reputation traditionally was one of conservatism and probity. If a banker was known to have failed in one financial enterprise, a good reputation would be very difficult to maintain. In fact, a banker's reputation might be tarnished if the banker became involved in any speculative or risky operation. This notion is reflected in *Investment Co. Institute v. Camp*,²⁴¹ in which the Supreme Court expressed the fear that aggressive securities practices could damage

239. Some critics argue that neither bank managers nor capital suppliers worry about bank failure, since the cost of failure is imposed on the government. See Macey & Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1162-65 (1988). Recently, the bank regulators have attempted to ensure that managers and shareholders of failed banks and their holding companies lose their investments. See *infra* text accompanying notes 308-311. For example, the regulators may take over and sell a failing bank's healthy assets to another institution, using the proceeds to reimburse bank creditors and government expenses. *Id.* Increasing the burden of bank failure on managers and shareholders actually may strengthen incentives to use bank assets to support nonbank operations. *Id.* If the bank's resources are transferred to its nonbank affiliates, then, even if the bank fails, these assets will be available for bank holding company investors and managers. *Id.*

240. Moreover, the taint of failure may affect a manager's ability to find a new job. See, e.g., Roe, *supra* note 235, at 11 (describing effect of failure on managers of liquidated mass tort firms).

241. 401 U.S. 617 (1971).

the reputation of the banker for prudence and restraint.²⁴²

Changes in the financial markets have altered the banker's image. Nevertheless, in some ways, these changes have made reputation an even more significant factor in the success or failure of a bank. Today, success in the financial services industry depends on the ability to demonstrate experience and expertise in a wide variety of related financial markets.²⁴³ The modern banker needs a reputation for financial acumen as well as a proven track record as a successful manager of risk. If a banker has presided over the failure of an operation, such as securities underwriting, it is unlikely that customers will choose to rely on that banker for other financial services, such as advice on financing or mergers. Moreover, the bank regulators may distrust management's ability to run its banking operations in a risk-averse manner. The regulators may require certain undertakings from the banking organization with respect to future operations, and may even require divestiture of remaining nonbanking operations²⁴⁴ or the resignations of incumbent management.²⁴⁵

Failure of a nonbank operation may have more general effects on public confidence in the bank itself. Although, as a legal matter, liabilities of a nonbank affiliate are not the responsibility of investors in the bank, many depositors are unable or unwilling to make this distinction. This tendency to identify the bank with its affiliates is not irrational. Until recently, most bank holding companies were simply shells set up to hold bank stock, with few if any other assets. Thus, holding company problems were bank problems, and vice versa. Even now, the similarity in names between holding companies and their lead banks promotes confusion, particularly among less sophisticated depositors.²⁴⁶ Foreign depositors also may be unfamiliar with the holding company structure, and assume that a bank and its affiliates are a single entity. Finally, regulatory policies with respect to bank failure continue to blur the distinction between the bank and its affiliated companies.²⁴⁷

242. *Id.* at 632.

243. *See supra* text accompanying notes 190-199.

244. *See* 12 U.S.C. § 1844(e)(1) (1988) (authorizing Federal Reserve Board to force divestiture of nonbank affiliates if their continued operation poses a risk to an affiliated bank).

245. *See id.* § 1818(e)(3).

246. *See supra* note 232.

247. For example, the regulators occasionally have tried to force a bank holding company to contribute nonbank assets to support a failing subsidiary bank. *See infra* text accompanying notes 309-310. This policy understandably exacerbates confusion over the separate identities of bank and nonbank affiliates.

Whether or not public perception has any basis in fact, if management fears that depositors or other investors or customers identify nonbank affiliates with the bank, it has a strong incentive to prevent the failure of an affiliate. This attitude has been expressed by bankers themselves in describing their management policy with respect to nonbank affiliates.²⁴⁸ In addition, the fear that banks are so closely identified with their nonbank operations that the bank will be penalized if its nonbanking business fails occasionally has led even the regulators to encourage banks to bail out nonbank operations.²⁴⁹ This suggests that management will rationalize the use of bank funds to assist troubled nonbanking operations as necessary to prevent the potentially negative impact of failure on the bank itself.²⁵⁰

c. Management's Incentive to Preserve Business Links.—Even if all legal barriers to bank diversification are removed, banks are unlikely to acquire and hold a portfolio of separate and autonomous businesses. All prior bank diversification has involved entry into complementary businesses that can be operated in conjunction with existing banking operations.²⁵¹ Expansion into complementary businesses permits the bank to take advantage of certain economies of scale, particularly the sharing of expensive computer and data processing services and joint marketing and exchange of customer lists.

As banks diversify into complementary product areas, they tend to integrate their new businesses with their traditional banking operations. Initially, banks may keep their new businesses in separate divisions or affiliates.²⁵² Nevertheless, because the bank's new services are marketed to the same customers that already deal with the bank's lending and trust officers, eventually the bank will prefer to

248. Even Walter Wriston, former chairman of Citicorp, admitted that it was "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,' Mr. Wriston added." " 'Lawyers can say you have separation, but the marketplace is persuasive and would not see it that way.' " Garsson, *Building a 'Firewall': Can It Work?*, Am. Banker, Dec. 14, 1987, at 1, col. 2.

249. See, e.g., J. SINKEY, *supra* note 220, at 237-55.

250. If nonbanking operations are located in the bank itself, the need to avoid failure, and the incentive to use depositors' funds to bail out troubled nonbank operations, is even stronger. See *supra* note 233.

251. See *supra* text accompanying notes 183-209.

252. This often is required by law or regulation. See, e.g., *Bank Underwriting Decision*, *supra* note 27, at 195 (underwriting of corporate securities only through separate nonbank affiliates).

reorganize its business to facilitate joint marketing. This integration permits the bank to avoid duplication and to maintain more centralized control of credit appraisal and documentation. Several large banking organizations have reorganized their operations to combine investment and commercial banking functions in divisions or groups oriented toward particular industries or geographic markets.²⁵³ Others have streamlined their operations by providing centralized services, such as data processing, to all of their subsidiary banks and nonbanks.²⁵⁴

This restructuring inevitably increases operational dependencies between traditional banking and the new nonbanking operations. Financial difficulties in one operation not only hurt the earnings of the organization as a whole, but deprive other parts of the entity of essential services. For example, a bank's securities brokerage operation not only may service bank customers, but also may provide execution for the bank's trust department and sell securities underwritten by the bank or another affiliate.²⁵⁵ If the brokerage operation fails, the bank's other businesses may suffer. Thus, the interdependence of operations justifies using bank resources to support a troubled broker or other affiliate.

In addition, the substantial investment in time, human capital, and reputation required to make a success of financial businesses may justify a management strategy that preserves each independent part of the operation. Entry into such activities as securities underwriting or dealing demands some showing of experience and expertise before a bank can gain a sufficiently strong reputation in the market to attract business. Banks have sought to build this reputation in a variety of ways, including paying substantial premiums to buy established and successful businesses,²⁵⁶ wooing experts from nonbank rivals to head new operations,²⁵⁷ and servicing less profitable sectors of the securities market to obtain experience in new

253. See, e.g., Horowitz, *Morgan Revamps Corporate Lending Group*, Am. Banker, Sept. 26, 1988, at 3, col. 2 (reorganization into industry group teams); Fraust, *Chemical Restructures to Merge Investment Banking, Lending*, Am. Banker, Feb. 19, 1987, at 1, col. 2 (one-stop shopping for corporate clients).

254. See Luke, *1st Interstate Begins Round of Staff Layoffs*, Am. Banker, July 5, 1988, at 2, col. 1 (consolidation of back office operations).

255. See, e.g., *Bankers Trust New York Co.*, 74 Fed. Res. Bull. 695, 699 (1988) (authorizing bank brokerage affiliate to recommend or sell securities it underwrites or deals in to institutional customers).

256. See, e.g., *supra* note 128.

257. See, e.g., Neustadt, *Rosenfeld to Run Merchant Bank at Bankers Trust*, Am. Banker, Nov. 10, 1988, at 2, col. 2 (former Salomon chief financial officer hired by bank to run new corporate finance division).

areas.²⁵⁸

Once these substantial start-up investments are made, it is very difficult for management to abandon the business if it begins to experience losses. Moreover, the need to maintain a loyal client base may demand that certain services be provided even when spreads are thin. A bank cannot succeed in the securities business by underwriting issues of securities only when spreads are wide. Successful underwriters must maintain ongoing relationships with both issuers and securities purchasers.

The need to build and maintain a reputation suggests that a successful financial services company must support its operations in lean times. This always has been true in the traditional banking business. Banks are reluctant to refuse to lend to good customers when spreads are thin for fear of losing customer good will that is of value in good times. This need to sustain financial operations was demonstrated by the actions of banks in the 1920s with respect to their securities affiliates. In order to break into the securities business, the banks relied upon their superior ability to distribute securities through their retail branch networks and contacts with correspondent banks. Once banks hired securities salesmen for those offices and provided correspondents with securities, they felt pressure to supply a continuous flow of new securities for their employees to sell and their customers to buy.²⁵⁹

Although to conclude that bankers' need to justify their investments in securities operations was the sole cause of the securities speculation of the 1920s²⁶⁰ may overstate the role of the bank securities affiliates, this example does illustrate the pressures inherent in the financial services industry. A banking organization cannot afford to let the failure of one of its businesses disrupt other services to clients. Therefore, bank management has strong justification to use bank funds to support related financial operations.

d. Management's Incentives and Regulatory Policy.—Ironically, bank regulatory policy unintentionally may provide a motive for management to use bank funds to support an ailing nonbank affiliate. Largely because of regulation, bank deposits are more readily

258. See *supra* text accompanying notes 195-198.

259. 75 CONG. REC. 9911 (1932) (statement of Sen. Bulkley). Senator Bulkley argued that the fixed expenses of the national securities distribution networks set up by banks required the banks to find a sufficient supply of new issues to keep the securities salesmen busy, in some cases even by encouraging underwriting clients to issue new securities when they had no need of financing. *Id.*

260. See *id.*

available, and less expensive, than other sources of funding for a diversified banking organization.²⁶¹ The protection afforded by deposit insurance, the bank's access to the discount window, and regulatory monitoring of bank condition all make investments in a bank safer than investments in a nonbank affiliate.

The ready availability of deposits is likely to affect management's preferences with respect to the use of assets in diversified banking organizations. Should an ailing nonbank operation require funding, management will prefer to use bank funds to assist it, rather than relying on more expensive holding company or nonbank affiliate funds. Moreover, even if this cross-funding jeopardizes the healthy source of funds, the consequences may appear to be less severe when a bank rather than a nonbank affiliate is the source of funding. Management may count on the protection afforded by deposit insurance and the discount window to reassure depositors who fear the effect of any resulting financial drain on the bank's liquidity. In addition, management may count on the bank's regulators to monitor the bank's condition and to sound a warning and take preventive measures before the financial drain leads to failure.²⁶² This suggests that management may have reason to gamble on the bank's ability to survive the strain of inefficient interaffiliate transfers, particularly if, in management's view, the problem at the nonbank affiliate is temporary.²⁶³

261. See *supra* text accompanying note 230.

262. Reliance on the regulators to anticipate problems at the bank may be misplaced. Interaffiliate funds transfers, including those that violate bank regulation, are very difficult for the regulators to discover. If the regulators do find that management has been diverting bank funds to affiliates in violation of regulatory restrictions, they may have limited means of punishing the violation, particularly if the bank is in financial difficulty. Refusing to permit the bank to borrow from the discount window or to provide other financial assistance to the ailing bank may punish bank management. But in deciding what to do about a failing bank, the regulators must consider constituencies other than the bank's management, including depositors, healthy banks that might be affected by the failure, and the insurance fund itself. These considerations may prevent the regulators from indulging in the luxury of revenge against management.

263. Regulation that limits or restricts funding and other asset transfers from banks to nonbank affiliates is intended to discourage this kind of gambling. See *supra* note 218. This regulation may discourage some individual abuses. Nevertheless, management's incentives to bail out a failing nonbank affiliate may outweigh its fear of violating regulatory restrictions. Moreover, as will be described, existing rules do not prevent all opportunities for inefficient funds transfers among affiliates. See *infra* text accompanying note 330. Finally, regulation does not control the transfer of funds between divisions in a single corporate entity. See *supra* note 223.

C. *The Hazard of Inefficient Management*

Use of portfolio theory to evaluate the consequences of bank diversification cannot take into account the special risks associated with managing a diversified enterprise. By investing in different companies with different managers, a portfolio investor has a chance of diversifying away the risk of bad management at any one company. In contrast, a conglomerate cannot eliminate the risk of bad management by adding new divisions or affiliates. If the organization's management is unskilled or inattentive, all of its operations may suffer.²⁶⁴

The risk of bad management is not unique to diversified banking organizations. But the combination of banking and nonbanking activities may create some new risks that increase the opportunities for, and the negative impact of, management error. For example, studies of bank holding company management policies have found that holding company banks tend to be more highly leveraged, and more likely to be operated in a risky manner, than their independent competitors.²⁶⁵ This difference in approach to risk-taking may simply reflect the benefits of diversification, which enables a diversified investor to accept relatively greater risk in any individual investment.²⁶⁶ But examination of management policies in nonbank diversified conglomerates leads to a different conclusion as to the risk preferences of conglomerate managers. These managers' apparent preference for asset growth, even at the expense of profitability, suggests that conglomerate managers are more risk averse than their shareholders, a divergence that explains the market's recent preference for deconglomeration.²⁶⁷

What then differentiates management risk in diversified banks from management risk at any institution? This Section will explore two special risks that appear to result from bank diversification. First, efforts to integrate nonbanking with banking activities tend to

264. See Rhoades, *Interstate Banking and Product Line Expansion: Implications from Available Evidence*, 18 LOY. L.A.L. REV. 1115, 1153 (1985). Diversification studies tend to overlook "operating risk," the risk that managers of an operation will do a relatively poor job. *Id.*

265. See, e.g., Mayne, *A Comparative Study of Bank Holding Company Affiliates and Independent Banks, 1969-1972*, 32 J. FIN. 147, 151 (1977); Mingo, *Managerial Motives, Market Structures and the Performance of Holding Company Banks*, 14 ECON. INQUIRY 411, 420-21 (1976). Evidence of the tendency of holding company banks to accept greater risk relative to independent banks included their lower capital ratios and larger holdings of high yielding, high risk assets. See Mayne, *supra*, at 151; Mingo, *supra*, at 420-21.

266. See *supra* text accompanying note 45.

267. See Coffee, *supra* note 103, at 16-24.

increase the risk of mismanagement in banking institutions. Second, diversification itself creates pressure on management to operate the bank in a more risky fashion.

1. *The Risk of Conglomerate Management.*—Conglomerate management requires special skills that differ from those required for management of undiversified businesses. The principal responsibilities of conglomerate managers are long-term planning and resource allocation.²⁶⁸ Excessive involvement by central managers in the actual operations of the diversified entity not only may be ineffective, given the limits of management's expertise and attention, but also may distort management's perspective on the organization as a whole.²⁶⁹ Ideally, conglomerate managers operate somewhat as portfolio managers of a mutual fund, responsible for funds allocation, performance monitoring, and investment strategy.²⁷⁰

Even after deregulation, banking organizations are never likely to become truly diversified conglomerates.²⁷¹ Nevertheless, the lessons of conglomerate management may be of use to managers of banks that are diversified even on a limited scale. Effective planning and control of a diverse operation require managers to maintain some distance from day-to-day operations. One manager cannot become expert in the details of each individual business.

Yet in banking organizations, management policy has tended to be highly centralized. Studies of bank holding company operating policies have found that holding company managers tend to exercise extensive control over the structures and operations of both bank and nonbank subsidiaries.²⁷² Bank holding company officials often serve as managers of bank and nonbank affiliates.²⁷³ The holding company frequently determines the liability and capital structure of nonbank subsidiaries and may raise all of their funds.²⁷⁴ This intensive management involvement may be encouraged by regulatory policy that assigns responsibility to bank holding company managers for the proper operation of bank and even nonbank sub-

268. See O. WILLIAMSON, *supra* note 119, at 148.

269. See *id.*

270. See *id.* at 148-49.

271. See *supra* text accompanying notes 170-181.

272. See Rose, *Bank Holding Companies as Operational Single Entities*, in THE BANK HOLDING COMPANY MOVEMENT TO 1978: A COMPENDIUM 69, 85-86 (1978).

273. *Id.* at 85.

274. See *id.* Although the studies reviewed by Rose date from the 1970s, more recent research confirms the continuation of this management style. See Eisenbeis, *How Should Bank Holding Companies Be Regulated?*, FED. RESERVE BANK OF ATLANTA ECON. REV., Jan. 1983, at 42, 43.

sidiaries. The regulators evaluate bank holding company management in approving applications for acquisitions of new operations,²⁷⁵ and may penalize management if it engages in practices that directly or indirectly harm the bank.²⁷⁶

This management style creates special problems as bank diversification continues. To the extent that bank holding company managers are usually bankers,²⁷⁷ they may lack expertise in the new nonbanking businesses. Although most of the new financial activities which banks enter today are very similar to traditional banking functions in terms of customer base and even technology, years of legal and regulatory isolation of the banking business from the remainder of the financial services industry have resulted in the development of very different operating philosophies, sales techniques, and management styles. Meshing these distinct corporate cultures has presented problems for banks seeking to enter new financial activities.

This clash of cultures not only is likely to increase the costs of diversifying acquisitions, but also may result in organizational inefficiencies for the banking organization struggling to adapt to new corporate cultures. First, management initially may face high information costs in monitoring newly acquired businesses with performance structures and operating techniques different from those of banking. Second, the bank may have difficulty imposing its own organizational structure and procedures on its new acquisitions. This may defeat some economies of scope, such as the ability to share back office operations, expected from the acquisition. Finally, management's lack of familiarity with the new businesses may distort its assessment of the acquisition's performance and funding needs, leading to inefficient resource allocations. This uncertainty may even cause bank executives to be overly conservative in managing new operations, thereby forgoing profits.²⁷⁸

275. See 12 U.S.C. § 1842(c) (1988) (in considering bank holding company applications for acquisition of new banks, the Federal Reserve Board considers the financial and managerial resources of the bank holding companies and banks involved); 12 C.F.R. § 225.24 (1989) (in considering bank holding company applications for entry into or acquisition of new nonbanking operations, the Board considers the financial and managerial resources of the bank holding company and its subsidiaries as well as any company to be acquired).

276. See *supra* text accompanying note 174.

277. See *supra* text accompanying notes 172-173.

278. These kinds of problems usually are expected in firms attempting to integrate foreign operations, particularly those located in countries culturally dissimilar to the United States. See Gatignon & Anderson, *The Multinational Corporation's Degree of Control over Foreign Subsidiaries: An Empirical Test of a Transition Cost Explanation*, 4 J. L. ECON. &

Many of these problems have arisen as banks have entered the securities business. Some banks have chosen to staff their new operations with personnel hired away from investment banks to gain instant expertise in securities market practices.²⁷⁹ Integration of these investment banking specialists with traditional lending officers has proved difficult. Investment bankers tend to be compensated on a different basis than traditional commercial bankers.²⁸⁰ Investment bankers generally are expert in particular types of financing, while commercial bankers traditionally concentrate on developing individual relationships with a few corporate clients.²⁸¹ These differences inevitably lead to antagonisms between the old and the new bank employees.²⁸²

Efficient integration of the new securities operations also has been complicated by the different client relationships that characterize the investment and commercial banking industries. The securities industry is in the business of selling products to customers. Although long established corporate relationships are significant to some investment banking firms, most firms today are aggressive marketers of services. Corporate customers can afford to pick and choose among competing investment bankers, and are more impressed by the number and variety of financings that a potential investment banker has arranged than by the names on the banker's client list.

Until recently, commercial bankers have not been forced to market their services aggressively. Many bankers assume that aggressive marketing taints the bank's reputation for impartiality and probity.²⁸³ Bankers' reluctance to become aggressive marketers of financial products has hindered banks in selling their new securities services in competition with the investment banks.²⁸⁴

ORGANIZATION 305, 309 (1988). Fifty years of legal isolation has made the corporate culture of investment banking and other nonbank industries very foreign to banks.

279. See, e.g., Neustadt, *supra* note 257, at 2, col. 2 (Bankers Trust hires former chief financial officer at Salomon to head new merchant banking group).

280. Bonuses based on profits traditionally have been far more important—and more lucrative—in the investment banking industry than in the commercial banking industry. See Hayes, *supra* note 190, at 58.

281. See Dickey, *It's a Bird, It's a Plane . . . It's a Bank?*, 5 BANK EXPANSION REP., Oct. 6, 1986, at 1, 10-11; see also Hayes, *supra* note 190, at 58.

282. This antagonism can impair the ability of traditional commercial bankers to market new securities products or to work in conjunction with investment bankers. See Hayes, *supra* note 190, at 58.

283. See *Investment Co. Inst. v. Camp*, 401 U.S. 617, 632 (1971).

284. See, e.g., Shovitz, *Sales Efforts Slumber at Financial Institutions*, Am. Banker, Oct. 31, 1988, at 1, col. 2. Although some securities services such as private placements draw on a bank's existing customer base and thus afford easy entry for banks, entry into even

Of course, the problem of integrating corporate cultures is likely to be temporary. Further experience with diversification should enable most banks to adapt their corporate cultures.²⁸⁵ Nevertheless, the cost of adaptation often is underestimated by proponents of deregulation, who assume that the risk-reducing effect of diversification is automatic.²⁸⁶ Moreover, although banks could lower integration costs by adopting less centralized governance structures for nonbanking operations,²⁸⁷ bank regulation itself encourages highly centralized management.²⁸⁸ This poses a risk for banks seeking to diversify into unfamiliar industries. If operating mistakes at individual banking organizations lead to serious losses or even failure, those banks never will have the chance to adapt to new corporate cultures. This risk is greater if deregulation occurs rapidly. Sudden deregulation may pressure banks to enter too many new businesses too quickly without the luxury of time to adjust their existing organization to new corporate cultures.²⁸⁹

2. *Risky Banks.*—Bank diversification may create another new management risk: the danger that management will operate its traditional banking business in a riskier manner. Several explanations may account for this increased risk at diversified banks. The decision to diversify itself may indicate that management is more

these businesses has been slowed by marketing problems, including bank loan officers' unwillingness or inability to sell securities services to borrowers. See Neustadt, *supra* note 186, at 1, col. 1.

285. Many banks, especially those with longer experience in the securities business, already are doing so. See Dickey, *supra* note 281, at 10.

286. The cost of integrating corporate cultures also may be underestimated by the banks themselves when they enter new businesses. See, e.g., Kutler, *Turnaround at Citicorp Unit Ushers in Era of Glasnost*, Am. Banker, Feb. 8, 1989, at 8, col. 1 (describing problems experienced by Citicorp in integrating independent data processing companies following their acquisition); cf. Kitching, *supra* note 181, at 91-92 (noting that many concentric mergers may fail because management assumes that integration of similar businesses is easy).

287. See Gatignon & Anderson, *supra* note 278, at 307.

288. See *supra* text accompanying notes 272-276.

289. An example of the pitfalls of too rapid an entry into new activities is the record of many participants, including securities affiliates of United States banks, in the London securities market. The affiliates, already experiencing problems in breaking into the competitive London market, had to adjust to the deregulation of London's financial markets in October 1986 and the stock market crash in October 1987. Many affiliates experienced internal control and management problems, which were exacerbated by competitive pressures. See GENERAL ACCOUNTING OFFICE, BANK POWERS: ISSUES RELATED TO REPEAL OF THE GLASS-STEAGALL ACT (GAO/GDC-88-37) (Jan. 1988). Because regulation limited the aggregate exposure of the affiliates, however, no bank experienced major losses. See *supra* note 156 (limits on equity underwriting overseas).

aggressive than average.²⁹⁰ Alternatively, management of a diversified bank may feel pressure to squeeze additional profits from all of its operations to offset the premium paid to acquire new nonbanking businesses.²⁹¹ These answers do not explain why managers of diversified banks are less risk-averse than managers of undiversified banks. Aggressive management may be found in undiversified as well as diversified banks. Acquisitions of banks as well as nonbanks may require payment of substantial premiums.

Diversification itself may create special pressures to operate the bank in a riskier fashion. In an undiversified bank, there is no competition for funding among different businesses. Diversification imposes new demands upon the banking organization for funds. If the bank is not a large contributor to the profits of the organization, investors may pressure management to allocate available funds to more successful operations. This pressure is exacerbated by regulation that imposes costs on the operations of the bank, but not on nonbank affiliates. For example, bank capital requirements impose a minimum capital to asset ratio upon banks.²⁹² These standards effectively require a bank to increase its capital for every new dollar of loans. Management therefore may prefer to take banking profits and invest them in nonbanking operations rather than in additional loans.

Moreover, regulation that restricts the ability of management to shift funds from bank to nonbank affiliates may contribute to pressure to operate the bank in a risky fashion. If management is limited in its ability to adjust the capital and holdings of its bank to assist other affiliates, it will be reluctant to make additional equity investments in its bank affiliate. Management also will look for ways to shift funds out of the bank legally, for example, by causing the bank to pay dividends to its holding company up to the maximum allowed by law.²⁹³

Finally, managers of a diversified banking organization may be reluctant to take funds from nonbanking operations to assist a failing bank. The bank's heavy dependence on deposits for funding means that, upon failure, depositors' claims will exhaust any remain-

290. See Mingo, *supra* note 265, at 413.

291. See *supra* text accompanying note 128.

292. See, e.g., 12 C.F.R. pt. 225, app. A (1989) (state member banks). Bank holding companies also are subject to capital to asset requirements, but the holding company's investment in and the assets of certain nonbank affiliates are excluded from the calculation. See *infra* note 325.

293. See *supra* note 207.

ing assets. If a deposit run occurs, any funds transferred into the bank immediately must be paid out to satisfy depositors. The bank's shareholders (in many cases, a bank holding company) can expect to lose their entire investment.

This risk of loss ordinarily should have the beneficial effect of causing shareholders and managers to avoid bank failure. But the growth of diversified bank holding companies with both bank and nonbank affiliates may affect this aversion to failure. If a subsidiary bank fails, the bank holding company cannot expect to recover its investment. But if the holding company has healthy nonbank affiliates, it can afford to allow the bank to fail. Moreover, the holding company has no incentive to contribute nonbank assets to help repay bank depositors. If nonbank assets can be sheltered from the bank, the deposit insurance fund will bear the cost of reimbursing the bank's depositors after the bank's own assets are exhausted.

Of course, bank failure still has negative consequences for the entire diversified organization, injuring the firm's reputation and ability to offer related financial services.²⁹⁴ Nevertheless, once the bank's problems become known and any resulting damage to the diversified banking organization is inevitable, management may prefer to let the bank fail rather than to deplete nonbanking resources to keep the bank alive.²⁹⁵ In any case, pressure from the organization's capital suppliers may make it difficult for management to justify massive transfers of resources to a troubled bank.²⁹⁶

D. *Why Do the Hazards Matter?*

The previous sections identified three potential hazards that may result from wholesale repeal of restrictions on bank diversification. Nevertheless, the question remains why these hazards should

294. See *supra* text accompanying notes 251-260.

295. This was the strategy of the management of MCorp, a Texas bank holding company that appealed to the Federal Deposit Insurance Corporation (FDIC) for financial assistance for its failing subsidiary banks but refused to contribute healthy nonbank assets to support the bank's capital. Klinkerman, *MCorp Gains Upper Hand in Rescue Talks*, *Am. Banker*, Nov. 8, 1988, at 1, col. 4. Even if the failure of the bank leads to the bankruptcy of the entire diversified organization, more assets will remain for holding company claimants.

296. Bank holding company shareholders and debtholders will resist the transfer of holding company assets to a troubled bank, because those assets will be depleted immediately in paying off depositors. As bank holding company investors are likely to be more sophisticated and better informed than depositors, they are likely to take prompt action to punish such funds transfers by refusing to invest in the holding company. For further discussion of the problems that may arise when a subsidiary bank of a diversified bank holding company fails, see *infra* text accompanying notes 304-311.

be taken seriously in fashioning future bank regulatory policy. Critics of regulation may admit that diversification can increase bank risk in the ways that this Article describes. Yet they still may argue that these consequences of deregulation do not justify regulatory concern.

This suggests the need to evaluate the new subtle hazards by reference to the two guidelines previously suggested for determining the need for regulatory intervention.²⁹⁷ Under these guidelines, the subtle hazards warrant a regulatory response if they interfere with the achievement of a significant regulatory goal in ways that cannot be prevented by alternative control mechanisms. The most significant goal of bank regulation is to prevent the risk of multiple bank failures that could impede the functioning of the banking system. Although quantifying systemic risk has proved very difficult, most observers agree that, at some point, additional bank failures are undesirable and that certain regulatory tools must be in place to prevent them. These tools, which work with varying degrees of effectiveness, include deposit insurance, central bank lending to private banks, and some form of government involvement in dealing with the consequences of bank failure.²⁹⁸

How may the new subtle hazards interfere with this goal of bank regulation? If diversification does not necessarily reduce bank risk, and may actually increase it in the ways that this Article describes, two problems arise for bank regulatory policy. First, more bank risk means more bank failure, both in the short-run during any transition period as banks adjust to deregulation and in the long-run. Second, and perhaps more important, bank diversification itself means that if bank failure occurs, it will become increasingly costly and complex for the regulatory system to handle. These problems, although interrelated, are explored separately in this Section.

1. *The Problem of More Frequent Failure.*—Any bank deregulation is likely to increase the risk of bank failure. In the short-run, the fact of regulatory change itself will have an impact on the industry. Some individual institutions will be unable to adapt to the new competitive environment and will fail. In the long-run, diversification creates new managerial and organizational hazards for banks. These new hazards will make bank management a more difficult task, increasing the chance of mistakes and failure.

297. See *supra* notes 105-117 and accompanying text.

298. See *supra* notes 108-113 and accompanying text.

Some critics may argue that increased failure is not a concern for bank regulatory policy. More frequent bank failure is not undesirable if failure serves to weed out weak and inefficient players. Inefficiently managed banks eventually may fail anyway. Deregulation simply hastens their demise. The threat of failure serves as a warning to other managers to take special care in running their diversified banks.

Even if one accepts the view that failure serves the beneficial function of eliminating weak banks,²⁹⁹ more frequent failure still poses a problem for the regulatory system. So long as the safety net is in place to deal with the consequences of bank failure, the cost of any individual failure must include the cost to the safety net itself. At a minimum, bank failure requires reimbursement of depositors out of the insurance fund. It also may require central bank lending to the failing institution and a substantial investment of regulatory time and effort either to liquidate the bank's assets or arrange an alternative disposition, such as a federally assisted merger.³⁰⁰ Too many bank failures may impose too heavy a burden on this safety net.³⁰¹

One solution to this dilemma is to do something about the safety net. For example, if too many bank failures strain the safety net, portions of the net could be removed, for example, by reducing deposit insurance coverage. Yet these kinds of reforms are apt to spawn their own new risks. Drastic changes in insurance coverage may affect the ability of the deposit insurance system to achieve its goal of preventing systemic risk. If cutbacks in insurance coverage lead to depositor panic and loss of confidence in banks, then the very danger that deposit insurance was designed to prevent may become a reality. Neither regulators nor deregulators can afford to take that risk.³⁰²

299. This assumption is subject to some question. Experience suggests that the nature of the banking business, particularly the constant exposure to liquidity risk, subjects banks to external risks that cannot always be foreseen and prevented even by good managers. See Garten, *supra* note 78, at 153-56. Thus, to assume that bank failure is confined to bad banks is an oversimplification. It may be more accurate to say that the nature of the banking business makes the consequences of management mistakes more serious than in other businesses.

300. See *supra* note 111.

301. This problem was illustrated by the crisis in the savings and loan industry. The thrift insurance fund was not adequate to handle the increased rate of thrift failure. Thrift regulators were reluctant to close insolvent institutions to avoid bankrupting the fund. See McTague, *Many Hands Pulled the Plug on Thrifts*, Am. Banker, Oct. 28, 1988, at 1, col. 2.

302. Ideally, the safety net should be preserved for those situations for which it was

Further, it is unclear why the drastic step of reworking the safety net is necessarily preferable to continuing some regulatory restrictions on bank diversification. The principal benefit that is claimed to result from diversification is that bank risk thereby will be reduced, not increased. If more banks fail as a result of deregulation, then this justification for regulatory reform is flawed. A good example is provided by the savings and loan crisis. Deregulation of permissible thrift investments was intended to help the industry boost its earnings and reduce risk in its traditional narrow lending businesses. Diversification only contributed to the industry's problems, both because of management problems and too rapid deregulation. This in turn put pressure on the insurance fund, prompting restoration of restrictive regulation.³⁰³

This experience offers a lesson for bank regulation. Because repairing damage to the safety net is very difficult, it may be more efficient to deal directly with the new risks of diversification by looking carefully at the need for regulatory reform. The solution may be either to halt further diversification, or to attempt to develop a regulatory approach that can minimize the specific hazards created by diversification.

2. *The Problem of More Complex Failure.*—Perhaps a more serious consequence of bank diversification is what happens after bank failure occurs. Traditionally, bank failure had relatively predictable consequences for the regulatory system, bank investors, and management. The investments of insured depositors, and often even of uninsured creditors of the bank, were protected, either by deposit insurance or by the transfer of the failed bank's liabilities to a healthy bank.³⁰⁴ The bank's assets, consisting principally of loans, were either sold to the acquiring bank or liquidated for the benefit of remaining creditors, including the deposit insurance fund. In either case, the bank's shareholders lost their investments. Bank managers lost their jobs.³⁰⁵

intended, namely, bank failures that pose systemic risks. The safety net should not bear the cost of failures of "bad" banks that serve a beneficial function. Although this is an attractive notion, in practice, it may be impossible to make such a fine distinction between different failures.

303. See Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (to be codified at scattered sections of 12 U.S.C.) (reregulating thrift institutions).

304. See *supra* note 111.

305. The bank regulators also have the option of providing direct financial assistance to prevent a bank from failing. 12 U.S.C. § 1823(c) (1988). As a condition to granting this assistance, however, the regulators generally have required that the bank raise new

If the bank was owned by a holding company, the results were almost identical. Because the bank tended to be the holding company's principal asset, the failure of the bank generally resulted in the bankruptcy of the holding company. The only mystery was whether, in any regulatory disposition of the bank, creditors of the holding company would lose their investments or be protected along with the bank's creditors.³⁰⁶

Diversification by banking organizations greatly complicates procedures for dealing with bank failure. One problem is simply that of size. As banks expand into new activities, the value of the failed bank's assets may be difficult to determine. Arranging the merger of a large diversified bank is harder than selling a small bank. It is unclear how potential purchasers will value nonbanking businesses. Businesses such as brokerages may have few tangible assets, but derive their value from reputation, human capital, and established customer relationships. These firm-specific assets may be worth very little after failure of the bank.

Diversification complicates bank failure policy in another way. Bank failure policy always has had to balance the goal of protecting depositors and the banking system against the danger of removing incentives for managers and investors to operate banks responsibly. Although regulatory dispositions of failed banks result in the protection of all insured depositors and often other creditors of the bank, the regulators have tried to ensure that equityholders and managers pay some price for bank failure.³⁰⁷ When a banking organization has significant nonbank as well as bank affiliates, the failure of a bank does not necessarily result in the bankruptcy of the entire organization and losses for equity investors and managers. These stakeholders have less reason to fear bank failure when the organization has sufficient nonbank assets to survive as an operating

private capital (thereby reducing the interests of existing shareholders) and replace management. See *First City Rescue*, *supra* note 175, at ¶ 87,067 (financial assistance plan conditioned on reduction of existing shareholders' interest to less than three percent and replacement of management).

306. In providing assistance to Continental, the regulators protected creditors of the bank holding company as well as insured and uninsured depositors and other creditors of the bank. See *Morris & Weiner, U.S. Rescues Continental Illinois Corp.*, *Am. Banker*, May 18, 1984, at 1, col. 2. More recently, the regulators have refused to protect holding company creditors. See *Klinkerman, First Republic Creditors Sue FDIC for \$700 Million*, *Am. Banker*, Nov. 4, 1988, at 8, col. 2 (creditors of bankrupt holding company object to regulatory disposition of company's failed bank subsidiaries, which resulted in the transfer of the company's valuable bank assets to an acquiring bank).

307. See *supra* text accompanying note 305.

entity.³⁰⁸

Moreover, although the failure of a bank subsidiary should have a negative effect on the rest of the organization,³⁰⁹ bank failure procedures may unintentionally minimize these costs. Because of the danger of depositor panic, the regulators may prefer to avoid publicity about a bank's problems. The regulators may provide financial assistance to keep a failing bank open. They may attempt to arrange a rapid disposition of the bank to minimize deposit outflows and further cost to the insurance fund. Bank holding company shareholders and managers may emerge from bank failure relatively quickly with nonbanking assets intact.

Finally, the presence of nonbank affiliates may provide management with a bargaining chip when it appeals to the bank regulators for assistance for failing subsidiary banks. The regulators would prefer that the banking organization contribute its own funds to assist in rescuing the bank. Management has no incentive voluntarily to transfer assets from its healthy operations to help pay off bank depositors or facilitate the sale of the failing bank.³¹⁰ In order to persuade management to make such a contribution, the regulators may have to grant concessions or delay disposition of the failing bank, which ultimately may impose greater costs on the insurance fund.³¹¹

The possibility that diversification will complicate bank failure policy is not an insurmountable barrier to deregulation. Nevertheless, before deregulation can proceed, some plan must be in place to deal with the consequences of more frequent and more complex bank failure. These dangers are serious enough to require a transitional approach to deregulation. The aim of such an approach is to permit controlled experimentation with diversification to determine if in fact it will result in hazards to the financial system. The remainder of this Article considers whether such an approach is possible.

III. REGULATING TRANSITIONS: THE FIREWALL SOLUTION

Few proponents of increased bank powers are willing to risk the unpredictable consequences of total deregulation. Reform propos-

308. See *supra* text accompanying notes 294-296.

309. See *supra* text accompanying notes 240-250.

310. See *supra* text accompanying note 295.

311. For example, MCorp's refusal to contribute its nonbanking assets to help bail out its failing subsidiary banks delayed for months the FDIC's efforts to find a solution. See *supra* note 295; see also Klinkerman, *MCorp Rescue Talks Bog Down*, Am. Banker, Jan. 17, 1989, at 1, col. 2.

als have contemplated some continued regulation of bank diversification. Most frequently, this regulation has taken the form of firewalls that are designed to separate, structurally and operationally, the traditional banking business from the new nonbanking businesses. The firewall approach has its philosophical antecedents in conflict of interest regulation developed for diversified nonbank financial firms.³¹² It also reflects the typical organization of a diversified conglomerate with separately operated, nearly autonomous business divisions.

Although firewalls have been part of most legislative proposals to reform the Glass-Steagall Act and other restrictive banking legislation, their real importance results from their inclusion in regulatory and judicial approvals of new bank powers.³¹³ To the extent that banks already have been permitted to diversify, they are conducting their new operations in the shadow of the firewall. Yet as a transitional solution to the hazards of deregulation, the firewall is faultily designed. First, the firewall fails to address the most serious hazards that result from bank diversification. Second, the firewall actually may increase these hazards by mandating organizational and management policies that are both risky and inefficient.

A. The Bricks of the Firewall

The principal goal of firewall regulation is to isolate traditional banking operations, both physically, financially, and legally, from nonbanking activities. Although details may vary, the design of most firewalls is very similar. This Section describes the "bricks" of the typical firewall that has been required as a condition to bank entry into new nonbanking activities.

First, the new nonbanking activities must be conducted in separate subsidiaries from the bank itself.³¹⁴ This legal separation follows the approach of the Bank Holding Company Act, which requires nonbanking activities to be conducted through subsidiaries of the holding company.³¹⁵ Separate incorporation is designed not only to deny creditors of a nonbanking business recourse to bank assets, but also to discourage joint management and decision-making. Thus, certain management interlocks between bank and non-

312. See *supra* text accompanying note 80.

313. See *infra* text accompanying notes 314-326.

314. See, e.g., *Bank Underwriting Decision*, *supra* note 27, at 202 (separate underwriting affiliates).

315. See 12 U.S.C. § 1843(c)(8) (1988).

bank affiliates also have been prohibited.³¹⁶

Second, strict limits are placed on the ability of the bank to fund its nonbank affiliates. Section 23A of the Federal Reserve Act places restrictions on a bank's extensions of credit to or purchases of assets from its nonbank affiliates.³¹⁷ Section 23B requires that transactions between a bank and its nonbank affiliates, including furnishing of services, be on terms comparable to arm's length transactions.³¹⁸ Regulatory approvals of bank entry into particular nonbank activities, such as underwriting corporate securities, have required even higher firewalls, for example, forbidding virtually all lending by a bank to its nonbank affiliate.³¹⁹

Third, nonbank affiliates must make extensive disclosures to customers that they are separate legal entities from the bank and that their obligations are not protected by deposit insurance.³²⁰ Such disclosure is intended to prevent public confusion of the bank with its nonbank affiliates. Occasionally, the nonbank affiliate even has been required to have a different name and separate offices from the bank itself.³²¹

Fourth, some restrictions are placed on the joint marketing of bank and nonbank products. For example, prospectuses and sales literature relating to securities underwritten or traded by an affiliate may not be distributed by the bank.³²² Although banks and their nonbank affiliates may share customer lists, direct solicitation of bank depositors by nonbank affiliates is limited.³²³ Moreover, banks and their affiliates may not share confidential credit information

316. See *National Westminster Bank PLC*, *supra* note 189, at 588 (no officer or director interlocks between bank and brokerage affiliate). *But see Bankers Trust New York Co.*, *supra* note 255, at 698 (permitting bank officer to serve as director of brokerage affiliate).

317. 12 U.S.C. § 371c (1988). Section 23A does not forbid all interaffiliate funds transfers. Banks may make advances to nonbank affiliates in amounts not in excess of 10% of the bank's stock and surplus for each affiliate, *id.* § 371c(a)(1)(A), and 20% for all affiliates, *id.* § 371c(a)(1)(B). Advances secured by United States government obligations or by deposits in the bank are permitted without restriction. *Id.* § 371c(d)(4).

318. 12 U.S.C. § 371c-1 (1988).

319. See *Bank Underwriting Decision*, *supra* note 27, 206-07.

320. See, e.g., *Bank of New England Corp.*, *supra* note 153, at 703.

321. See *National Westminster Bank PLC*, *supra* note 189, at 588. *But cf. J.P. Morgan & Co., Inc.*, 73 Fed. Res. Bull. 810, 813 (1987) (allowing bank and brokerage affiliate to have similar names).

322. See *Citicorp/Morgan/Bankers Trust*, *supra* note 28, at 495.

323. See *Bank of New England Corp.*, *supra* note 153, at 701 n.6 (brokerage affiliate may use bank customer lists for mass mailings but not individual solicitation). *But see Bankers Trust New York Co.*, *supra* note 255, at 697 (bank may introduce institutional clients to affiliated broker's services).

about customers, particularly retail customers.³²⁴

Fifth, nonbank affiliates must be capitalized independently to avoid impairment of the resources of the holding company and the affiliated bank. The holding company may invest in some nonbank affiliates only with capital above the amounts necessary to meet the minimum capital to assets requirements for bank holding companies.³²⁵ In some cases, advances made by the holding company to nonbank affiliates must be deducted from the holding company's capital unless they are fully secured by government or other marketable securities.³²⁶

This summary suggests that the firewall consists principally of rules prohibiting specific conflicts of interest in diversified banking organizations. The firewall is designed to respond to the question left unanswered in *Investment Co. Institute v. Camp*:³²⁷ Why cannot each of the hazards mentioned by *Camp* be prevented by narrowly drawn regulation that addresses the specific undesirable practices? If such rules can be developed, then the rationale for restricting all bank securities activities, or other nonbanking activities, disappears.³²⁸

Is the firewall an adequate solution to the hazards that may result from bank diversification? Although the firewall may be effective in deterring some individual abuses by banks, it does not address the real concerns raised by diversification. Like all conflict of interest rules, the firewall is designed to create counterincentives to temptations for individual banks to engage in abuses. For example, any gain in the form of trading profits that a banking organization can make by revealing confidential information about bank borrowers to a securities affiliate may be outweighed by the high

324. See *Bank of New England Corp.*, *supra* note 153, at 701 n.6 (no exchange of confidential information concerning retail customers); *Canadian Imperial Bank of Commerce*, 74 Fed. Res. Bull. 571, 572 (1988) (exchange of confidential information about institutional customers permitted only with such customers' consent).

325. Thus, investments in nonbank affiliates must be deducted from the bank holding company's consolidated capital in applying regulatory standards. See *Bank Underwriting Decision*, *supra* note 27, at 205.

326. *Id.* at 205-06.

327. 401 U.S. 617 (1971).

328. Critics of firewalls may argue that conflict of interest rules are too easily evaded. Yet the firewall is more sturdy than ordinary conflict of interest rules. For example, placing nonbanking activities in separately incorporated affiliates prevents some opportunities for commingling bank and nonbank funds and other abuses that might be difficult for regulators or investors to detect. In fact, the firewalls occasionally may work too well, creating peculiar management problems for banking organizations. See *infra* text accompanying notes 341-344.

cost of violating rules against exchanging such information, including fines, negative publicity, and loss of reputation. Likewise, the firewall may make some abuses so difficult that most banks may be deterred from attempting violations. For example, forcing banks to put nonbanking operations in separately managed and capitalized affiliates may prevent many opportunities for conflicts of interest that arise within unitary organizations.

Nevertheless, the real hazards created by diversification are not these specific abuses, but more general problems of organization, funding, and management in complex organizations. Since the firewall does not address management's motives to engage in abuses such as inefficient cross-funding, it may not be very effective in deterring such conduct. For example, the existence of rules restricting interaffiliate funds transfers provides some incentive for management to avoid violations for fear of detection and punishment by bank regulators. But if management is motivated by fear of loss of reputation or of essential services as a result of the failure of a nonbank affiliate, even law-abiding management may feel justified in ignoring regulatory restrictions.³²⁹

Further, management has an incentive to find ways to evade the restrictions, thus vitiating their effectiveness. For example, the firewall does not prevent all bank funding of nonbank affiliates. Management of a diversified bank holding company always can obtain funds from the bank by causing it to pay dividends up to the limits allowable under applicable banking laws and then allocating those funds exclusively to nonbank operations.³³⁰ This suggests that when firewalls conflict with organizational incentives, management will rationalize evasions and even violations on the basis of business need, including the interests of depositors and shareholders.

Perhaps the best evidence of the inability of the firewall to address the hazards of diversification is past experience with very similar restrictions. Before the Glass-Steagall Act was passed, a form of

329. See *supra* text accompanying notes 240-263. The Federal Reserve Board has admitted that restrictions on interaffiliate funds transfers frequently have been violated or interpreted creatively by management in times of stress. See *Bank Underwriting Decision*, *supra* note 27, at 206.

330. Restrictions on holding company advances to nonbank affiliates may make this funds allocation more difficult. See *supra* text accompanying note 326. This additional restriction on cross-funding itself was necessitated by the continuing efforts of bankers to scale earlier firewalls. This suggests that any new firewall may impede banks' efforts to fund affiliates for a while, but that banks eventually will find a way to evade it. As incentives to violate the firewall are apparently so strong, perhaps the firewall approach is not the most efficient way to address the problem of cross-funding.

firewall was in place between banks and their securities affiliates. Most banks engaged in securities operations through separately capitalized affiliates which often were not owned by the bank or even the bank's holding company, but directly by the bank's shareholders.³³¹ Moreover, bank shareholders risked double liability on their shares in the event of bank failure.³³² This double liability not only should have provided an additional source of funds for depositors in failing banks, but also should have caused shareholders to put pressure on management to discourage practices that could lead to bank failure.³³³ Nevertheless, these firewalls apparently were not sturdy enough to prevent abuses by banks in 1933. Modern-day firewalls are not likely to be much stronger.

B. *Structural Weaknesses in the Firewall*

In addition to failing to address the significant hazards created by bank diversification, in some cases, the firewall may exacerbate these hazards. By mandating a particular organizational and management structure for diversified banking organizations, the firewall interferes with banks' efforts to integrate new businesses effectively with existing operations. In addition, the organizational structure required by the firewall may have unintended consequences for banks and for bank regulation.

1. *The Incredible Shrinking Bank.*—The firewall forces banks to diversify through a holding company structure. Ideally, this structure allows the banking organization as a whole to obtain the advantages of diversification while discouraging the use of bank assets to support nonbank activities. Moreover, the holding company structure facilitates the construction of other firewalls, such as limits on funding, joint marketing, and sharing information between banking and nonbanking operations.

331. See Note, *Securities Affiliates of National Banks: The Legal Aspects*, 33 COLUM. L. REV. 324, 326 (1933). One reason why direct shareholder ownership of the affiliate was preferable to the bank holding company structure was that courts tended to disregard the separate corporate identities of holding company affiliates. *Id.*

332. For a discussion of these assessability provisions, see Vincens, *On the Demise of Double Liability of Bank Shareholders*, 75 BANKING L.J. 213 (1975).

333. As a practical matter, assessability of bank shares did not provide much additional financial support for depositors. See Note, *Branch, Chain, and Group Banking*, 48 HARV. L. REV. 659, 669 n.77 (1935) (problems in collecting assessments from shareholders). The threat of double liability, however, should have made bank shareholders, including bank holding company shareholders, more risk averse. See *Anderson v. Abbott*, 321 U.S. 349, 357 (1944) (assessing bank holding company shareholders upon failure of subsidiary bank).

Nevertheless, the holding company is unlikely to be the most efficient organizational structure for a diversified bank. Bank diversification is motivated by opportunities for cross-selling related products to existing customers. Thus, any legal separation between banking and nonbanking operations is somewhat artificial. In practice, although nonbanking activities formally are located in separate affiliates, banks are trying to manage their different businesses as integrated operations.³³⁴ As a result, many regulatory restrictions on joint operation, particularly joint marketing of traditional banking and nonbanking products, that originally were imposed as a condition to bank entry into new activities have been either dismantled or ignored. For example, early regulatory approvals of bank entry into securities activities required that the activities be performed through separate affiliates with separate names, employees, and offices from the bank.³³⁵ Recent approvals have permitted more and more joint operations between banks and their securities affiliates, including sharing of customer lists,³³⁶ joint advertising,³³⁷ and even the direct solicitation of bank customers by sellers of nonbank products.³³⁸ This relaxation of restrictions reflects the futility of attempting to prevent integrated development and marketing of functionally related products.³³⁹

Other portions of the firewall also may force banking organizations to adopt inefficient management strategies. Because the firewall restricts management's flexibility in allocating funds among banking and nonbanking operations, it will affect management's diversification strategy. Assume that management is deciding where in the holding company structure to place a profitable new operation. If the operation is located in the bank, the holding company's future ability to draw on its earnings for the benefit of the rest of the organization is limited by the firewall. The bank cannot share its profits with nonbank affiliates. If such affiliates buy services from the bank, management will have to demonstrate that the terms of any interaffiliate transaction replicate an arm's-length bargain. Thus, management may prefer to shrink the bank, locating profita-

334. See *supra* text accompanying notes 252-254.

335. See, e.g., *National Westminster Bank PLC*, *supra* note 189, at 588.

336. See, e.g., *Sovran Financial Corp.*, 74 Fed. Res. Bull. 504, 505 (1988).

337. See, e.g., *Canadian Imperial Bank of Commerce*, *supra* note 324, at 572.

338. See, e.g., *Bankers Trust New York Co.*, *supra* note 255, at 697.

339. See *Canadian Imperial Bank of Commerce*, *supra* note 324, at 571 (removing restrictions on sharing of securities research and recommendations between brokerage affiliate and lending banks on the ground of impossibility of preventing information flows).

ble operations in nonbank affiliates that are not subject to any of these restrictions.

Shrinking the bank has several implications for regulatory policy. Shifting operations out of the bank into nonbank affiliates is likely to increase operational dependencies between banks and their affiliates. This may increase incentives to use bank funds to bail out a failing affiliate.³⁴⁰ Moreover, if banks become smaller and relatively less important components of the diversified banking organization, management will have even less reason to allocate a disproportionate amount of funds to banking operations, particularly when they are experiencing financial difficulties.

2. *The Collapsible Firewall.*—Ironically, in some respects, the firewall may work too well. At times, even the regulators may prefer that banking organizations disregard the walls that they carefully have constructed between affiliates. For example, joint marketing of banking and nonbanking products often is desirable to promote sales of banking services. If the firewall makes it difficult for bankers to acquaint their borrowers with nonbanking services, the banks may lose their customers to competing nonbank firms. Thus, the firewall itself may contribute to the banks' problems in successfully selling their new financial products.³⁴¹

The firewall may even have some undesirable effects in the event of failure of one or more parts of the diversified banking organization. If a nonbank affiliate is failing, the firewall prevents use of bank assets to bail out the affiliate. Even the bank regulators occasionally encourage banks to support their nonbank affiliates when the failure of those affiliates would have a direct negative impact on the bank itself.³⁴²

If a bank is failing, the regulators do not want the firewall to restrict use of nonbank assets to bail out the bank. In fact, the regulators prefer that such cross-funding takes place. Allowing the bank to have access to nonbank assets in the event of bank failure not only makes failure resolution cheaper, but also encourages management and shareholders of the diversified banking organization to operate the bank in a manner that minimizes the chance of failure.

Although the firewall does not prevent the use of nonbank as-

340. See *supra* text accompanying note 255.

341. Recognition of this problem has led to the dismantling of some firewalls, particularly restrictions on cross-marketing of banking and nonbanking services. See *supra* text accompanying notes 336-339.

342. See *supra* text accompanying notes 220-221.

sets to benefit the bank, it may frustrate efforts by the regulators to compel such a contribution. The more solid the firewall, the harder it becomes for the regulators to take the position that nonbank affiliates are not independent entities and should be collapsed into the bank upon insolvency. Moreover, if the firewall successfully prevents bank funding of nonbank affiliates, the regulators cannot argue that nonbank assets were bought with bank funds or otherwise belong to the bank.

Thus, even the regulators may not favor impregnable firewalls. The ideal firewall would be collapsible, to be removed on occasions when joint operation, funding, and management of bank and nonbank affiliates makes regulatory sense. Yet designing this kind of firewall is impossible. If bank holding companies were prohibited from transferring bank funds to nonbanking operations, but were required to use nonbank funds to bail out failing banking operations,³⁴³ the result would be undesirable for the bank holding company, its investors, and ultimately the regulatory system. Investors in diversified bank holding companies would insist on high premiums to compensate for the increased risk.³⁴⁴ If the bank holding company's cost of funds became too high, management would feel even greater pressure to ignore the firewall and raise funds for the entire organization through the bank. Otherwise, the holding company would have no nonbank assets that could be reached by the regulators in the event of bank failure.

More fundamentally, the preference for a collapsible firewall suggests a basic problem with the firewall approach. The firewall is not a transitional solution to the potential problems of deregulation, but a permanent regulatory structure that will shape the organization of diversified banks. Like the regulatory restrictions it is replacing, the firewall will have an impact on the future organization, management, and operation of the banking industry. Yet limited experience with the firewall shows that some of these effects are undesirable. This suggests that a better transitional approach to deregulation is one that is more easily dismantled should experience demonstrate that the new regulatory approach is unwise.

343. The Federal Reserve Board has taken the position that bank holding companies must serve as a source of "financial and managerial strength" to their subsidiary banks. 12 C.F.R. § 225.4(a)(1) (1989).

344. See Klinkerman, *Texas Bank Rescues Pit Wall Street Investors Against Regulators*, *Am. Banker*, Nov. 29, 1988, at 3, col. 1 (investors will view holding company debt as junk bonds).

IV. REGULATING TRANSITIONS: DIVERSIFICATION BY MINORITY EQUITY INVESTMENT IN NONBANK VENTURES

This Article makes three points about the hazards of deregulation of banking. First, the real hazards of deregulation are not specific abuses that can be discouraged through preventive rules, but problems of organization, structure, and management that arise when banks attempt to diversify into new businesses. Second, these hazards pose a sufficient threat to bank regulatory goals to warrant a transitional approach to deregulation. Third, fashioning such a transitional approach may create its own new hazards. This difficulty in fashioning a transitional approach to deregulation reflects the dilemma posed at the beginning of the Article: If the consequences of deregulation are unpredictable, how can the debate over regulatory reform be resolved?

Any transitional approach to deregulation can best address this question by allowing some controlled experimentation with deregulation in order to measure the consequences of regulatory change. In banking law reform, such an approach would test whether banks can in fact obtain the risk-reducing benefits of diversification without creating the organizational, funding, and management hazards that may defeat any gains from deregulation and pose a risk to the regulatory system.

Viewed in this way, a transitional approach to bank diversification suggests itself. Ultimately, the hazards of diversification are the product of the organizational structure of diversified banks. If banks diversify by buying entire new businesses, they incur substantial investment and integration costs. The pressures of conglomerate management create incentives for inefficient resource allocation and strategic decision-making. This suggests that diversifying by acquiring new business entities may create too many risks for banks. But there are other ways in which banks can diversify. Banks can buy a minority equity stake in a nonbanking business, or hold a minority interest in a joint venture with a nonbanking firm. This form of investment enables banks to experiment with diversification while sharing the risks of organizing, funding, and managing unfamiliar operations.

This form of investment is not new for banks. Banks already invest in and participate in joint ventures with nonbanking firms, although the extent of their interests in such ventures is limited by

existing regulation.³⁴⁵ These investments have not been large enough to permit banks to experience the effects of diversification. Allowing larger minority investments in nonbanking ventures, for example, ranging from twenty-five to forty-nine percent of the equity of the business, would enable banks to test the consequences of diversification.

As a transitional policy, permitting banks to diversify by making minority investments has several advantages. First, it allows banks to share funding and operational risks with one or more partners. Second, it lowers the cost of investing in and divesting diverse businesses. Third, it substantially reduces information costs for banks entering unfamiliar ventures. Fourth, it somewhat diminishes incentives for inefficient cross-funding and other abuses of the bank for the benefit of nonbank operations. Finally, and perhaps most significant, it facilitates banks' move toward more integrated organizational structures after banks gain experience in managing diversification risk.³⁴⁶

A. Minority Ownership as a Means of Risk Sharing

Diversification by acquisition of entire businesses requires banks to incur considerable start-up costs as well as the longer term expense of integrating new operations into existing organizational structures. Diversification by minority investment in nonbank ventures can reduce these costs substantially. Because the risk of loss is shared with a partner, the bank's financial commitment to the new venture is reduced, requiring smaller capital contributions. In addition, the bank's managerial responsibility is reduced. As a substantial minority participant, the bank will elect some percentage of the board of directors and influence operating policy. But the bank will not exercise the tight control that characterizes bank holding com-

345. The Bank Holding Company Act limits bank holding company investments in voting equity of nonbanking ventures to five percent. 12 U.S.C. § 1843(c)(6) (1988).

346. Significantly, banks have begun voluntarily to diversify into new businesses through joint ventures even when regulation does not prevent sole ownership. *See, e.g., Dresdner Bank AG*, 75 Fed. Res. Bull. 642 (1989) (joint venture with investment adviser that engages only in activities permissible for a bank holding company). In one case, a bank holding company even sold a minority stake in one of its wholly owned nonbank ventures to an international bank. Carlson, *Mitsui Bank to Buy Stake in Security Pacific Unit*, *Am. Banker*, June 14, 1989, at 3, col. 2. These "strategic alliances" will facilitate banks' entry into unfamiliar markets and permit banks to share the funding costs of risky new operations. These and other advantages of shared control may make diversification through joint venture the preferred approach of a deregulated banking industry even without legislation mandating this diversification strategy.

pany management of affiliates.³⁴⁷

Shared control offers several benefits for the newly diversified bank. Initially, loose control may be a more efficient organizational approach for banks entering businesses with very different corporate cultures and operating procedures from the banking business. Banks often underestimate the cost of integrating newly acquired operations into their highly centralized organizational structures.³⁴⁸ More limited investments in nonbank ventures maintain the separation of bank and nonbank, avoiding integration problems.³⁴⁹ In addition, because the nonbank operation is not wholly controlled by the bank, public awareness of the separation of the bank from its nonbank investment is facilitated. Depositors are less likely to identify the nonbank venture with the bank.

Thus, a minority investment achieves the legal and operational separation of banks from their nonbank ventures that is the goal of the firewall approach. Unlike the firewall, however, a minority investment permits mutually beneficial joint transactions between the bank and the nonbank venture without creating the risk of inefficient wealth transfers, conflicts of interest, and other abuses that may threaten the bank. Because the bank is not the sole stakeholder in the nonbank venture, transactions between the bank and nonbank can be negotiated on an arm's-length basis. If the bank expects to receive only part of the profits from the venture, there is no incentive to enter into arrangements that benefit the nonbank venture at the expense of the bank.

B. Minority Ownership as a Means of Facilitating Efficient Portfolio Adjustment

Diversification by acquisition of entire businesses is a more expensive and unwieldy process than the purchase and sale of securities by portfolio investors. For this reason, firms are unlikely to hold efficiently diversified portfolios, or to make efficient portfolio alterations, by buying and selling subsidiaries.

Diversification by minority investment in nonbank ventures per-

347. See *supra* text accompanying notes 272-274.

348. See *supra* text accompanying notes 277-287.

349. Loose control can create monitoring problems. This is a concern for banks, since regulation forces bank managers to assume enhanced responsibility for problems in any part of the bank's operations. See *supra* text accompanying notes 275-276. But when a bank is unfamiliar with its new operations, monitoring is of limited utility. The bank may be better off relying on an experienced partner for monitoring until it gains sufficient expertise in the new business. See *infra* text accompanying note 350.

mits more efficient portfolio adjustment. Such investments allow a broader diversification strategy than mergers or acquisitions of whole firms. Investing in a minority block of stock requires less cash outlay than buying an entire company. The bank may be able to invest in several different ventures rather than buying a single business. Further, the bank may have a wider choice of potential investments if it limits its investment to a minority interest. Many nonbank firms may welcome an infusion of capital from a bank, as well as the opportunity for profitable joint ventures, in exchange for a minority equity stake. These firms may resist a takeover by the bank.

In addition, should the bank's diversification strategy change, a minority equity investment is easier to dispose of than a fully integrated subsidiary. Even a substantial block of equity is easier to price and to market than a wholly owned business. The bank's partner is an obvious candidate to purchase the bank's interest should the venture prove unsatisfactory to either party. The bank and nonbank have reason to negotiate some kind of call provision in the bank's investment contract in order to provide both parties with the flexibility to terminate the arrangement.

C. Minority Ownership as a Means of Economizing on Information Costs

Diversification by acquisition of entire businesses can fail if the bank underestimates the cost of learning a new business. The bank must train personnel to understand new operations, adapt its existing technologies to new business cultures, and establish effective monitoring systems.³⁵⁰ Diversification by minority investment in nonbank ventures permits the bank to rely on its partner's expertise for many day-to-day operations. Moreover, the presence of an experienced partner can facilitate the rapid education of bank personnel in the new business. Bank employees can be rotated to the nonbank venture to work with experienced nonbank managers.

Of course, reliance on agents for day-to-day management creates opportunities for shirking or opportunism. The bank may have difficulty monitoring the performance of its partner. The bank's partner may have incentives to appropriate most of the value of nonbank venture for itself. But similar agency problems affect banks' wholly owned nonbank operations. If bank managers are unfamiliar with a newly acquired business, their monitoring will be in-

350. These information costs are part of the general costs of integrating new acquisitions into existing management structures. See *supra* text accompanying notes 347-349.

adequate. They will be forced to rely on existing personnel who remain with the acquired company for day-to-day management. These employees may have no loyalty to the bank. Thus, the problem of monitoring is less a function of the bank's organizational structure than of information costs as banks enter unfamiliar businesses.

In view of these high information costs, shared ownership of nonbank operations may solve agency problems more effectively than other organizational structures. The isolation of the banking industry from other financial and nonfinancial businesses has not just affected bankers' learning curves. Nonbankers are unfamiliar with the special business and regulatory environment of banking. In any joint venture between a bank and a nonbank, the nonbank must rely on the bank's expertise as to matters peculiar to banking and bank regulation. For example, if a bank and an insurance company form a joint venture to market new hybrid bank-insurance products, each partner must rely on the other's expertise as to special legal or business considerations that affect the development and marketing of products. Both the bank and the nonbank are in a mutually dependent relationship, discouraging opportunistic behavior by either partner.

As both partners gain expertise in the other's business, their mutual dependence will break down. Each partner then will become more concerned with safeguarding its own proprietary information and skills than with gaining new information from the other. At this point, information costs no longer provide a motive for joint control, and the arrangement may terminate. In fact, one advantage of allowing diversification by minority investment is the ease with which the ownership structure can be altered as banks gain experience with nonbank ventures.

D. Minority Ownership as a Means of Discouraging Inefficient Funds Transfers

Diversification by acquisition of entire businesses may create pressures for inefficient cross-funding and other abuses of the bank for the benefit of nonbank affiliates. Diversification by minority investment in nonbank ventures may somewhat relieve these pressures. Management should have less incentive to use bank funds to bail out a nonbanking operation in which it has only a minority stake. If bank funds are used to keep the nonbank venture profitable, the bank can expect to receive no more than forty-nine percent

of the profits. Yet if the bank fails, its losses cannot be shared with a partner.

Of course, the bank will have joint operations with the nonbank that may suffer if the nonbank venture fails. If such joint operations are extensive, some incentives for cross-funding remain.³⁵¹ Yet, as previously discussed, these joint operations provide a significant motive for bank diversification.³⁵² Thus, any diversification provides a reason for inefficient cross-funding. Limiting banks to minority investments in nonbank ventures offers some counterincentives.

E. Minority Ownership as a Means of Facilitating Regulatory Transition

Diversification by acquisition of entire businesses poses a dilemma for bank regulation. Deregulation of bank product restrictions will leave banks free to acquire nonbanks with few if any regulatory controls. The potential hazards of unregulated diversification, however, make wholesale deregulation unlikely. Realists will seek a transitional approach that permits some experimentation with diversification without greatly increasing bank risk. The form that this transitional approach takes will affect how, and how effectively, banks diversify.

As a transitional approach, diversification by minority investment in nonbank ventures has the advantage of flexibility. Banks can gain some experience with nonbank ventures without risking the hazards of running nonbanking companies by themselves. If, after a time, it appears that no hazards are likely to result from further bank diversification, it is a simple matter to allow full ownership of nonbanking firms by banks. Because most banks will have existing stakes in nonbank ventures, they can simply buy out their partners and continue to manage operations with which they have gained familiarity.³⁵³ In contrast, if regulation is simply repealed and, in a

351. See *supra* text accompanying notes 251-255.

352. See *supra* text accompanying notes 192-204.

353. This transitional approach also offers the advantage of minimum legislative involvement. Removal of statutory restrictions on bank diversification requires congressional action. After that, the authority to set specific limits on bank investments in nonbank ventures could be delegated to the bank regulators. Should bank experience with minority investments prove satisfactory, allowing full bank ownership of nonbanks would not require a return to Congress, but could be authorized by the regulators. In contrast, if experience with totally unregulated diversification proves dangerous to the banking system, only Congress can restore regulatory limits on bank investments in nonbanks.

year or two, the results are undesirable, it may be impossible to return to the good old days of 1990.

CONCLUSION

In banking, the only remaining barrier to deregulation is the unpredictability of its consequences. In a regulatory environment in which the failure of a single large bank could wipe out the entire deposit insurance fund, the hazards that may result from deregulation must be taken seriously. This Article has identified three new subtle hazards that may make total deregulation of banking undesirable. These hazards suggest the need for a transitional strategy that allows banks some experience with diversification while minimizing opportunities for organizational, funding, and management problems that may result in more frequent and costly bank failure.