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The One-Bank Holding Company Conglomerate: Analysis and Evaluatiou

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I. INTRODUCTION

The last few years may mark a turning point in the evolution of our financial structure. One-bank holding companies, which for decades were a dormant and inconspicuous part of the financial structure, surged into popularity as a device for circumventing the restrictiveness of bank regulation. During the three-year period from 1965 to 1968, the number of one-bank holding companies increased by more than 200.[1] More important, in 1968 a sudden change occurred: most of our largest banks decided to form holding companies. First National City Bank of New York, Chase Manhattan, Bank of America, and six more of the twelve largest banks in the country either formed or announced plans to form one-bank holding companies.

While this interest on the part of large banks is new, the idea of one-bank holding companies is not. In fact, the current surge in activity represents the acceleration of an existing trend rather than the beginning of a new trend. For example, in 1955 there were 117 one-bank holding companies in existence; in 1965 there were 550; and today there are more than 800. In terms of the volume of bank assets or deposits controlled by these companies, the trend is even more striking—by the end of 1968 over 27 percent of the deposits held by insured banks were controlled by existing or proposed one-bank holding companies.[2]

Not surprisingly, this acceleration of activity has evoked a strong reaction and, for a variety of reasons, has provoked hurried calls for restraining legislation. To some observers, the trend toward one-bank holding companies dramatically symbolizes the continuing threat of big business to break out of the regulatory bonds which purportedly

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1. HOUSE COMM. ON BANKING AND CURRENCY, 91st CONG., 1st SESS., THE GROWTH OF UNREGISTERED BANK HOLDING COMPANIES—PROBLEMS AND PROSPECTS 1 (Comm. Print 1969) [hereinafter cited as BANKING AND CURRENCY PRINT]. As of December 31, 1968, 34 of the 100 largest banks either have formed or announced plans to form one-bank holding companies.

2. *Id.* at 1, 5.

protect the public against the economic tyrannies of the nineteenth century business cartels.[3] Indeed, for those who harbor this fear and wish to legislate one-bank holding companies out of existence, bank holding companies may be merely an initial skirmish preliminary to an all-out assault on "super-corporations."

The one-bank holding company is an attractive target. First, the image of large banks growing even more powerful has always been an anathema to a large segment of Americans of populist heritage; secondly, banks are normally held to a higher duty to society because of their special and privileged role as guardians of our money; and, lastly, since banking is already a highly regulated industry, further regulation may not evoke as much political opposition.

The fanatical trustbuster is not the only opposition. There is opposition from those who, after careful consideration, have concluded that one-bank holding companies are not in the public interest. Most members of the Federal Reserve Board fall into this category. There is also the usual opposition from varied special interest groups, who for one reason or another feel threatened by holding companies. For example, multi-bank holding companies may oppose one-bank companies because they (multi-bank companies) do not have the same privileges of engaging in non-banking activities and therefore are at a distinct competitive disadvantage.[4] Small banks, on the other hand, fear a take-over by large banks, and many big banks are fearful of being acquired by aggressive non-bank corporations.[5]

Thus, in response to strong opposition, the political tide is slowly moving towards restrictive legislation that may well spell the demise of the one-bank holding company movement.[6] But regardless of its form, the legislation ultimately adopted is certain to have an important

3. "[T]he entire structure of the American economy is being changed through conglomerates centered around banking institutions. This is clearly a threat to everyone—both inside and outside the financial community—and it is essential that the Congress act quickly to provide meaningful remedies." 115 CONG. REC. 902 (daily ed. Feb. 17, 1969) (remarks of Representative Patman).

4. Multi-bank holding companies are registered and regulated by the Federal Reserve Board and are prohibited by law from owning non-banking subsidiaries. Although they would probably prefer to possess additional non-banking powers, their safest course may be to support a position against the broadening of such powers. Existing holding companies have the advantage of owning many banks.

5. Leasco Corporation's proposed tender offer for the stock of Chemical Bank of New York in February, 1969, was a bomb which awakened bankers to the competitive threat of "outsiders."

6. On June 27, 1968, the House Banking and Currency Committee reported out legislation which would severly curb the activities of banking conglomerates. *See* N.Y. Times, June 28, 1969, at 37, col. 5.

influence on the future of our financial structure since many of the basic structural aspects are at issue. It therefore provides Congress with a golden opportunity to make fundamental changes.[7] In effect, Congress's task is to reappraise our financial system with a view towards determining whether its underlying structure is still compatible with present goals and contemporary needs and, if not, to determine whether one-bank holding companies can make a meaningful contribution towards altering its structure.[8]

The purpose of this paper is to explore, analyze, and evaluate the issues raised by the controversy over one-bank holding companies. If, however, it succeeds in merely exposing the essence of these issues, the author will consider it a success. Although in the following discussion evaluations are made and conclusions drawn, these are obviously provisional judgments which await the results of more thorough research.

II. An Explanation For The Growth of One-Bank Holding Companies

A. *What Are One-Bank Holding Companies*

One-bank holding companies are the bank holding companies exempt from registration (and therefore regulation) under the Bank Holding Company Act of 1956.[9] That Act basically requires all holding companies which own 25 percent or more of the stock of two or more commercial banks to register with the Federal Reserve Board. (This explains why one-bank holding companies are often referred to as "unregistered" bank holding companies.) Thus, if a company owns all of the stock of only one bank or less than 25 percent in each of several banks, it is exempt from registration. This is true even though the company has effective control over these banks through closely affiliated corporations, through multi-bank stock holdings of its directors, or through its trust investments.

Registration with the Federal Reserve Board carries with it several

7. Some changes are clearly desirable. For example, we have needlessly specialized consumer and mortgage lending, savings institutions, etc., which leads to undesirable specific monetary controls, such as those of Regulation Q. 12 C.F.R. §§ 217.0-.6 (1969). In addition, dual state and federal bank regulation is archaic and leads to undesirable differences in states' banking structures; and at the federal level, the division of supervisory authority results in unnecessary dissension.

8. Senator Proxmire's proposed bill on one-bank holding companies does contain a provision for a complete study of the banking structure. S. 1052, 91st Cong., 1st Sess. (1969).

9. 12 U.S.C. § 1842 (1964).

disadvantages: (1) the holding company must divest itself of control of all non-banking and non-bank-related corporations; (2) the holding company must file annual reports and submit to examination by the Federal Reserve Board; and (3) all acquisitions of more than five percent of the stock of additional banks must be approved by the Federal Reserve Board.[10] Unregistered bank holding companies, on the other hand, can engage in non-banking business, need not submit to examination or file an annual report with the Federal Reserve Board, and can merge without approval of the Board. Nevertheless, it is still true that all banks, whether or not subsidiaries of a holding company, must submit to examination by at least one bank supervisory agency, such as the State Banking Commission or the Federal Deposit Insurance Corporation. This examination, however, is limited to the operations of the bank and does not encompass the operations of the entire holding company. In addition, all bank aquisitions are subject to the usual antitrust laws. Thus, the most important difference between registered and unregistered holding companies is the power which unregistered companies have to engage in non-banking activities and to own non-bank-related corporations.

Unregistered bank holding companies have not allowed this privilege to go unused. As of September 1, 1968, unregistered holding companies owned real estate companies, finance companies, all types of insurance companies, savings and loan associations, and even a few farms and grocery stores.[11] A particularly surprising statistic is that 397 one-bank holding companies are engaged in 9 different non-financial activities.[12] While one-bank holding companies have manifestly restricted themselves to financial activities, the facts betray a definite interest in non-financial activities. In summary, one-bank holding companies are largely unregulated and totally unrestricted as to the kinds of business they may pursue.

B. The Struggle to Diversify

The widespread organization of one-bank holding companies is the newest effort by banks to diversify their operations; it follows a long series of prior and unsuccessful attempts. Previously, banks attempted to expand into non-banking activities by broadly interpreting the "incidental powers" clause, which forms the heart of the basic

10. The Federal Reserve Board has exclusive supervisory authority over registered bank holding companies, whether the banks involved are state or national, insured or uninsured.

11. BANKING AND CURRENCY PRINT, *supra* note 1, at 49-51.

12. *Id.*

legislation from which banks derive their powers. The National Bank Act sets forth the basic powers of national banks:

> To exercise by its board of directors or duly authorized officers or agents, subject to law, *all such incidental powers as shall be necessary to carry on the business of banking*; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter.[13]

Beginning in the early sixties, banks began to construe the "incidental powers" clause as permitting them to expand their activities directly into such related activities as life insurance, travel services, commingled trust accounts, data processing services, credit cards, armored car services, and direct leasing. In addition, through wholly-owned subsidiaries, they engaged in mortgage servicing, factoring, credit reporting, warehousing, etc. Most importantly, their efforts were supported by the Comptroller of the Currency, James Saxon, who also interpreted the "incidental powers" clause in a liberal manner. In a letter on the subject of national banks acting as insurance agents, Saxon said:

> Congress has consistently recognized that the business of banking covers a wide range of activities. In the National Bank Act of 1864, Congress wisely refused to define the business of banking as it then existed, foreseeing that the banking business would change and develop with the passing years. It is clear that the business of banking is advanced by financial and related services, and powers necessary to achieve and promote the fundamental purposes of banking must be regarded as powers incidental to those expressly granted by paragraph seven of 12 U.S.C. 24.[14]

Even Saxon, however, clearly recognized that the law prohibited banks from engaging in a nonrelated, non-banking business. In a letter on the subject of banks providing travel services, he said:

> Traditionally, national banks have been excluded from direct participation in the production of raw material, manufacturing, or commerce, so as to immunize the banking system from the risks inherent in the employment of venture capital. *Subject to this restriction*, however, it is clear that the business of banking is the furthering by financial and related services of commerce and industry and the convenience of the public. Powers necessary to achieve the fundamental purposes of banking must be regarded as powers incidental to those expressly granted.[15]

Comptroller Saxon nevertheless permitted national banks to provide travel services based on the broad theory that travel services are related to the banks' overall financial services.

13. 12 U.S.C. § 24, para. 7 (1964) (emphasis added).
14. Letter from Rep. Phil M. Landrum, May 7, 1965.
15. Letter from Rep. Edward J. Gurney, October 26, 1964 (emphasis added).

Industry representatives in those lines of commerce threatened by bank competition struck back through the courts. One after another they filed suit to enjoin banks from providing the newly authorized services, arguing that defendant-banks lacked statutory authority to offer such services (or that banks were engaging in *ultra vires* acts). In *Baker, Watts & Co. v. Saxon*,[16] plaintiff sought and obtained an injunction prohibiting banks from underwriting and dealing in obligations of states or political subdivisions not secured by the general power of taxation; while in *Georgia Ass'n. of Independent Insurance Agents, Inc. v. Saxon*,[17] banks were prohibited from acting as agents for the issuance of insurance in connection with loan transactions in any location where the population exceeds 5,000 inhabitants. More recently, in *Dickinson v. First National Bank*,[18] banks were prevented from establishing armored car services, or any off-premises activities which could be construed as contrary to states' branch banking statutes.[19]

Banks have, however, made some gains as well, although some of these gains may be temporary. In *Arnold Tours, Inc. v. Camp*,[20] for example, the district court found that the plaintiff lacked standing to challenge the right of a national bank to operate a travel agency and dismissed the suit. In *Wingate Corp. v. Industrial National Bank*[21] and *Association of Data Processing Service Organizations, Inc. v. Camp*,[22] plaintiffs were also unsuccessful in obtaining an injunction in the district court preventing national banks from providing electronic data processing services. In the *Wingate* case, however, the First Circuit reversed, finding that plaintiff had standing to sue under the Bank Service Corporation Act.[23] Very recently, in *Investment Company Institute v. Camp*,[24] the Court of Appeals for the District of Columbia ruled that banks could operate commingled investment accounts, or mutual funds.

An important point in all of these decisions, especially those won by the banks, is that in no case did the court rest its decision on section 24 of the National Bank Act, which avoided the complex problem of defining the incidental powers of commercial banks. The above named

16. 261 F. Supp. 247 (D.D.C. 1966).
17. 268 F. Supp. 236 (N.D. Ga. 1967), *aff'd*, 399 F.2d 1010 (5th Cir. 1968).
18. 400 F.2d 548 (5th Cir. 1968).
19. *See also* Continental Bank & Trust Co. v. Taylor, 14 Utah 2d 370, 384 P.2d. 786 (1963).
20. 286 F. Supp. 770 (D. Mass. 1968), *aff'd*, 408 F.2d 1147 (1st Cir. 1969).
21. 288 F. Supp. 49 (D.R.I. 1968), *rev'd*, 408 F.2d 1147 (1st Cir. 1969).
22. 279 F. Supp. 675 (D. Minn. 1968), *aff'd*, 406 F.2d 837 (8th Cir. 1969), *cert. granted*, ___ U.S. ___ (No. 1246, June 23, 1969).
23. 408 F.2d 1147 (1st Cir. 1969).
24. Civil No. 21,662 (D.C. Cir. June 1, 1969).

cases were resolved on the basis of entirely different statutes or on technical grounds such as the lack of plaintiff's standing to sue. Whether the courts will eventually be forced to tackle the difficult issue of what powers are incidental to banking remains to be seen. Much will depend on whether Congress again ducks a question which is properly within its province.[25]

Hemmed in against direct expansion by a multitude of regulations and restrictive court decisions, banks turned to the holding company scheme, an old but little used device. The recent trend toward one-bank holding companies, therefore, can be partially explained by the frustration banks have encountered in pursuing their persistent desire to diversify. There remains, however, the fundamental question of why banks wish to diversify.

C. *The Reasons for Diversificaton*

Since 1900 commercial banking as an industry has been declining in relative importance. Savings institutions, consumer lenders, and a host of other financial institutions have slowly but persistently made inroads on commercial banks. Table 1 below shows that commercial bank assets, considered from several points of view, have grown less rapidly than those of competing financial institutions.[26] In 1900 commercial banks held more than three-fifths of all assets retained by financial intermediaries, but by 1965 their share had declined to roughly one-third.

TABLE 1

	Commercial bank assets as percentage of assets of all financial intermediaries	Commercial bank assets as a percentage of assets of only private financial intermediaries	Commercial bank assets as a percentage of GNP
1900	62.5	62.5	53.8
1912	64.5	64.5	60.7
1922	59.1	65.0	65.2
1929	49.8	53.6	63.4
1933	41.6	48.5	82.3
1939	40.0	52.2	72.8
1945	46.1	63.0	75.1
1949	40.2	54.5	61.7
1952	38.8	51.8	54.8
1958	34.2	43.6	54.3
1965	31.7	38.3	52.3

25. For a possible interpretation of the incidental powers clause, see Beatty, *The Incidental Powers of National Banks*, 4 NAT'L BANKING REV. 263 (1967); Huck, *What is the Banking Business?*, 83 BANKING L.J. 491 (1966).

26. Burns, *The Relative Decline of Commercial Banks: A Note*, 77 J. POL. ECON. 122-28 (1969).

This decline may be due to a lack of aggressiveness on the part of commercial banks, but this factor alone is not a complete explanation. At the turn of this century commercial banking consisted primarily of accepting short-term liabilities (demand deposits) and extending short-term business credit. In 1900 savings deposits constituted less than one-sixth of total commercial bank deposits, and the loan-to-deposit ratio was roughly 50 percent. In fact, nearly 25 percent of banks' assets were "cash assets."[27] Since that time, savings and time deposits have continually risen to today's level of almost 60 percent of total deposits, banks have increased their loan-to-deposit ratios to roughly 60 percent, and have moved increasingly into longer-term lending.[28]

The drift of commercial banking away from demand deposits and short-term assets and into longer-term liabilities and assets is partially the result of changing customer tastes, partially a response to a changing economy, and partially the result of regulation. In 1946 bank customers held 50 cents in currency and demand deposits for each dollar of gross national product; today they hold less than 25 cents. This sharp change is the result of the following factors: (1) Growing confidence in the stability of our economic and financial system which reduces the need for liquidity; (2) improved credit arrangements, such as credit cards, available to large segements of the population which lessen the need for carrying large liquid balances; (3) the prohibition against banks' paying interest on demand deposits which encourages customers to switch from demand deposits to income-yielding assets; and (4) the increasingly attractive yields on substitute liquid assets, such as savings deposits, which have induced customers to shift funds from demand deposits to time and savings deposits.

As a larger proportion of banks' liabilities have taken the form of interest-bearing savings and time deposits, bank costs have increased commensurately, forcing banks to raise their loan-to-deposit ratios and to search for higher yielding assets in order to maintain acceptable profit levels. Although bank earnings (net current operating revenue) as a percent of total capital have not declined substantially during the 1950's and 1960's (ranging from 18.5 percent to about 14.5 percent),[29] during the last few years bankers began to fear that they could no longer offset increasing costs by further increases in their already high

27. U.S. Bd. of Gov. of Fed. Res. Sys., All-Bank Statistics, United States 1896-1955, at 34-36 (1959).

28. 55 Fed. Res. Bull. A19-25 (March 1969).

29. FDIC Ann. Reports (1952-1967).

loan-to-deposit ratios. Consequently, they began looking for alternative sources of earnings, either higher yielding assets or entirely new lines of business. Thus, slow relative growth and increasing costs combined to push bankers into attempting to diversify the scope of their operations, at first directly under a permissive comptroller of the currency, and then later through the device of the one-bank holding company.[30]

The message of this discussion is clear: the one-bank holding company movement is not a sudden, unexpected, and whimsical phenomenon, but is the predictable consequence of real economic problems. As such, it demands thoughtful consideration. The remainder of this paper is devoted to an analysis and evaluation of the economic implications of one-bank holding companies.

III. The Economic Consequences of One-Bank Holding Companies

The potential economic effects of one-bank holding companies are separated for convenience of discussion into the following issues: (1) The effect on competition—is competition likely to increase or decrease as a result of the proliferation of one-bank holding companies? (2) The effect on economic efficiency—will the affiliation of different enterprises result in internal cost savings or economies of scale? (3) The effect on bank solvency and depositor safety—will the affiliation of banks with non-banking businesses lead to unsound financial transactions or excessive risk-taking? (4) The effect on monetary policy—since commercial banks are the primary institution through which the Federal Reserve implements monetary policy, will structural changes in banking affect the success and efficiency of monetary policy?

A. Competition

Since all one-bank holding companies are conglomerates to some degree, the competitive issues they raise are in general similar to those raised by most conglomerates. In his thorough analysis of conglomerate mergers, Professor Donald Turner analyzes four major

30. Another way of viewing the diversification trend may be in terms of a non-price competition theory. If banking markets can be considered close-knit oligopolies so that open price competition is not feasible, perhaps because of a "kinked" demand curve, banks would choose to compete on non-price terms. Further, the extensive regulation of banking activities may inhibit even non-price competition, so that banks may aggressively seek new ways to compete; and one way is to offer customers a greater variety of services than that offered by competitors. The slow growth and profitability theories discussed in the text can be made compatible with this approach.

possibilities of how conglomerates may adversly affect competition:[31] (1) Existing firms may restrain their competitive efforts out of fear of invoking massive retailiation (such as predatory pricing) by competitors associated with large and financially powerful conglomerates. (2) The mere size and financial strength of firms affiliated with conglomerates may significantly deter entry. (3) Permitting entry through acquisition by a conglomerate rather than through the establishment of a new enterprise may eliminate important potential competition. (4) Affiliates of conglomerates may develop reciprocity agreements and tying arrangements among themselves. Professor Turner draws the following conclusions with respect to these issues:[32]

> 1. (a) Predatory or unfair pricing by conglomerates in order to achieve monoply does not appear to be of significant concern.
>
> (b) A disproportionately large conglomerate which enters an industry by acquisition is likely to restrain the competitive behavior of smaller rivals *only* in those industries where there has been vigorous competition and the number of competing firms are few enough that the identity and nature of competitors is a significant aspect. Even here, however, the effect may be pro-competitive if there are substantial economies of scale.
>
> 2. There is no reason to believe that conglomerates have a preponderately adverse effect upon new entry; in fact, since conglomerates may be able to enter with greater ease than smaller firms, they may stimulate competition.
>
> 3. There is no reason to believe that conglomerate acquisitions will, in general, significantly lessen potential competition; and in those instances where this does happen, present antitrust laws are adequate to prevent it.[33]
>
> 4. Reciprocity agreements and tying arrangements, especially of an informal nature, are likely to have the most serious adverse competitive effects, but Professor Turner recommends that "a conglomerate merger should not be outlawed . . . unless at least fifteen or twenty percent of a market is made subject to foreclosure."[34]

Accepting Professor Turner's conclusions as the best available judgment on the competitive effects of conglomerates, the question remains whether these conclusions are equally applicable to one-bank holding companies. One-bank holding companies are unique in the sense that they include banks among their affiliates, unlike the typical conglomerate.

With respect to predatory or unfair pricing, one-bank holding companies do not appear to be any greater threat than the typical

31. Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313 (1965).

32. *Id.* at 1352, 1354-58, 1391.

33. *Cf.* United States v. Penn-Olin Chem. Co., 378 U.S. 158 (1964); United States v. El Paso Natural Gas Co., 376 U.S. 651 (1964).

34. Turner, *supra* note 31, at 1391.

conglomerate, and for the same reasons advanced by Turner: it is unlikely to be very profitable and it is an obvious violation of section 2 of the Sherman Act. With respect to the general effect on smaller rivals, however, it is possible that the inclusion of a bank may result in greater competitive restraint, since most small competitors are very dependent on banks for credit. To take an extreme example, envision a small town with two banks each of which decide to form a holding company and acquire household appliance firms. If there are three appliance stores in town, the third (independent) store will clearly be in an unenviable position. Since he is dependent on the banks for credit, the last thing he wishes to do is strain relations with the banks by competing "too" vigorously with their affiliated appliance stores. He might, therefore, voluntarily restrain his competitive behavior. The seriousness of this effect depends upon the degree to which the unaffiliated appliance store is dependent on local banks for credit, the number of local banks, the degree of banking competition, and the exact nature of the bank holding companies. For example, if banks in the community do not all have affiliates in the same lines of commerce, independent firms should not feel any competitive restraint, since they can always turn to a disinterested bank for credit. Thus, in some circumstances, one-bank holding companies will restrain the competitive behavior of smaller rivals, while in other circumstances they will have no impact. The obvious policy implication is that acquisitions by one-bank holding companies should not be left completely free, but should be subject to the approval of a regulatory agency which can properly evaluate its likely competitive impact.

With respect to Professor Turner's conclusions on the entry effect, one-bank holding companies are even more likely to have a net pro-competitive effect than the typical conglomerate. The effect may occur in two ways: Banks may enter non-banking industries and non-banking businesses may enter banking. Banks in particular would be a substantial entry threat. Since they have as their customers firms from many industries, they are privy to information about costs and profits in these industries, and therefore likely to attempt entry into those industries where it is needed most—high profit, monopolistic industries. Possession of reliable information of this sort, moreover, lessens the risk of attempting entry. In addition to those industries having high entry barriers due to high absolute capital requirements or great promotional costs,[35] banks represent a great threat because of their easy

35. *See* J. BAIN, BARRIERS TO NEW COMPETITION 142-43 (1956); Comanor & Wilson, *Advertising, Market Structure and Performance*, 49 REV. OF ECON. AND STATICS 423 (1967).

access to capital and their high quality names which can be transferred to other products. The recent entry of banks into equipment leasing and credit cards are examples of this ability.[36] Despite these advantages, of course, banks may still not have easy access to certain financial industries, since there are additional entry barriers in the form of governmental licensing requirements. Even here, however, it seems very reasonable to conclude that banks will be a substantial entry threat, since if any potential entrants can meet the public interest tests of regulators, banks are the most likely to meet them—banks are well-established, profitable businesses with financial management of proven ability and high integrity.

With respect to entry into banking itself, one-bank holding companies open the door to the entry of large, established firms, which have ready access to financial capital and possess management of proven ability. Once again, the degree to which these firms will pose an entry threat depends upon the "licensing" attitude of bank regulators, but whatever their immediate attitude may be, bank regulators will certainly be forced eventually to give these potentially strong entrants careful consideration. It is clear, in fact, that banks themselves appreciate the significance of this threat. Within a few months of the attempted take-over of the Chemical Bank of New York by Leasco Data Corporation, banks quietly pushed through the New York State legislature a bill that requires the New York State Banking Superintendent to approve all acquisitions of State banks by non-bank companies,[37] which by increasing the uncertainty and risk in acquiring a bank tends to discourage entry into banking by non-banking companies. State legislation of this type, however, cannot succeed alone. If federal legislation makes entry easy through the acquisition of national banks, such state legislation will become largely ineffectual.

Professor Turner's fourth conclusion—that conglomerates will not lessen potential competition—is equally valid for one-bank holding companies. In fact, on the basis of the preceding arguments that one-bank holding companies will increase competition through greater actual entry, we might conclude that competition will also be improved by increasing the threat of potential entry; if, on the other hand,

36. Although banks are presently doing leasing directly, an adverse outcome of pending litigation may force them to resort to the holding company device. It is also interesting to note that it took an antitrust suit by the Justice Department to induce de novo entry into credit cards.

37. N.Y. Times, May 27, 1969, at 68, col. 3.

acquisitions by banks or one-bank holding companies tended to lessen potential competition, present antitrust laws could be used to prohibit such acquisitions.[38]

Reciprocity agreements and tying arrangements among holding company affiliates are of greater concern. Professor Turner says:

> . . . informal reciprocity pressures through a conglomerate company's salesmen, whether sanctioned or not, are probably not only common but extraordinarily hard to detect, and they are likely to persist whenever the market structure is conducive to them. More important is the problem that even in the absence of formal or informal pressure, there is a strong liklihood, which increases with the stakes, that at least some producer "in the middle" will voluntarily favor the conglomerate firm with their purchases in the hope of substantially increasing their own sales. It would be wholly unreasonable, even if possible, to prohibit such behavior; it can be eliminated only by forestalling the creation of the conglomerate structure that fosters it.[39]

As an example of the tie-in problem, suppose that a large bank forms a holding company and acquires a fire and casualty insurance company. If the bank is in a strong position vis-a-vis its business customers, or they are dependent on the bank for their credit needs, the bank could force its customers to buy insurance from its insurance affiliate, perhaps even at a price above market. An example of reciprocity is the following: suppose a bank combines with a large chain of supermarkets to form a holding company. Many producers of items such as foodstuff and dairy products will be in the middle. They use bank credit as well as sell their produce to supermarkets. If these firms covet the opportunity to sell their produce to the supermarket chain, they may "voluntarily" use the services of the bank to curry the favor of the supermarket affiliates.

In what circumstances are one bank holding companies likely to use these devices and when do they pose a serious threat to competition? Although present antitrust laws prohibit most tie-in sales and reciprocity arrangements,[40] these laws are unlikely to be very effective against informal or voluntary arrangements. The real question, therefore, is what kinds of market structure conditions tend to foster the use of these devices and how do we prevent these conditions from developing.

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38. *See* Edwards, *Bank Mergers and the Public Interest: A Legal and Economic Analysis of the 1966 Banking Act*, 85 BANKING L.J. 753 (1968).

39. Turner, *supra* note 31, at 1390.

40. FTC v. Consolidated Foods Corp., 380 U.S. 592 (1965); Northern Pac. Ry. v. United States, 356 U.S. 1 (1958); International Salt Co. v. United States, 332 U.S. 392 (1947); United States v. Investors Diversified Services, 102 F. Supp. 645 (D. Minn. 1951). Although there is some question about whether Clayton Act § 3, 15 U.S.C. § 14 (1964) applies to "service" tie-ins, the Sherman Act § 1, 15 U.S.C. § 1 (1964) is clearly applicable.

Generally speaking, tie-in sales and reciprocity arrangements are not considered to be a serious competitive problem unless: (1) a seller is either the sole seller or a very important seller of a product and can use this power to foreclose additional markets to competitors, and (2) the buyer or distributor affiliate of the holding company in a reciprocity arrangement is a substantial and important buyer or distributor of the "middleman's" product. In other words, for a tie-in sale to harm competition, the seller must possess some monopoly power over the tying product which can be used as a lever to impose a tying arrangement in order to foreclose the tied-product market. But even in cases where the seller does possess this monopoly power, his success in foreclosing competition will also depend upon the degree to which consumers of the tied-product also use the tying product and the difficulty of new entry into the tied-product market (which will depend on the magnitude of economies of scale in producing the tied product, the minimum efficient plant size, etc.).[41] In a similar fashion, the impact of a reciprocity arrangement on competition will depend upon the importance or size of the bank's buyer or distributor affiliate (supermarket). If the buyer or distributor affiliate is small and unimportant, it is improbable that customers of the bank will be willing to buy an unattractive product in order to gain the privilege of selling their own products to the bank's buyer affiliate.

What are the implications for onc-bank holding companies? Assuming that the antitrust laws arc inadequate to prevent the voluntary type of arrangement, is there any policy short of a complete prohibition of one-bank holding companies which can successfully cope with this problem? Since the successful use of tie-in sales and reciprocity arrangements depends critically upon the structural conditions of the market, much of their potential anticompetitive impact can be avoided by controlling the market structure. For example, to curb reciprocity arrangements, banks could be prevented from acquiring a sizable buyer affiliate in any market, or vice versa; and if an affiliate in time grew to become a substantial firm, it might be necessary to require divcstiture. To alleviate the tie-in problem, authorities could prohibit the acquisition of firms operating in markets particularly vulnerable to foreclosure—markets with high entry barriers where the users of the product are also heavy users of bank credit. Again, it is conceivable that at some point divestiture may become necessary.

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41. *See* Edwards, *Tie-In Sales in Banking and One Bank Holding Companies*, to appear shortly in ANTITRUST BULL. (1969).

It is obvious that a structural policy along these lines would require giving substantial discretionary power to banking regulatory authorities to regulate acquisitions and affiliate relationships. Further, developing clear and specific guidelines will not be easy. Nevertheless the alternatives are not terribly attractive: a complete prohibition of one-bank holding companies or total freedom for holding companies to acquire affiliates. Giving discretionary power to regulatory authorities is at least consistent with our present policy. Authorities now approve bank acquisitions only if they are in the public interest. Extending these powers to one-bank holding companies seems only natural.

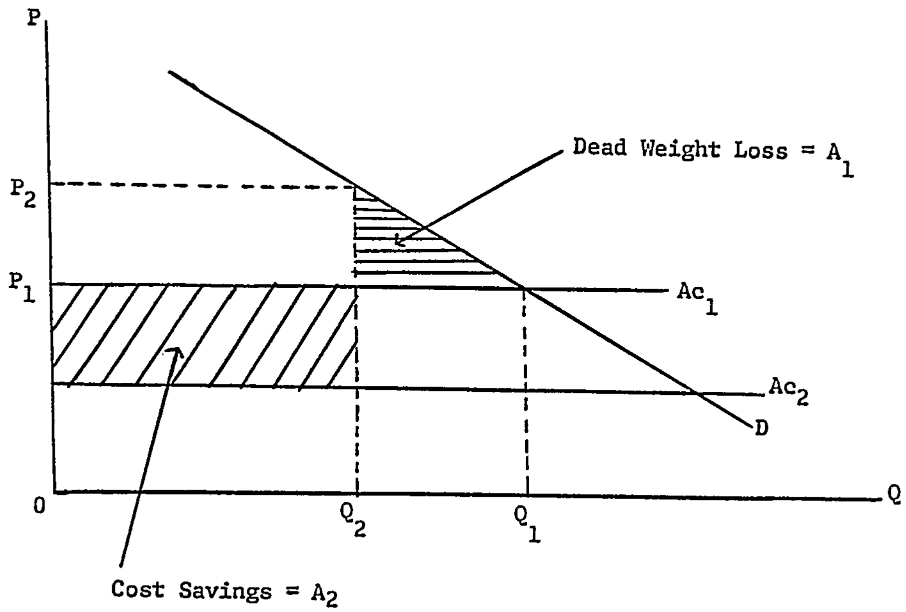
With respect to the issue of competition, we have seen that in some circumstances one-bank holding companies may increase competition, while in others competition may be diminished. The issue is far from clear-cut. If one-bank holding companies are prohibited altogether, we lose the benefits of increased competition. In addition, it is clear that one-bank holding companies should be subject to acquisition guidelines designed to prevent acquisitions of the kind associated with either the undesirable tying and reciprocity arrangements or with the suppression of smaller competitors. What is not clear, of course, is whether it is possible to formulate acquisition guidelines adequate to control these undesirable practices, or whether no policy short of a complete prohibition is adequate. In part, the desirability of trying to devise such guidelines, rather than accepting an outright prohibition of one-bank holding companies, must rest on an evaluation of the total economic benefit associated with one-bank holding companies, both of a competitive and a noncompetitive nature.

B. Economic Efficiency

Assuming that one-bank holding companies do on balance diminish competition, it is possible that they could still be beneficial in a public interest sense. If, for example, the affiliation of two independent firms yields both substantial economies of scale and diminishes competition, the net allocative (welfare) effect may still be positive.[42] Figure 1 demonstrates this possibility. The horizontal line Ac_1 is the level of average costs before the merger, Ac_2 the level of

42. The achievement of economies of scale need not necessitate a reduction in competition. For example, lower costs might stimulate greater entry or put added pressures on other firms to improve their performance.

average costs after the merger, P_1 the price before the merger, and P_2 the price after the merger. P_2 exceeds P_1 since it is assumed that the merger diminishes competition. The net allocative effect of the merger



is the difference between the two areas represented by A_1 and A_2 (A_2 minus A_1). The area A_1 is the loss in consumers' surplus due to a rise in price to P_2 and a fall in output to Q_2; or, it is a measure of the welfare loss to consumers. The area A_2 represents the cost savings involved in producing output Q_2 compared to what it would have cost to produce Q_2 prior to the merger; or, A_2 is the welfare gain to the producer. If A_2 exceeds A_1, the merger yields a net welfare gain.[43]

The decision to prohibit one-bank holding companies because they may possibly reduce competition, therefore, must in part turn on an evaluation of the extent to which possible cost savings may outweigh possible adverse competitive effects. To make this determination, some idea of the respective magnitudes is necessary. It is important to recognize, of course, that the adverse effects of a reduction in competition are not confined solely to the allocative effects, but

43. *See* Williamson, *Economics as an Antitrust Defense: The Welfare Tradeoffs*, 58 AM. ECON. REV. 18 (1968).

probably extend to effects on technological progress, managerial discretion, etc.[44] The relevant test is the net welfare impact of all of these factors. The following discussion attempts to evaluate the probable magnitude and importance of the effect of each of these factors.[45]

A merger or affiliation may yield efficiencies if it results in economies of scale in production, distribution, research, selling, management, or capital costs. With respect to "pure" conglomerate affiliations (affiliations between firms producing entirely unrelated products), most economists would undoubtedly agree with the following statement:

> Economies of scale involve common supply or demand factors—products that can be produced with the same facilities, or sold to the same customers through the same distribution channels, or for which research and development in the two or more lines can be pooled. Since a "pure" conglomerate merger produces few economic interrelations between the products of the acquiring and the acquired firm, the possibility of significant economies is slight. A "pure" conglomerate merger may, however, yield economies in management services (accounting, legal advice, engineering, repairs, etc.), or in advertising expenditures, or in capital costs even though the products involved have no other common supply or demand relationships. Moreover, it is possible with any kind of conglomerate merger that the acquired firm will subsequently be run more efficiently than before simply because the new management is more capable than the one replaced. But the latter kind of improvement seems less likely when the difference between the lines of products of the two firms is great. . . . Also, advertising economies seem less likely to follow the "pure" conglomerate: different media and different appeals are commonly needed for products bought by quite different classes of customers, and the appeal of a strong trademark is more readily transferable to similar products . . . than to widely different ones . . . . Insofar as the likelihood of economies of scale in capital costs is concerned, however, there seems little basis for distinguishing among various kinds of conglomerate mergers: size alone is an important factor in the ability to attract cheap capital, and it is quite possible that "pure" conglomerates, by diversifying risks, may obtain capital as cheaply or more cheaply than a comparably sized conglomerate producing closely related lines.[46]

Put in the context of one-bank holding companies, these general conclusions would refer to affiliations between banks and *nonfinancial* enterprises, since affiliations of banks with other *financial* institutions is clearly not analogous to the "pure" conglomerate case. Many financial institutions provide products similar to those offered by

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44. *Id.* at 29-32; Leibenstein, *Allocative Efficiency versus "x-efficiency,"* 56 AM. ECON. REV. 392 (1966).

45. Depending upon our exact social welfare function, we may choose to assign varying degrees of importance to each of these effects. For example, one income distribution may be preferred to another, or small firms may be preferred to large firms.

46. Turner, *supra* note 31, at 1330-31.

commercial banks: savings institutions offer almost identical savings deposits and make similar kinds of mortgage loans; consumer loan companies extend consumer credit not very different from that extended by banks; life insurance companies provide business credit equivalent to commercial bank term loans; and several of these institutions manage portfolios of government bonds, commercial paper, corporate bonds, and common stock, just as commercial banks do (the latter as trust accounts). Thus, although rather insubstantial efficiencies might be expected from affiliations of banks with non-financial businesses, the likelihood of achieving economies is much greater when banks are joined with other financial institutions, since the economic interrelationships among the products of banks and financial institutions are much greater.

What kinds of economies are "financial" conglomerates (banks affiliated only with financial institutions) likely to yield? First, there are likely to be some economies of scale in production. Improvements in data processing are rapidly changing the technology used to produce financial services. Today, for example, many instutions have completely automated their accounting and bookkeeping systems. It is true, of course, that these technological advances may be achieved in ways other than through the formation of one-bank holding companies. For example, financial institutions might achieve the same economies through horizontal merger, internal growth, or by using the facilities of data processing service bureaus. None of these alternatives, however, are considered to be good substitutes. Antitrust laws and restrictive branching laws greatly limit growth by horizontal merger,[47] and achieving economies through internal growth may take an exorbitantly long time. Using a service bureau is the most promising alternative, although lack of in-house skilled personnel and the difficulty of tailoring the service bureau's product to the unique requirements of a particular institution are not insignificant problems. In the absence of more concrete evidence, therefore, it is probably reasonable to conclude that one-bank holding companies do yield economies of production through the use of greater automation, although it would seem imprudent to assign a heavy weight to this gain.

Second, there may be economies in distribution. For example, the affiliation of a bank which operates a large branching system with an

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47. *See* Edwards, *Bank Mergers and the Public Interest: A Legal and Economic Analysis of the 1966 Bank Merger Act*, 85 BANKING L.J. 753 (1968). Many financial institutions, however, such as savings institutions, have not been restricted by the antitrust laws.

insurance company may enable the consolidated company to use the branch offices as distribution centers for its insurance. Third, there may be economies in selling for some of the same reasons. In the previous example, for instance, the insurance salesmen might also be used to sell the bank's services—trust services, savings accounts, estate planning, etc. The magnitude of such economies will obviously depend on the degree to which the products are related, or the ease with which the same salesmen or offices can bc used. Although there are substantial similarites between many different financial services, there are also important distinctions, so that any conclusion is at best speculative. Nevertheless, there are probably some selling and distribution economies.

Economies in research and associated product development may be the most important gain accruing to one-bank holding companies. Important gains in research may come in several ways: (1) many financial institutions manage similar portfolios so that common research personnel can be utilized—portfolios of common stock, government bonds, corporate bonds, etc.; and (2) since many financial institutions have common management problems, research can be directed towards developing new management techniques beneficial to all of the institutions.[48] In addition, permitting different types of financial institutions to combine may stimulate research towards developing new products which utilize combinations of different financial services. Examples may be the development of comprehensive financial planning for individuals and businesses. At present, little effort is being made in this direction because no single financial institution is capable of providing all of the necessary services. To the extent that better products are developed or existing services are combined to create more convenient or cheaper products, the public interest is benefited.

Fourth, there are likely to be economies of promotion and capital costs. Since promotional economies stem from the similarity among products, they too are most likely in the case of financial conglomerates. Even in these cases, however, the distinction between the products is probably too great to yield substantial promotional economies. Selling life insurance, for example, is quite different than selling consumer loans. But holding companies may also reap promotional benefits from their large size by being able to get quantity

48. For examples of such techniques, *see* K. COHEN & F. HAMMER, ANALYTICAL METHODS IN BANKING (1966).

discounts in the purchase of advertising time or space or by being able to use more efficient promotional techniques, such as television instead of radio. In addition, there may be promotional economies in transferring goodwill or an established trademark to new products. Economies in capital costs would seem as likely or unlikely in the case of the "pure" conglomerate as in the case of the financial conglomerate. Size, more than any other factor, determines economies in capital costs, so that the combining of financial institutions with non-financial institutions is irrelevant to this issue. Judging the magnitude of such economies, of course, is impossible.

Lastly, economies in management are likely. Large holding companies are more successful in attracting young management talent of high quality, partly because of the additional prestige and partly because of the higher possible return to the employee. Higher quality management is believed to raise efficiency more than that commensurate with the increase in labor costs due to employing superior talent. In addition, the management skills utilized by most financial institutions are so similar that there should be easy transferability of management abilities among affiliates of financial conglomerates, although not among affiliates of a "pure" conglomerate. These economies may be significant in the long-run.

What conclusions, if any, can we draw from all these observations on economic efficiency? First, and most striking, there is an absolute dearth of hard facts and figures upon which to base conclusions about the economic efficiences associated with one-bank holding companies; and, second, these observations support the notion that the efficiencies associated with "financial" conglomerates are much greater than those associated with "pure" conglomerates. Financial conglomerates may achieve important efficiencies in research, product development, and management, and lesser economies in production, selling, distribution, and promotion, while economies in capital costs accrue to both kinds of conglomerates.

C. *The Safety and Solvency of Banks*

Determining the correct policy to adopt towards mergers and acquisition is normally a problem of evaluating the economic costs and benefits from increases or decreases in competition and economic efficiency. When financial institutions, especially commercial banks, are involved, there are additional considerations: those of solvency and monetary policy.

Unlike most industries, the solvency of the banking system is an important public interest concern. Without a financial system which instills complete confidence, our complex and sophisticated economy might collapse, or at least function in a far less efficient way. Although few would quarrel with solvency as a basic objective, reasonable men often differ over exactly what increases or decreases financial safety and solvency, and it is this difference of opinion that permeates the one-bank holding company controversy. This section examines the potential effects which one-bank holding companies may have on financial solvency. The other important consideration—that of monetary policy—is discussed in the section following. There, as in this section, we shall see that one-bank holding companies raise unique issues due to the involvement of commercial banks.

Historically, the idea that banks should be kept separate from more speculative financial activities led to extensive regulation and limitation of banks' activities. For example, the 1933 Glass-Steagall Act[49] required the complete separation of commercial banking from the securities business on the theory that the collapse of the banking system in the 1930's was due largely to bank involvement in speculative activities.[50] More recently, Representative Patman, a leader in the fight to curb holding companies, has echoed these sentiments: "In the wake of the great stock market crash of 1929 and the subsequent great depression, Congress, in its wisdom, decided that commercial banking should be divorced from all other activities."[51] In addition, Governors Martin and Robertson of the Federal Reserve Board have called for the separation of banking from "business wholly unrelated to banking."[52] Implicit in all of these statements is the notion that combining banking with non-banking businesses somehow leads to a situation which undermines the soundness of the financial system.

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49. 12 U.S.C. § 377 (1964).

50. On the problems of a bank owning a securities affiliate, the Comptroller of the Currency in 1920 said: "[I]t would be difficult, if not impossible, for the same set of officers to conduct safely, soundly, and successfully the conservative business of the national bank and at the same time direct and manage the speculative ventures and promotions of the ancillary institutions." *Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency*, 71st Cong., 2d Sess. 1067-68 (1931). *See also* REPORT OF THE COMM. APPOINTED PURSUANT TO H.R. 429 AND H.R. 504 TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT, pt. 2, 55-106 (1913).

51. 115 CONG. REC. 902 (1969).

52. *See* the joint statement of Govenors Martin and Robertson of the Federal Reserve Board in the *Hearings Before the Subcomm. of the Senate Comm. on Banking and Currency*, 84th Cong., 1st Sess. 44 (1955). "We believe . . . that the principal problems in the bank holding company field arise from . . . the combination under single control of both banking and non-

There are two aspects of one-bank holding companies which, if left unchecked, may undermine solvency. First, the corporate structure may be such that the failure of one affiliate will bring down all of the affiliates. This might happen if the assets of all affiliates were liable to the creditors of any one affiliate, or the intracorporate financial transactions among affiliates were such as to make the bank's solvency dependent upon the solvency of other affiliates. Second, the equity structure of the various affiliates may encourage the practice of shuffling assets among affiliates in a way which conceivably could increase the risk of bankruptcy to the bank affiliate.

Both of these possibilities can be corrected by regulation. For example, the vulnerability of a bank affiliate can be substantially lessened by regulation which requires the separate incorporation of each affiliate and which severely restricts intracorporate transactions. The requirement of separate incorporation prevents the creditors of a bankrupt affiliate from attacking any other solvent affiliate, while restrictions on intracorporate transactions may prevent the bank from getting into trouble directly. (All one-bank holding companies thus far have pursued a policy of separate incorporation.) National banks, of course, are already subject to regulations which prohibit them from lending more than ten percent of their resources to any one affiliate or more than twenty percent to all affiliates,[53] but it is probably naive to think that any regulation can be so all-inclusive and so expertly drawn as to eliminate every possibility of undesirable intracorporate dealing. Chairman Martin of the Federal Reserve Board has recently noted that loans to the customers of the holding company's affiliates are not subject to regulation,[54] and therefore bank affiliates may very well come under pressure to favor financially unsound customers of affiliates. This problem, however, is only one aspect of a much larger problem—that of asset shuffling.

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banking enterprises, thus permitting departure from the principle that banking institutions should not engage in business wholly unrelated to banking, which involves the lending of other people's money, whereas other types of business enterprise do not involve this element of trusteeship." *See also* Chairman Martin's recent testimony in *Hearings on H.R. 6778 and H.R. 9385 before House Comm. on Banking and Currency*, 91st Cong., 1st Sess. (1969).

53. 12 U.S.C. § 371c (1964).

54. "A bank should be insulated from pressures that might lead it to favor customers of affiliated businesses in its credit decisions. Otherwise, the bank might build an unbalanced loan portfolio by discounting an excessive amount of obligations of such customers or a low-quality portfolio by accepting substandard risks to foster sales to such customers." *Hearings on H.R. 6778 and H.R. 9385 Before House Comm. on Banking and Currency*, 91st Cong., 1st Sess. (1969).

The following example demonstrates the dangers that asset shuffling presents to banks' solvency. Moreover, it shows that the severity of the practice will depend upon the equity structure of the holding company. Assume that a single individual owns all of the stock in the holding company and that the holding company owns the entire stock in each affiliate. In addition, assume that there are two affiliates—a commercial bank and a small loan company—and that both start out with cash (period I in Table 2). In period II, the small loan company purchases

TABLE 2

HYPOTHETICAL EXAMPLE OF RISK-SHIFTING

	Small Loan Company		*Commercial Banks*	
Period	*Assets*	*Liabilities and Net Worth*	*Assets*	*Liabilities and Net Worth*
I	Cash 100	Liabilities 50	Cash 100	Deposits 90
		Equity 50		Equity 10
II	Cash 20	Liabilities 50	Cash 100	Deposits 90
	Loans 100	Equity 50		Equity 10
III	Cash 120	Liabilities 50	Loans 100	Deposits 90
		Equity 50		Equity 10

100 dollars of risky receivables at a discount of 20 dollars and, in period III, transfers this paper to the bank affiliate in exchange for 100 dollars in cash. At this point the small loan affiliate shows an increase in net worth of 20 dollars together with a perfectly liquid asset structure, while the bank is left holding the high risk paper. If, in period IV, the high risk paper becomes completely worthless, the commercial bank affiliate becomes insolvent, causing a loss in equity of 10 dollars. Assuming that the two affiliates are separately incorporated, the small loan company does not become insolvent but, on the contrary, shows an increase in net worth of 20 dollars. Therefore, the owner of the holding company has increased his net worth by 10 dollars (the 20 dollars profit less the 10 dollars loss due to the bank failure).[55]

The point is obvious. Different capital structures or variations in leverage provide an economic incentive for one-bank holding companies to shift risky assets to the most leveraged affiliates, which is almost certain to be the commercial bank affiliate. Although restrictions on the kinds of assets banks can hold may limit this activity, these restrictions are not severe enough to represent a

55. I am indebted to Dr. George Hall of the Rand Corporation for this example.

significant deterrent. Furthermore, since bank regulatory authorities very often lend generous assistance to troubled banks, the incentive to shift risky assets into the bank affiliate is even stronger. This risk-shifting incentive together with the difficulty of controlling intracorporate transactions clearly creates a problem which must be solved before one-bank holding companies can be given free rein.

Various solutions are possible. The most direct is to require in bankruptcy proceedings that all of the holding companies' assets be vulnerable to attack by the insolvent bank affiliate's depositors, and, at the same time, continue to insulate the bank's assets from the failure of other affiliates. This procedure would lessen the incentive for risk-shifting, since the bank failure would be costly in terms of capital losses. Nevertheless, the regulatory policy of preventing bank failures would still serve as some incentive for risk-shifting, so that a change in regulatory policy towards greater toleration of bank failures is a concommitant to eliminating all risk-shifting incentives. Another partial solution would be to prohibit all non-recourse transactions between non-bank affiliates and the bank, or, more specifically, prohibit non-recourse transfers from non-bank affiliates to the bank. This requirement is simply another way of making the assets of non-bank affiliates stand behind the bank's in case of bankruptcy. Since this solution may not remedy the situation where banks lend directly to an affiliate's risky customers, the former, more inclusive solution seems preferable.[56]

A final issue in the solvency debate is the diversification argument: that greater diversification of earning assets by combining widely different business activities will reduce profit variance and risk to the holding company and thereby strengthen all of its affiliates, including the banking subsidiary.[57] The more disparate the activities, the more

56. The extent to which risk-shifting represents a serious potential danger is debatable. Although somewhat the same incentives exist in the case of "captive" finance companies, these companies in general have been managed prudently. *See* Andrews, *Interest Rates, Liquidity, and the Financing of Captive Finance Companies*, 2 NAT'L BANKING REV. 461, 480 (1965). Nevertheless, it seems prudent to apply additional safeguards in the case of commercial banks.

57. The formula for the variance of total profits from two activities a and b is:

$$\sigma^2_{a+b} = \sigma^2_a + \sigma^2_b + 2r\sigma_a\sigma_b$$

The equation shows that variance of a firm's total profits is equal to the variance of the profits of the separate enterprises (a and b) plus the last term which consists of the correlation between the two profit streams times the square root of each variance. A positive correlation between the profit streams gives the last term a positive value which increases total profit variance. A negative correlation gives the last term a negative value which reduces total variance. Thus, depending upon likely it is that total profit variance will diminish. In contrast, very closely related activities may actually increase profit variance and risk. Therefore, a "pure" conglomerate is the most likely candidate to achieve a reduction in risk.[58]

What are the implications for one-bank holding companies? Since one-bank holding companies are most interested in becoming financial conglomerates or in expanding into closely related financial activities, the result may very well be to increase rather than reduce profit variance. This increased risk, of course, is not a threat to the bank subsidiary as long as a policy of separate incorporation is followed; nor is it of any assistance. Therefore, solely on the basis of earnings variation, one-bank holding companies are unlikely to enhance the solvency of banks.

Some of the risk, however, in operating a bank or a financial institution, may be associated with illiquidity rather than with poor profits. A financial institution with a basically sound balance sheet may still lack the necessary liquidity to meet its short-term obligations. But, it is also true that financial institutions are backed by government agencies (such as the Federal Reserve Banks and the Federal Home Loan Banks) designcd specifically to supplement short-term liquidity when the need arises. Therefore, liquidity may not be the problem it appears to be at first sight.

Despite these safeguards, however, liquidity must still be considered important because the Federal Reserve may not always be willing to rescue banks. To alleviate this problem, one-bank holding companies may have more to offer. Combining depository institutions such as banks with contractual savings institutions such as life insurance companies may achieve a reduction in the variance of total cash flow, since declines in bank deposits may be partially offset by increases in flows into life insurance companies. In addition, non-bank subsidiaries such as finance companies or even the parent company itself could sell commercial paper to offset deposit losses, as was the case with the 10 billion dollar reduction in negotiable certificates of deposits which occurred during the past year. Therefore, there may be some potential for risk reduction through joint liquidity management.

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the correlation between the profit streams, total profit variance may rise or fall. If it falls, we argue that risk is reduced; if it rises, risk is increased. The same reasoning is also applicable to variances in cash flows, which may measure the risk of insolvency due to illiquidity. *See* Adelman, *The Anti-merger Act, 1950-60,* 51 AM. ECON. REV. at 241-42 (1961).

58. For a recent verification of tbis judgment, *see* Smith & Scbreiner, *A Portfolio Analysis of Conglomerate Diversification*, 24 J. FINANCE 413 (1969).

In summary, one-bank holding companies do raise a few problems with respect to financial solvency, but none that require complete prohibition as a solution. The most critical problem is that of risk-shifting through the shuffling of risky assets. This difficulty can be mitigated by requiring (1) all of the holding companies' assets to stand behind the bank's assets in the event of bankruptcy, and (2) a separate incorporation to insulate the bank from the insolvency of other affiliates. These requirements greatly reduce the economic incentives that induce risk-shifting. If the one-bank holding companies are given free rein, these are the minimum safeguards necessary to insure the solvency of the banking system.

D. The Effectiveness of Monetary Policy

A final consideration is the effectiveness of monetary policy. One-bank holding companies may have an impact on the effectiveness of monetary policy in two ways: (1) by enabling certain banks to circumvent Regulation Q,[59] and create a discriminatory competitive advantage which may cause undesirable deposit flows and liquidity problems; and (2) by altering banks' liability structures and therefore their required reserves, which may loosen the Federal Reserve's control over credit. Both of these effects, we shall see, are the consequence of one-bank holding companies being able to sell non-deposit debt instruments, such as commercial paper.[60]

Although commercial banks can now sell short-term paper directly, the Federal Reserve has ruled that such liabilities are to be treated as time deposits, which are subject to the usual reserve requirements as well as to the limitations of Regulation Q.[61] The liabilities of one-bank holding companies, on the other hand, are outside the purview of Federal Reserve regulation. Thus, having complete freedom to issue short-term paper, a one-bank holding company may use such paper to replace a bank-affiliate's deposits (especially its certificate of deposits), which will reduce the bank-

59. 52 FED. RES. BULL. 1451 (1966). Regulation Q gives federal bank supervisory agencies the authority to set interest rate ceilings on the deposits of commercial banks, mutual savings banks, and savings and loan associations.

60. The question of whether one-bank holding companies will eventually alter the banking structure in ways that affect the transmission of monetary policy is not considered a likely possibility. Even if there is a shift of banking deposits from small to large banks, monetary policy should not be seriously hampered. *See* Peltzman, *The Banking Structure and the Transmission of Monetary Policy*, 24 J. FINANCE 387 (1969).

61. 52 FED. RES. BULL. 963 (1966).

affiliate's required reserves and permit it (as well as the banking system as a whole) to expand the total volume of credit outstanding.[62]

Let the following represent the initial partial balance sheets of the parent holding company, the bank-affiliate, and Corporation Y, which holds a certificate of deposit issued by the bank. The bank holds 50 dollars of required reserves since there is a five percent reserve requirement against time deposits, and holds 100 dollars of cash, which we will assume is its minimum desired cash balance for liquidity purposes. The remainder of its assets consists of loans.

HOLDING COMPANY		BANK AFFILIATE		CORPORATION Y	
Assets	*Liabilities*	*Assets*	*Liabilities*	*Assets*	*Liabilities*
0	0	Cash: 100	Time Deposits: 1000	CD Time Deposit: 100	General Liabilities: 100
		Reserves: 50			
		Loans: 850			

Suppose the holding company now sells 100 dollars of commercial paper to Corporation Y, which is enticed to convert its CD into the holding company's commercial paper by a higher yield or interest rate. To reflect this transaction, the respective balance sheets become (assuming a sixteen percent reserve requirement against demand deposits):

HOLDING COMPANY		BANK AFFILIATE		CORPORATION Y	
A	*L*	*A*	*L*	*A*	*L*
Demand deposits held at bank affiliate: 100	Commercial paper Liabilities: 100	Cash: 89	Time Deposits: 900	Commercial Paper of Hold. Co.: 100	General Liabilities: 100
		Reserves: 61	Demand Deposits held by Hold. Co.: 100		
		Loans: 850			

The bank-affiliate's required reserves increase by eleven dollars, but this increase is very temporary since the parent company will not continue holding demand deposits.

Suppose that the holding company uses its newly augmented demand balance to purchase 100 dollars of the bank-affiliate's assets,

62. Up to the present only a few unregistered bank holding companies have made use of this device. *See* N.Y. Times, March 27, 1969, at 65, cols. 2, 3.

such as 100 dollars of its loans.[63] The balance sheets of the parent holding company and the bank change to (assume that the loans are purchased at face value):

HOLDING COMPANY		BANK AFFILIATES	
Assets	*Liabilities*	*Assets*	*Liabilities*
Loans Purchased from bank affiliate: 100	Commercial paper liability: 100	Reserves: 45 Cash: 105 Loans: 750	Time Deposits: 900

Note that the bank-affiliate's required reserves are reduced by five dollars, its cash balances augmented by five dollars, and its deposit liabilities reduced by 100 dollars. Since the bank's initial desired cash balance was 100 dollars, it now holds five dollars "too much" in cash. (The reduction in its deposit liabilities should also lower its desired cash balance to below 100 dollars.) Note also that the volume of total credit outstanding has not decreased. Although bank credit has declined by 100 dollars, or bank loans have declined by 100 dollars, this decline was matched by what appears as an equal increase in credit extended by the parent holding company. No one has less credit to spend than before.

But the ramifications of these transactions will not be complete until the bank-affiliate brings its actual cash balance into equilibrium with its desired cash balance. Since it holds excess balances of five dollars, the bank will either purchase securities or make additional loans. For the banking system as a whole, the impact of these portfolio adjustments will not be complete until total bank deposits (either demand or time) have increased to a level sufficient to absorb the excess balances into required reserves. This could be when time deposits increase by 100 dollars, or demand deposits by approximately 30 dollars, or some combination of these results. The crucial point and important consequence is that bank credit will be expanded by some additional amount (bank assets increase when bank deposits increase), so that total credit outstanding (bank and non-bank) will be greater than it was initially.

How does this result affect monetary policy? If the Federal Reserve's objective is to reduce or limit credit availability, the foregoing device works against this policy by enabling credit expansion

63. There are, of course, other means by which a holding company could transfer funds to its bank-affiliate: purchasing the bank's investment securities, long-term debentures, equity, etc.

just when the Federal Reserve is trying to achieve credit constraint. Of course, if the Federal Reserve were able to predict the exact magnitude of this expansionary effect, it could employ off-setting measures, such as further decreases in bank reserves to neutralize the effect. Predicting this effect, however, will be difficult. Its magnitude will depend upon the interest rate that bank holding companies choose to pay on their commercial paper and on the cross-elasticity of demand of bank depositors, both of which may vary substantially over a business cycle. Indeed, holding companies could conceivably vary their interest rates to offset the Federal Reserve's (offsetting) policy measures. Thus, during periods of credit restriction, such as inflationary episodes, one-bank holding companies may undermine the effectiveness of monetary policy.[64]

Are one-bank holding companies really an integral part of this scheme, or are they merely being used to achieve an end that banks could achieve anyway? For example, what is to prevent banks from directly selling their assets to their depositors, instead of doing it indirectly through the parent holding company? The answer is that banks themselves are not able to supply an attractive substitute asset, or they are not able to offer depositors a liquid asset sufficiently substitutable for deposits. Most depositors are not interested in exchanging very liquid deposits for illiquid loans, and banks will not usually be in a position to sell short-term liquid assets (such as Treasury Bills) to their depositors.[65] Assuming that banks have already reduced their liquid assets to the desired level (or minimum level believed necessary), which will be the case during tight money, banks will clearly be unwilling to sell liquid assets in order to reduce deposits by only an equivalent amount. This transaction would leave a bank with an undesirably low liquid asset to deposit ratio. (Since this ratio has a value of less than one, reducing both the numerator and denominator by equal amounts will reduce the value of the ratio even further.)

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64. Although the above discussion implicitly assumes that the Federal Reserve's over-all objective is to control total credit outstanding, the point of the analysis also holds true if the Federal Reserve's objective is some level of the interest rate, since interest rates are affected by the supply of loanable funds.

65. Banks have used the direct device of selling their loans under a repurchase agreement, which accomplishes the same end. The repurchase provision makes the loans more liquid and therefore attractive to depositors. The Federal Reserve, however, has recently closed this avenue by imposing reserve requirements on the liabilities which arise from such sales. *See* N.Y. Times, July 25, 1969, at 67, col. 1.

One-bank holding companies, on the other hand, can provide assets which are attractive to depositors. For example, commercial paper has a short maturity and can be made highly liquid through some type of repurchase arrangement. In addition, obligations of the parent of an unregistered holding company (or of a non-bank subsidiary) are not subject to the limitations of Regulation Q, permitting more flexibility in the yields which can be offered to depositors. Both of these aspects combine to make one-bank holding companies an attractive organizational structure to banks, but a potentially troublesome problem for monetary policy.

A final implication of holding companies selling commercial paper is the discriminatory competitive advantage it may give to banks affiliated with holding companies, vis-a-vis non-affiliated banks and savings institutions. Since unregistered holding companies (and therefore, indirectly, affiliated banks) are not subject to interest rate regulations as are unaffiliated banks and savings institutions, affiliated banks have a definite advantage in competing for savings deposits, especially for large depositors. If this competitive edge were substantial, it would establish strong incentives for all banks and savings institutions to form one-bank holding companies, or at least to establish an affiliation with one. At critical times, moreover, this competitive advantage may cause severe liquidity strains to be placed on the financial system by causing large deposit flows from savings institutions into affiliated banks.

How important is all this for the conduct of monetary policy? Generally speaking, its importance will vary directly with the potential magnitude of the deposit shifts. If a large volume of depositors stand ready to exchange their deposits for assets like commercial paper at small yield differentials, it will be a substantial problem for monetary authorities. If on the other hand, the cross-elasticity of substitution of deposits for commercial paper is small (to use the correct economic jargon), the problem will be minimal. The appropriateness of this measure of importance is obvious: large shifts in deposits will be associated with large changes in total credit outstanding and vice versa. Further, greater deposit sensitivity to yield differentials will subject regulated institutions like saving and loan associations to greater liquidity strains. Thus the question of importance turns on the likely magntiude of the cross-elasticity of substitution of deposits for substitute assets issued by one-bank holding companies.

Assuming that holding companies are unable to issue (or create) a more attractive asset than commercial paper, the problem reduces to determining which depositors might consider commercial paper as a reasonably good substitute. To the ordinary small saver or checking account depositor, commercial paper is not liquid enough. In addition, their deposits are so small that they would probably not find the gain large enough to make it worthwhile to switch.[66] It is with respect to large depositors, especially holders of negotiable certificates of deposits, that commercial paper may become a problem—CD holders are less interested in liquidity and more interested in return than are small depositors. Many of these depositors are large corporations which temporarily invest their liquid assets in an effort to raise earnings.

If the problem can be limited to large depositors, particularly owners of large certificates of deposits, it may be less bothersome than initially suspected. It would, for example, seem to be much less of a liquidity threat to savings institutions, since most deposit customers of these instituions are small and may therefore not be responsive to higher yields on commercial paper issued by holding companies. In addition, the potential magnitude of the problem is greatly rcduced: large certificates of deposits, at their highest level, amounted to only about 25 billion dollars, or roughly seven percent of total bank deposits.[67] Nevertheless, even deposit shifts of this magnitude can be troublesome to monetary authorities at critical times, as the Federal Reserve's present concern over the fifteen billion dollars of Eurodollar borrowings clearly indicates.[68] Moreover, there is also a distinct possibility that one-bank holding companies may at any time develop new substitute assets which are attractive to an even larger volume of depositors, thereby increasing the problem significantly.[69] It would seem wise, therefore, to close this loophole by regulation before it can develop into a larger problem for monetary authorities.

Bringing one-bank holding companies under the supervision of the Federal Reserve would be sufficient to control this problem. Reserve

66. The "transaction" and "search" costs will be the same for all sizes of depositors, but the expected return of switching will vary proportionately with the size of the deposit, making it more worthwhile for large depositors to make the change.

67. Fed. Res. Bank of St. Louis, *U.S. Financial Data*, at 8 (July 2, 1969).

68. American banks' borrowing of Eurodollars is a similar "loss of control" problem for the Federal Reserve, since these borrowings are largely unregulated and also affect the composition of the banks' liabilities and therefore required reserves. *See* Saunders, *American Banks in London's Eurodollar Market*, 4 NAT'L BANKING REV. 21 (1966); MARTENSON, THE EURODOLLAR MARKET (1964).

69. If the Eurodollar loophole were closed, as the Federal Reserve is now trying to do, the one-bank holding company loophole would undoubtedly see more action for this reason alone.

requirements could be imposed directly on short-term liabilities of the parent holding company, or on its non-bank subsidiaries, although such regulation may be too much of a "shot-gun" approach. Alternatively, the Federal Reserve could impose tight controls on inter-affiliate transactions, preventing, for example, bank-affiliates from selling their loans to other holding company affiliates. Informal pressure may be still another technique for exercising control. In short, to control their potentially adverse effects on monetary policy, one-bank holding companies should be required to register with the Federal Reserve and should be made subject to the same powers the Federal Reserve now exercises over multi-bank holding companies. There is, however, as far as considerations of monetary policy are concerned, no need for a complete prohibition of one-bank holding companies.

IV. OVERALL EVALUATION AND POLICY IMPLICATIONS

In traversing the broad subject of one-bank holding companies, a number of specific judgments were made. First, the potential net impact of one-bank holding companies on competition need not be adverse. Although holding companies may limit competition either by engaging in informal tying and reciprocal agreements or by restraining the competitive behavior of smaller rivals, they will also exert a strong procompetitive effect by increasing both actual and threatened entry into many industries. Further, if acquisitions by one-bank holding companies are made subject to the approval of a regulatory agency, such as the Federal Reserve Board, authorities can substantially mitigate the adverse competitive effects, since the potential seriousness of these effects is largely dependent upon the underlying market structure. In others words, if given adequate power, regulatory authorities can prevent the development of a market structure conducive to the widespread and effective use of anticompetitive practices, while at the same time encourage competition by permitting holding companies to enter new fields.

Secondly, one-bank holding companies will clearly achieve some economies of scale. The most important gains in efficiency will come from affiliations among banks and non-bank financial institutions. Little or no economies, however, can be expected to result from affiliations of banks and financial institutions with non-financial companies. Thirdly, one-bank holding companies may engage in certain practices (such as the shifting of risky assets among affiliates), which if left unchecked could undermine the solvency of the banking system. Lastly, since they are outside the sphere of Federal Reserve regulation, one-bank holding companies may interfere with the effective implementation of monetary policy.

Despite the two latter findings, however, the overall conclusion of this paper is that one-bank holding companies should not be prohibited outright. Rather, they should be constructively regulated. As indicated in the earlier discussions, direct regulation can be used to eliminate the economic incentives which threaten bank solvency. In addition, by strengthening the Federal Reserve's control, regulation can prevent holding companies from hindering monetary policy. Thus, although the overall conclusion is that one-bank holding companies should be permitted, this conclusion is contingent upon the adoption of certain safeguarding regulations. A policy of permitting one-bank holding companies to operate under regulation is superior to either a policy of complete freedom or a policy of complete prohibition. It allows us to enjoy the benefits associated with increased efficiency and competition, but to escape the dangers inherent in the holding company form of organization.

What are the implications of all this for the current legislative inquiry? Should Congress enact new legislation, and, if so, what kind? The following are the policy recommendations suggested by the preceding analysis:

(1) One-bank holding companies should be required to register with the Federal Reserve and submit to regulation;

(2) "Effective control" should be made the primary test of whether equity ownership in a bank necessitates registration as a one-bank holding company;

(3) Acquisitions of one-bank holding companies should require the approval of the Federal Reserve and be subject to a "public interest" standard similar to that contained in the Bank Merger Act of 1966.[70] In addition, all acquisitions and practices of bank holding companies should remain subject to the antitrust laws;

(4) All subsidiaries of one-bank holding companies should be required to be incorporated as completely separate legal entities; but

(5) All assets of non-bank companies or subsidiaries should be made subject to attack in bankruptcy proceedings by the depositors of an insolvent affiliated bank;

70. 12 U.S.C. § 1828(c) (Supp. III 1968).

(6) The Federal Reserve should be permitted to prohibit interaffiliate transactions which it considers to be either a threat to bank solvency or a significant interference with its control over monetary policy:

(7) The Federal Reserve Board should be given discretionary authority to decide which non-bank activities bank holding companies[71] should be permitted to engage in. The criteria for approval should be whether entry into a particular activity increases or decreases competition, increases or decreases efficiency, threatens bank solvency, or significantly interferes with monetary policy. In particular, the "incidental to the business of banking" test should be discarded.[72]

These policy recommendations flow directly from an analysis of the economic consequences of one-bank holding companies. It is important to point out, therefore, that they may be subject to modification on the basis of non-economic or quasi-economic considerations such as the social or political ramifications of holding companies. In fact, one of these aspects has received such widespread attention that to end this discussion without at least mentioning it would be to expose the entire paper to a charge of irrelevancy; that aspect is bigness. A recurring uneasiness is that one-bank holding companies (and conglomerates in general) will become too large to be compatible with democratic ideals, or that they will wield so much power and influence as to make our democratic system unworkable. There can be no doubt that if bank holding companies are permitted to diversify along the lines recommended, the result will be larger firms and a greater concentration of economic, political, and social power. This problem, however, is not strictly speaking a one-bank holding company issue. It is rather a more general problem, which should be dealt with on a general basis. Giant non-bank conglomerates, large labor unions, and perhaps even big government are also part of the "bigness" problem. If we were to decide to arrest the trend towards bigness by establishing a policy of absolute size limitations on

71. As long as the recommended regulatory safeguards are also made applicable to multi-bank holding companies, no distinction need be made between them and one-bank holding companies.

72. The Federal Reserve Board was chosen as the most appropriate agency in which to vest regulatory power over bank holding companies because: (a) the Board presently regulates multi-bank holding companies, (b) it alone has responsibility for monetary policy, (c) it has a large, well trained staff and ample resources at its disposal, and (d) it is undesirable to divide supervisory authority among several agencies (such as the Comptroller of the Currency or the FDIC), since experience indicates that such division leads to rivalry and conflicts of interest.

businesses and other organizations, this policy should be applied in a rational way to all segments of the economy, including banking and bank holding companies. Thus, as important as the "bigness" problem is, it should not be allowed to obscure the economic logic of one-bank holding companies.