The Bank Holding Company—A Superior Device for Expanding Activities?

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Is the bank holding company a vehicle that ought to be used for purposes of *public policy* to permit banking organizations to perform functions that ought not be performed by banks *per se?* Or is the bank holding company structure merely an entity with no social function – an historical and political accident? The latter view seems to have pervailed in the deliberations of the Commission on Financial Structure and Regulation, which recommended

> after public hearings by the appropriate regulatory agency and application of the same criteria as apply to bank holding companies, commercial banks and their subsidiaries be permitted, upon individual application, to engage in a variety of financial, fiduciary or insurance services of the type, but not more extensive than those approved for bank holding companies by the Board of Governors under the Bank Holding Company Act.[1]

Although the supervisory agencies (the new Administrators of National Banks and of State banks, if the Commission had its way) would have discretionary powers to limit the activities of banks *per se* more narrowly than the Federal Reserve limited the powers of registered bank holding companies, the Commission seems quite clearly to have intended – or expected – that the limits on banks would not be significantly more narrow than those on holding companies. For, as the *Report* explains:

> The Commission believes that bank holding companies should not be the only vehicle through which services may be extended. The Commission would extend to banks and subsidiaries of banks, with the

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[1] *Report of the President's Commission on Financial Structure and Regulation,* p. 43.

> same procedural requirements, including the requirement for individial applications to the appropriate regulatory agencies, powers of the type, but not more extensive than those approved for bank holding companies by the Board of Governors under the Bank Holding Company Act. The Commission urges the Board to be as liberal as possible in approving new classes of service.[2]

In short, the *Report* reflects a belief that there are no important social questions at stake in the corporate structure of banking and bank-related operations, other than those that would be taken into account in the *private* decisions made by the banks themselves. These private decisions would, I presume, be made – quite legitimately – mainly on the basis of serving the interests of stockholders.

It can, however, be argued that the organizational form within which expanded activities that entail substantial risks are pursued really does make a difference in terms of public welfare. The reason is that, the holding company form of organization can permit greater flexibility for banking organizations while minimizing threats to the stability of the banking system. It should not be forgotten that much of the resistance to the "break-out" of banking from old restrictions during the 1960s came from supervisory authorities who feared the effects of expanded activities on the stability of the banking system. The Commission itself recognized on the very first page of the text of its *Report* that there is tension between the goals of lessened regulation and stability:

> For well over a century the American public has insisted that its financial institutions be both competitive and sound. The two objectives are not easily reconciled, and yet both must be achieved if we are to avoid, on the one hand, a highly concentrated financial structure and, on the other, a system unable to withstand the vicissitudes of economic change. The public is entitled to the benefits of a dynamic and innovative system responsive to shifting needs. Yet the public also should be able to rely on the strength and soundness of the system.
>
> Inevitably, difficulties are encountered in balancing these objectives.[3]

But the *Report* does not indicate that the Commission considered this tension a problem as far as expanded activities for banks, as opposed to bank holding companies, are concerned.

[2] *Ibid.*, p. 54.

[3] *Ibid.*, p. 7.

New Activities, New Risks

Expanded activities raise new risks and hence complicate supervision. Historically, bank supervision has dealt primarily with limited types of credit risks and risks of illiquidity.

Several of the new activities being pursued (and contemplated) by bank holding companies fall well-outside the traditional purview of bank regulation. That is, they raise different kinds of risks from those commonly encountered. Some "expanded" activities entail possible operating losses which might in some cases be substantial. It is difficult, (but not impossible) to imagine, say, a bank-operated travel agency incurring sizeable losses. But, say, selling computer services, or insurance underwriting could entail substantial risks of operating losses. Expanded activities may also entail significant exposure to costly damage suits. For example, a bank-connected insurance agency could be sued by a customer who had been told, incorrectly, that he is insured; a computer services operation could be sued by a customer who suffered losses due to faulty service. Many mortgage banking, factoring, and sales finance subsidiaries of bank holding companies are operated in ways that would baffle experienced bank examiners, and raise classes of risk not traditionally encountered in banking operations.

The main purpose of bank supervision and regulation is, in the first instance, to protect the interests of depositors and of the Federal Deposit Insurance Corporation. More broadly it is to preserve public confidence in the ability of banks to meet their obligations. The major sources of protection, aside from sound monetary policy are, first, the cushion provided by bank capital and positive net earnings flows, and, second, the legal and regulatory limitations on the extent to which bank resources are exposed to risk of loss.

New types of risks complicate the job of determining and enforcing standards of capital adequacy and of drawing lines beyond which banks cannot go. Although, as G. R. Hall points out, a new activity may, in fact, reduce the overall risk exposure of a bank, as a practical matter it is more likely that the opposite will be the case.[4]

Once it is admitted that there is a *public* stake in the prevention of bank failures, expanding activities pose complex problems of regulation. It is true, of course, that solutions are not difficult to find

[4] "Anticompetitive Impacts of Expanded Bank Service Lines," paper prepared for the Commission on Financial Structure and Regulation, February 1971, p. 24.

conceptually. A bank's capital could be made to vary directly and precisely with the magnitude of the overall risk it ran, so as to make the probability of failure independent of the amounts and kinds of risks taken. Or, even better, variable deposit insurance premiums could be used to charge banks fully for the risks to which they expose the deposit insurance fund, and the public at large through a collapse of confidence, while holders of uninsured deposits policed the banks in their own behalf. Banks could take all the risks they wanted, provided they paid the full price.

These possible approaches are interesing and useful to contemplate, because they force the analyst to specify precisely the problems he is dealing with. But they are not adequate as a practical matter. Either would require something approaching omniscience and omnipotence on the part of supervisory agencies. Even without an expansion of bank activities beyond traditional boundaries, the actual job of setting and enforcing standards of capital adequacy, or of prescribing variable deposit insurance rates, would be beset with enormous difficulties. Assuming the "right" approaches were found, new legislation would be required, and the history of banking legislation does not suggest that enactment of such theoretically complex solutions is likely.

In my view, to the extent that it is allowed to create increased fears of financial instability, the expansion of bank activities will call forth a muddled, inefficient extension of supervisory and regulatory activities. This would tend to defeat the basic purpose of granting wider powers to banking organizations – to permit them to meet real social needs. The holding company form of organization, properly used, provides a useful way of insulating the resources of banks from risks occasioned by expanded activities – and hence of minimizing regulatory interferences with these new pursuits.

Corporate Separateness – Real or Imagined?

In the eyes of the law, every corporation is a separate "person;" a holding company and each of its subsidiaries are therefore separate legal entities. Legally, then – with exceptions to be noted later – losses of one member of the family have no direct effect on either the profits or the capital of another. If one subsidiary should go into receivership, neither the parent nor sister subsidiaries are legally obligated to make good on its obligations. Likewise, if the parent corporation should go into receivership, only its equity interest in subsidiaries is available to satisfy claims on the parent. This means that, in principle, the resources of a banking subsidiary are not exposed to risks run by the parent or by nonbanking subsidiaries. Failure of the parent would lead to a change in equity ownership in the bank, but would not directly affect the bank as a going institution.

If this were the whole story, supervisory authorities would have no need to interest themselves in the risks run by parent bank holding companies and their nonbanking subsidiaries. Expansion of activities could proceed withour concern over their effects on bank soundness as long as the expanded activities were carried out by nonbanking affiliates, rather than by banks themselves. The tension between the goals of freedom of banking organizations to expand their services and innovate, on the one hand, and protection of the interests of depositors, the deposit insurance corporation, and confidence in the banking system on the other, would be resolved. (Of course, to the extend that requiring separateness interfered seriously with the efficiency with which the organization pursued expanded activities, such enforced separation would entail a social cost to be balanced against this gain in freedom.)

In addition, as matters stand, both deposit insurance and the faith of holders of uninsured deposits that, *as a matter of social policy*, bank failures will be made "rare events," give banks an advantage in borrowing funds. They thereby relieve banks of much of the "policing" that might otherwise be performed by private creditors. The holding company route of expansion, with enforced corporate separateness, would automatically guard against banks' taking advantage of their privileged position as borrowers, stemming from Federal guarantees of deposits and faith of holders of uninsured deposits that, as a matter of policy, bank failures will be held to a minimum.

In practical terms, however, the usefulness of the holding company approach is much less certain. Doubts can be raised on two grounds:

1. The legal separateness of affiliated corporations might turn out to be fictional because courts would "pierce the corporate veil," treating the holding company and all its subsidiaries as one legal person in the event that one subsidiary fails.

2. Holding companies would not, in fact, be willing to "walk away" from bankrupt subsidiaries but would use all of

their resources, including those of banking subsidiaries, to meet the obligations of a failing subsidiary.

Neither argument is entirely correct or incorrect, and it is necessary to examine both in some detail.

Legal Insulation – "Piercing the Veil"

When is a subsidiary corporation not a separate legal entity? When are its debts also debts of its parent, or of sister subsidiaries? That is, under what conditions might a court "pierce the corporate veil?"

This is a perplexing question and a critical one. If the courts could be expected routinely to hold that the separateness of holding companies and their subsidiaries was a fiction, the holding company form would provide no insulation at all. In that case, no advantages, in terms of protecting bank resources, reducing the need for regulatory interference, or preventing unfair competition, would be gained by restricting the activities of banks more narrowly than those of bank holding companies.

One can get differing opinions from lawyers on this question. After consulting with several, I have come to the following conclusions:

1. Courts would not ordinarily pierce the corporate veil, although the law and guiding precedents differ among the 50 states so that generalizations are hazardous.
2. The probability that a court would pierce the veil is smaller when the parent company or nonbanking subsidiary in trouble:
   a. Has a board of directors that does not entirely overlap that of the banking subsidiary under fire.
   b. Keeps separate books.
   c. Employs separate management.
   d. Has a name that is not easily confused with the name of the bank.
   e. Uses its own letterhead.
   f. Conducts its own advertising.
3. "Piercing crosswise" would be less likely than "piercing upward." That is, if a nonbank subsidiary failed, the likelihood that a banking subsidiary would be held liable for its debts is considerably smaller than the (already small) likelihood that the parent holding company would be held liable.

It therefore seems reasonably safe to say that, for banking organizations as well as for other corporations, piercing would be the exception, not the rule, as long as steps were taken to make nonbank subsidiaries separate in substance as well as in form.

Practical Insulation

Given that corporate separateness, in the strict legal sense, can be maintained, the achievability or even desirability on insulating banking resources from the fortunes of nonbank operations is still open to question. The fact is that bank holding companies would rarely choose to "walk away" from failing subsidiaries. Rather, at least within the limits of the law, they would use all of the resources of their organizations to meet claims against any part of it.

Two recent experiences illustrate the point. The American Express Company stepped in to assume liability for claims against its subsidiary, American Express Warehousing, Ltd., that arose out of the salad oil scandal of 1963. (The warehousing subsidiary, with capital of about $100,000, was subject to claims in the neighborhood of $60 million because it had issued warehouse receipts for oil that was supposedly stored in tanks, but that actually didn't exist.) More recently, United California Bank, a subsidiary of Western Bancorporation, assumed responsibility for debts of its Swiss subsidiary, United California Bank of Basel, after the Swiss bank had suffered enormous losses mainly connected with illegal use of its resources for speculation in cocoa futures.

The unwillingness of both American Express and United California Bank to attempt to take advantage of the limited liabilities of their subsidiaries may have been partly a matter of pride, but more compellingly, it was good business judgment. "Walking away" would have profoundly affected the reputations of the parent companies. In finance especially, reputation is a paramount asset. As Howard L. Clark, then President of American Express, put it:

> Our success is based on good will and the belief in our integrity and soundness. The immediate acceptance of travelers checks, money orders, credit cards, and the maintenance of bank deposits are all a basic necessity to the prosperity of the company.[5]

[5]"The Future of American Express," *Fortune*, April 1964, pp. 158-159 and 254-260. Quote from p. 260.

There have, of course, been instances of corporations "walking away." For example, in 1968 the Raytheon Company's Italian subsidiary, Elsi, declared voluntary bankruptcy. This case was, however, surrounded by special circumstances. As *The Economist* put it, "Normally, no major company would avoid standing behind the debts of foreign subsidiaries."[6] And it is important to remember that Raytheon is not a financial corporation.

Only in very unusual cases would bank holding companies *choose* to abandon failing subsidiaries, given the option. If it is to be real, insulation of the resources of banking subsidiaries from potential misfortunes of nonbank affiliates must rest on externally-imposed restrictions on the use of banking resources to meet claims on the affiliates.

Resources of banking subsidiaries might be tapped in three ways. First, the bank (or banks) could extend credit to troubled nonbank subsidiaries, or to the parent to be reloaned to the subsidiaries. Second, banks could pass funds "upstream" to the parent through dividend payments. Third, the banks could buy some or all of the assets of a failing affiliate.

Loans to Affiliates. Extensions of credit to affiliates are limited by the Federal Reserve Act, as amended.[7] Loans of insured banks to individual affiliates may not exceed 10 percent, and loans to all affiliates combined, 20 percent, of the bank's capital and surplus. Further, with certain exceptions, such loans must be secured by collateral in the form of "stocks, bonds, debentures or other such obligations" having a market value (at the time the loan is made) at least equal to the amount of the loan.

Dividends. Upstream dividends are limited by laws that restrict the size of bank dividends generally. The National Bank Act, as amended, requires a national bank to obtain approval of the Comptroller before (a) paying dividends out of capital and surplus[8] or (b) paying dividends in any one calendar year in excess of the sum of net profits for that year and retained net profits for the two preceding years.[9] The Federal Reserve Act imposes identical restrictions on state member banks, except that in their case, approval must be

[6] "Raytheon and the Mayor of Palermo," June 22, 1968, pp. 69-70. Quote from p. 70.

[7] 12 U.S.C. § 371c.

[8] 12 U.S.C. § 56, § 59.

[9] 12 U.S.C. § 60.

obtained from the Board of Governors.[10] State banking laws generally restrict payment of dividends out of capital.

In addition, supervisory authorities (including the Federal Reserve, the Comptroller, the state banking commissions) can apply pressure on banks to maintain or increase capital. Although these pressures do not have the force of law, they do exert moral suasion that is hard to resist, at least for an extended period. And institutional holders of uninsured deposits pay a good deal of attention to the level of bank capital as a source of protection.

Thus the possibility of using dividends of banks to meet reverses of nonbank subsidiaries, while limited, is by no means ruled out. Since retained earnings are the chief sources of growth in bank capital, the potential use of extraordinary dividends to meet such reverses intensifies the problem of enforcing standards of capital adequacy.

Sales of Assets. The third possible route by which the resources of a banking firm could be used to bail out a failing nonbank subsidiary is the direct purchase of assets. There are, of course, limitations on the kinds of assets banks can purchase. Moreover, the law restricting loans of insured banks to affiliates mentioned earlier defines extension of credit so broadly that the Federal Reserve Board has taken the position that it covers generally the purchase of assets.

In addition, the Federal Reserve persumably has additional powers, under the Bank Holding Company Act, to police and restrain such activities. Still, it would probably be hard to distinguish between "legitimate" and "illegitimate" purchases, especially when they were made to salvage a nonbank subsidiary whose precarious condition was not yet apparent to the regulators.

Summing Up

It seems safe to say that, under present law, requiring some or all "expanded" activities of banks to be performed by holding companies rather than by banks *per se* would tend to insulate the resources of banks from risks entailed in expanded activities. But the insulation would not be complete, and its effectiveness would vary from case to case.

It should be noted that requiring that expanded activities be carried on by subsidiaries of banks (rather than by nonbank subsidiaries of bank holding companies) would also provide some

[10] 12 U.S.C. § 324.

protection of banking resources from the risks occasioned by expanded activities. But the insulation would be distinctly inferior because

a. the bank would stand to lose at least its equity investment in the subsidiary in the event that the subsidiary failed;
b. the possibility of piercing the corporate veil "upward" to a parent bank is greater than "crosswise" to a bank that is a subsidiary of a holding company; and
c. the incentives to use the bank's resources to "bail out" a failing nonbank affiliate are probably even greater in the case of a direct subsidiary than in the case of a sister subsidiary of the same holding company.

Pros and Cons of "Enforced Separateness"

This section summarizes the arguments for and against confining expanded activities to bank holding companies and their nonbanking subsidiaries.

Advantages of Separateness

To the extent that the separation of risks occasioned by expanded activities from those of "banking" more narrowly defined is achieved, the potential danger that these activities will interfere with "bank soundness" is reduced. This reduces the conflict between expansion of activities and bank safety and relieves the supervisory authorities of the need to police the activities, issue regulations pertaining to them, develop machinery for determining and enforcing standards of capital adequacy for holding companies, and face additional difficulties in enforcing standards of capital adequacy of banks. Furthermore, the requirement of separate accounting would make the financial status of each separate operation more visible, both to management and to supervisors.

Enforced separateness also reduces the possibility that banks can finance expanded activities at subsidized rates by, in effect, borrowing the required funds through Federally guaranteed deposits.

Distinct separation of expanded activities from banking operations would have another advantage not directly related to bank safety. It would probably reduce the occurrence of (illegal) "tied sales," since the more separate were the managements of banks and nonbank subsidiaries, the more likely they would be to attempt to maximize their own profits, rather than joint profits.

Disadvantages of Separateness

The case for widening the powers of banking organizations hinges partly on alleged advantages from economies of joint-supply, joint-demand, and larger-scale operations that permit spreading certain costs (such as research or computer costs) over a broader range of activities. Enforced corporate separateness is likely, at least in some cases, to interfere with achievement of these advantages, for the very reason that it impedes complete integration of operations.

Finally, it is possible that enforcing separateness would, in some circumstances, contribute to instability. Even though the bank's resources would be *legally* insulated from risks associated with expanded activities, if the inability of a holding company to use those resources to meet adversities encountered anywhere within the organization meant the difference between bankruptcy and survival for a nonbank subsidiary (and perhaps the holding company itself), the result might be to weaken confidence in banking subsidiaries even though their resources were not directly at stake. This possibility would be smaller the more clearly it were understood by depositors that holding company banks were not legally responsible for the debts of parent corporations or sister subsidiaries, and that law and regulation prevented the use of resources of holding company banks to bail out affiliates.

It is this latter consideration that probably argues most strongly against enforced separateness. It is often contended that desirable as it might appear in theory, enforced separation would not work. The explanation most often cited is that the public would almost always identify the bank with its affiliates and vice-versa. In other words, separation would not exist where it probably counts the most – in the public's mind. If this assumption is correct, then it follows that holding companies should probably not be considered very different from banks as far as regulation and supervision is concerned.

The critical issue, therefore, is whether it is possible to enforce separateness in the minds of the public as well as in regulation.

Would a legislated prohibition against making banks liable for the debts of their affiliates, perhaps together with tightened controls over the remittance of excessive dividends from banking subsidiaries, make the public's faith in banks independent of the fortunes of their nonbank affiliates? If so, there is much to be said for enforced separation. If not, then the Commission's view – that commercial banks and their subsidiaries be permitted to do anything that holding companies can do – makes sense.

DISCUSSION

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Postulate that those who control a commercial bank have decided to expand their activities beyond banking. With some limits, they might choose to do so through several different forms: they might choose to form a holding company in which the bank would be a wholly-owned subsidiary. Or, according to recommendation 20 of the Hunt Commission, the bank might, with appropriate regulatory approval, conduct such expanded activities either directly by itself or by its own corporate subsidiaries. Mr. Chase's paper asks whether variations in the form matter. There are several different senses in which it might matter whether the parties utilized a single banking corporation for all activities or formed a bank subsidiary or holding company.

(1) Which form facilitates efficient operation of the whole enterprise at least cost and maximum output?
(2) Which form best assures the security, stability, and safety of the banking operation?
(3) Which form best protects the several markets involved from "unfair" competition?

I shall follow Mr. Chase's example and merely note that requiring separate corporations for the incremental activities might impair efficiency in carrying out joint functions and flexibility in undertaking new functions. Accordingly, management may not be indifferent to these questions of form. Whether society – understood as the "public generally," the disinterested academic, the Federal

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Reserve Board, a hypothetical czar of the universe, or Congressman Patman – should be indifferent depends on answers to the second and third questions.

Insulating Bank Assets

Focusing on the second issue, Mr. Chase notes one respect in which corporate separateness might prejudice a bank's health and stability: the failure or weakness of a non-banking affiliate or subsidiary – which it is assumed the separate bank could not bail out – might infect public confidence in the bank, no matter how separate the two corporations. The implication is that the bank might best assure public confidence in itself by conducting its non-banking activities within the banking corporation and thereby answering for the sins and losses of the non-banking activities. But I wonder whether "public confidence" in this context bears more on prosperity for the shareholders than on solvency or protection for the depositors. If corporate separateness helps protect depositors against the non-banking use of bank assets, the shareholders of the enterprise are not entitled to use the bank to reduce the risk of engaging in non-banking activities. In short, society does not owe bank shareholders a rose garden in which they can reap the profitable benefits of undertaking non-banking activities without bearing the risk that some expanded activities will sour and reduce public confidence in the enterprise.[1] Those who manage non-banking activities badly have no just complaint when the public doubts their financial wisdom.[2] Now it may well be true that the public will make this identification regardless of the corporate forms. But that is the bank's risk of expanding into other areas and certainly not an argument against corporate separateness.

Thus, one critical question is that which Mr. Chase emphasizes: is corporate separateness likely to help insulate the bank's assets from the financial risks of engaging in the incremental activities? The risks are several: the new operations might be unsuccessful and generate losses or even destruction of the capital devoted to them. The new divisions might suffer substantial contractual or tort liabilities to

[1] I note, in passing, that one of the benefits for the shareholders may be the carry-over to non-banking activities of the public convenience and confidence in dealing with the bank.

[2] Even if the managers are distinct, common ownership implies that there will be some common directors supervising the different managers.

creditors or other persons whom it has negligently or otherwise injured – to say nothing of possibly large, and perhaps innocently won, liabilities under the federal Securities or Antitrust laws.

Intra-Corporate Liabilities

For ordinary tort and contract liabilities, Mr. Chase is, I think a bit too pessimistic on the power of corporate separateness to insulate the bank from the liabilities of its subsidiaries, its sister corporations or a parent holding company.[3] I must, of course, disclaim any assurance that a court would not "pierce the corporate veil," "lift the corporate skirts," or otherwise "disregard the corporate fiction." And I readily acknowledge that judicial rhetoric offers little basis for prediction. There is much talk in the cases of disregarding corporate separateness when one corporation is the "agent," "instrumentality," or "alter ego" of another. The fact is, however, that disregarding the corporate entity is a rather rare phenomenon. Four situations are worthy of note.

First is express or implied suretyship. Certainly, one corporation will be liable for another's obligations where it expressly agreed to act as surety. Implied suretyship is also possible. If, for example, two corporations impliedly "hold themselves out" to be a single entity, the law may treat them as such. Common advertising, common letterheads, or confusingly similar names may be sufficient to create such implied suretyship. But there is little danger on this score when management is, as it ought to be, scrupulous to avoid misleading creditors into believing that a deal with, say, the First National Banking Corporation is a deal with the First National Bank.

Second, and not entirely distinct from implied suretyship, is "unified operation" of separate corporations. Mere common central direction is not enough, for owners are expected to control, and the authorities are unanimous that mere ownership or control is not sufficient to make a parent corporation or owner liable. The primary sin here is commingling of assets. And when the owners mingle the assets of two corporations for their purposes, the courts will do the same for the benefit of creditors.

As a possible third and ill-defined category, the court may disregard corporate separateness when the owners disregard corporate formalities. Most of the cases in this category seem to involve

[3]There are some differences among these three different situations involving separate corporations, but the confines of a "comment" preclude great detail.

(1) confusion of the affairs of the two companies, or (2) operating one as a "mere division of the other," or (3) improperly diverting the assets of one corporation, or (4) abusing control to the prejudice of minority shareholders. A lack of complete identity in the directors of the several corporations will, if the non-overlapping directors are reasonably attentive, help protect against these sins.

Fourth, the corporate entity may be disregarded when the troubled corporation is severely under-capitalized. The courts see a fraud upon the public when one corporation launches another with capital grossly insufficient for the ordinary business risks.

Now it is true that most cases in this area have "pierced the veil" in order to hold a parent responsible for a subsidiary's obligations or to subordinate the parent's claims to those of unaffiliated creditors. Although somewhat harder, the subsidiary could also be held liable for the obligations of its parent or sister corporations. And, importantly, a bank might find its claims against a failing sister corporation subordinated to outsiders' claims. Nevertheless, and for all the qualifications, it can be said with some confidence that banking assets are more secure from the creditors and victims of non-banking activities when performed by separate sister or even subsidiary corporations than when performed by the banking corporation itself.

Intra-Corporate Dealings

A related issue concerns "improper" use of banking assets for non-banking purposes. Now, as Mr. Chase points out, there are statutory and regulatory limits on lending and on dividends. And corporate separateness has the advantage of increasing the "distance" between banking and other activities and thereby increasing the formality and visibility of transactions between the bank and the non-banking parts of the enterprise.

Although corporate separateness may thereby help in controlling improper use of bank assets, it does not eliminate the danger. For obviously, the bank may deal with a sister, parent, or subsidiary corporation in circumstances and on terms where it would not deal with a similarly situated but unaffiliated corporation.

Insulating Markets

Finally, the few words that time allows about the possible anti-competitive consequences of expansion by banks or bank holding companies into non-banking activities. I am not impressed with the danger of "unfair" allocation of credit to non-banking activities which, arguably, obtain the benefit of the bank's federally-guaranteed – and therefore cheaper – money which unaffiliated borrowers do not obtain. To lend to an affiliate is necessarily to forego the return otherwise available on the market and is therefore a real economic cost to the enterprise. There would, I suppose, be opportunities for the bank to allocate "tight" credit to affiliates where custom or law prevented the interest rate from rising sufficiently to allocate the available supply of credit to reliable borrowers willing to pay a market-clearing price.

But the main competitive threat of expanding activities by banking enterprises is the potential for the use of leverage in the form of tying or reciprocity. The fear is that the banking conglomerate will gain an unfair competitive advantage in its non-banking markets by "pressuring" borrowers to take their shared-time computer services, travel tickets, or whatever from the banking conglomerate. To that extent, an "alien factor" would displace "competition on the merits" for the second product. An express agreement of that sort would be a clearly unlawful tie in violation both of Sherman Act § 1 and the Bank Holding Company Act.[4] But perhaps the "pressure" would be subtle enough to escape antitrust condemnation and yet strong enough to influence borrower behavior. The legal issue in such a case would turn on whether a jury would reasonably infer from the circumstances that the loan was conditioned, in any formal or informal sense, on the borrower's accepting other products or services.

Similarly, competition in banking services might be affected to the extent that suppliers to the banking conglomerate believed that banking with the conglomerate was a *sine qua non* or at least an aid to selling to it. Again, the express agreement would be clearly unlawful. And again, the legal issue in most cases would be whether one could infer from the circumstances that reciprocity was being practiced.

[4] 12 USCA § 1972. The latter section is not limited to bank holding companies or their subsidiaries. It prohibits tying or reciprocity by any bank. Indeed, its language is so broad as to arguably cover many "legitimate" or at least customary banking activities. The statute does, therefore, give the Federal Reserve Board the authority to exempt transactions from the full sweep of § 1972. A Federal Reserve Board exemption from § 1972 however, would not immunize a transaction from the antitrust laws. Both the Senate Report and the Conference Report make clear that public and private remedies for the enforcement of § 1972 are not meant to be exclusive of otherwise available antitrust remedies to private parties or to the government. See 1970 U. S. Code Cong. and Adm. News 5519.

Now it is clear that illegality under the antitrust laws does not depend on the corporate form chosen. Nor do treble damages for violation of those laws. Indeed, the bank which is involved in such a violation would itself be liable quite apart from the corporate form.[5]

Nevertheless, corporate form might be relevant in two respects: to help minimize the likelihood of the violation and to help reduce the inference of tying or reciprocity from the circumstances. Separate corporations with separate managements, each responsible for its own profits, reduce somewhat the likelihood that either would base its decision on any factor other than its corporation's profits, regardless of the second corporation's profits. If those who buy supplies for other divisions of the conglomerate are formally and physically isolated from the lending officers, the chances of procurement personnel being influenced by the source of a supplier's borrowings is much reduced.

Accordingly, the distance between the banking and non-banking activities would reinforce the financial insulation of banking assets and also help reduce the likelihood of tying and reciprocity in violation of the antitrust laws. In both respects, corporate separateness helps establish such distance. But, of course, corporate separateness cannot necessarily guarantee either financial or antitrust immunity.

[5]Similarly, the Securities Exchange Act of 1934 imposes various liabilities on those who control a corporation regardless of the corporate form.

DISCUSSION

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The underlying theme of Dr. Chase's paper is that if a subsidiary of a holding company fails, the failure may possibly have an impact upon the safety of the deposits of a bank also belonging to the holding company. He asks whether some activities could be better carried on within the bank itself or in the holding company. He concludes that the more risky activities ought to be carried on in the holding company. But, since the failure of one of the subsidiaries of the holding company may lead to trouble in the bank itself, Dr. Chase comes face to face with a problem that is dear to the hearts of a regulator: How much freedom should management have to take risk if it can lead to failure? I would like to suggest that there is a serious misemphasis in this point of view.

Holding Company Activities

I am not a lawyer, but my understanding is that holding companies can enter into activities that are financially related to banking. I suspect that if Dr. Chase had his way there would be another criterion: the activity should not only be financially related to banking but it ought not to jeopardize the profitability of the bank itself. More specifically, the bank ought not to pay too high a price for the subsidiary that it acquires.

Let me elaborate on this point. Take an activity, such as financial consulting. Banks engage in financial consulting all the time. No customer can get a personal loan without the banker asking whether he needs the money, how much he needs, what his plans are for its use, and so forth. And based upon the information he develops, a program is established for repayment of the loan. This is financial

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consulting in the nitty-gritty sense of the term. We can cite a second example. A builder comes into the bank to get a loan for a proposed development. The banker may visit the site with the builder and say, "You know it looks like a nice property, but have you done a survey to determine whether or not there is any need for an apartment building where you want to put it?" Both the builder and the banker may examine the vacancy rate of two or three-bedroom apartments in the community, the trend of population, the location pattern of new highways, etc. This too is financial consulting and it is an activity that many many banks carry on. In spite of the fact that banks are continuously consulting with their clients, the Board recently ruled that bank holding companies could not engage in management consulting.

I don't know why the Board reached the conclusion that bank holding companies could not do what banks can do, but I have a hunch. My hunch is that the price that the holding company was willing to pay for these new acquisitions was too high. The management consulting firms which were to be acquired were going to command a premium over book. I suspect that other things being equal the Board would prefer new acquisitions to be at low rather than high prices.

Methods of Paying for Acquisitions

The reason for the preference is straightforward. There are two ways in which you can acquire a company. One is to buy it for cash, and that raises the question of where the money came from. The other way is to swap paper, an exchange of shares. Consider the first method, an exchange for cash. Where is the bank going to get the money? One likely answer is that the holding company sells a bond issue. Now what? Well, interest has to be paid on the debt and if the company borrows too much, in some years it may possibly not earn enough to pay the interest. It is a matter of judgment as to how much of a debt a firm can afford to carry, but I submit that the Board has a bias against too much debt in the capital structure of the holding company.

Now consider the second way to make an acquisition, through the exchange of shares. If I pay a premium – that is, if the company I acquire sells at a higher P/E ratio than the bank – then if I am to continue my per share dividend payments, I require that a larger percentage of my earnings be paid out. The implication is that not enough capital will be accumulated and retained and a failure may result.

Low Price of Bank Stock

Where do these speculations lead us? The answer, I think, is simply that the price of bank stock is too low. If the price of bank stock were higher, many of these consequences of acquisitions would disappear. But this only leads to the question: Why are bank stocks selling at such a low price? Why is the P/E ratio so low? I think there are several reasons. First, I think that one reason for the low P/E ratio is tough regulation. It almost seems that every time a bank gets a good idea and wants to do something that will be innovative and profitable, a regulator arises who says it cannot be done. I think if this activity continues and if the regulators are hostile because of some deep concern about deposit safety, bank stocks may possibly sell for less than book value. This condition now prevails in other regulated industries and I do not see why it could not happen to banks.

Second, I think that bank stocks sell at a low P/E ratio because of the industry's relationships with the Congress. Who wants to invest in an industry that gives the impression of constantly bickering with the legislative body?

Third, and perhaps most important, banks don't really advertise themselves very well. There was a glorious column a little while ago by Eric Heinemann in the New York Times that discussed what I consider to be one of the finest days of the commercial banking system. It was right after the Penn Central failed and we had a major panic pending in the commercial paper market. There began to be a run on Chrysler and the day-by-day and hour-by-hour development were described by Heinemann. The commercial banking system advanced Chrysler almost a billion dollars over the space of three days and as we know no crisis erupted. The banks stood there, put their money on the line and saved the day.

Aside from the New York Times, no one else talked about these developments and about the major public service that the industry performed. I think if the story were told, investors would be willing to commit their funds to companies with such foresight and courage.

To summarize, I believe bank stocks are selling at a low P/E ratio, because of hostile regulations, because of poor relations with Congress, and because banks themselves do not properly tell their story. So long as bank stocks continue to sell at low P/E ratios, acquisitions by holding companies are going to be challenged. The kinds of problems that Sam Chase talks about – about whether acquisitions can lead to failure – are going to remain. My own sentiment is that the way to promote better banking is for the Federal Reserve to go out and tell America to buy bank stocks, because they are tremendous investments.