March 23, 1987

Dear Senator:

The Competitive Equality Banking Act of 1987, S.790, addresses a number of important concerns, including the need to recapitalize FSLIC and to eliminate excessive check holds. However, from a long-run perspective the paramount issue addressed by the bill is the need to close the nonbank bank loophole. This loophole in the Bank Holding Company Act and an even wider loophole in the Savings and Loan Holding Company Act for unitary thrift holding companies threaten to undermine the longstanding separation of banking from commerce with serious adverse consequences. The most predictable adverse effects would be distortions in the allocation of credit and an unwarranted extension of the federal safety net established for banks to an array of commercial, industrial, and agricultural firms. Whatever modest benefits the proponents of mixing banking and commerce might claim in the form of increased competition or innovation would be swamped by the economic costs of credit distortion and a massive increase in the supervisory burden of banking regulation. Moreover, the mixing of banking and commerce would ultimately lead to excessive concentrations of economic and political power. Finally, apart from the separation issue, the nonbank bank loophole undermines the ability of individual states to assure that banks controlled by out-of-state bank holding companies continue to adequately serve the credit needs of their local communities.

In considering this legislation, it is crucial to distinguish between the mixing of banking and commerce -- the issue raised by exploitation of the nonbank bank loophole and addressed by Title I -- and the concept of integration within the financial service sector. Financial service integration -- the issue addressed by the moratorium proposed in Title II -- refers primarily to the mixing of banking, securities, and insurance activities. Financial service activities generally revolve around the transfer of funds from savers and investors to ultimate borrowers, although they can include other important financial functions, such as payments systems and insurance. The financial service sector with its emphasis on financial intermediation is clearly distinct from the commercial, industrial, and agricultural sectors, which are end-users of credit.

Ending the separation of banking from commerce would have far-reaching adverse consequences that could not be ameliorated by statutory or regulatory safeguards. By contrast, the desirability of integration within the financial service sector turns on a number of complex but less far-reaching issues with substantial arguments both pro and con. The issue of financial service integration should be resolved by Congress on a case by case basis, with the nature and the efficacy of accompanying safeguards as the controlling factor in most cases. But, legislators should keep in mind that while the issue of financial service integration generates much passion among various factions within the financial service industry, the separation of banking from commerce is the issue with far greater public import.

Distortion in the Allocation of Credit

If commercial, industrial, or agricultural firms are permitted to acquire banks, there will inevitably be a tendency to allocate the credit of their subsidiary banks in a manner that benefits the controlling firm's commercial interests. Introduction of such bias into the credit decision process undermines banks' essential role as a neutral arbiter of credit. Fortunately, such distortion in the allocation of credit has in general not been a problem in the United States because we have for the most part maintained a separation of banking from the commercial sector of the economy.

In the instances where the separation between banking and commerce has been breached there is evidence of credit flow distortion. For example, before 1970 a commercial bank controlled by Sears made a majority of its commercial loans to Sears' suppliers. More recently, savings institutions given authority to own real estate have extended large volumes of credit under relaxed credit standards to their own real estate interests.

Self-dealing through loans to the business interests of bank insiders -- principal stockholders and officers -- has been a chronic cause of preferential loans and even bank failures at small and medium size banks. It has been less of a problem at large banks because given the diffusion of their stock ownership and their control by large management structures they are less likely to come under the influence of insiders promoting outside business interests. However, breaching the separation of banking from commerce would radically extend the scope of self-dealing from an individual to an institutional level and encompass the largest banks as well as smaller institutions. Clearly, this would greatly complicate the task of bank supervision.

More important, no set of safeguards can adequately address the problem of credit misallocation. Congress could prohibit banks from making loans to commercial affiliates, but this would not stop the more subtle forms of credit assistance, such as placement of commercial paper. Even a prohibition against all forms of credit support for commercial affiliates would not prevent a bank from granting the suppliers or customers of its affiliates preferential access to credit. Moreover, in smaller markets with only one or two local banks a bank could effectively assist its commercial affiliates by refusing to deal with their competitors. Asking the banking regulators to control these secondary and tertiary effects would impose an impossible supervisory burden.

Extension of the Federal Safety Net for Banks to the Commercial, Industrial, and Agricultural Sector

The federal government provides depository institutions with deposit insurance and emergency borrowing privileges in order to maintain public confidence and stability in the banking system. The presence of this federal safety net, however, shields banking institutions from market discipline to a considerable extent and this in turn necessitates federal supervision of their activities. The mixing of banking and commerce would result in an implicit and unavoidable extension of this safety net to the commercial, industrial, and agricultural firms that acquired bank subsidiaries. The would over-extend the safety net and impose a tremendous supervisory burden on bank regulators.

The mixing of banking and commerce would expand the demands on the federal safety net because as a practical matter it is not possible for bank management, regulators, or investors in the market to separate and insulate a bank subsidiary from the operations of its parent holding company or other affiliates. As former Citicorp Chairman Walter Writson has stated, "it is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital and assets are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace ... would not see it that way."

The extension of the federal safety net occurs in two ways. First, when financial difficulties are encountered by a holding company or non-bank affiliate, holding company management will attempt to use subsidiary bank resources to ameliorate the problem. Perhaps the most dramatic example of this dynamic is the financial assistance that Chase Manhattan Bank and First Wisconsin National Bank provided during the 1970's to the troubled REITs which they sponsored.

Second, a commercial firm that acquires a bank will often be able to operate with less capital by virtue of its association with the bank. In essence, financial markets will allow the commercial firm and its nonbank affiliates to operate in a riskier mode because some of the risk of failure has been implicitly shifted to the bank subsidiary and the federal safety net. Of course, the ability to operate with less capital would give commercial firms with bank affiliates an important competitive advantage over firms without bank affiliates. Thus, an extension of the safety net would not only be imprudent, but would also create competitive inequity in the commercial, industrial and agricultural sectors.

The fact that affiliation between a commercial firm and a bank enables the commercial firm to shift some risk to the bank means that federal banking regulators must supervise the commercial firm as well as the affiliated bank if they are to protect the resources of the federal safety net. The Federal Reserve Board currently supervises bank holding companies for this reason. One of the greatest dangers inherent in the nonbank bank loophole is that the Federal Reserve Board has no supervisory authority over commercial firms that acquire nonbank banks.

However, even if commercial firms controlling nonbank banks were brought under the Federal Reserve Board's supervisory authority, this would not solve the basic problem created by mixing banking and commerce. Open entry into banking would require the Federal Reserve Board to set capital ratios and engage in risk-limiting supervision for a host of commercial, industrial, and agricultural conglomerates. This would impose a tremendous supervisory burden and could hardly be characterized as "deregulation."

Economic Concentration

The mixing of banking and commerce would lead over time to excessive concentration of economic resources and political power. Consider for example the economic and political influence that would accrue if the largest oil companies or auto firms were to merge with the largest banking institutions.

Even if the separation of banking from commerce is maintained, financial concentration will be increasing rapidly in the years ahead due to interstate banking and greater integration within the financial service sector. It would be unwise to allow even greater economic concentration by authorizing mergers between banking institutions and commercial, industrial, or agricultural firms.

Local Community Credit Access

Apart from the separation issue, the nonbank bank loophole should be closed because it undercuts the ability of individual states to take action to assure continued credit availability for their local communities. Congress enacted the Douglas Amendment to the Bank Holding Company Act to give individual states the authority to control entry and the conditions of entry by out-of-state banking institutions. In the last several years a number of states acting under this authority have established various credit access safeguards as a condition for entry by out-of-state banks. Nonbank banks, especially those with national bank charters, pose a serious threat to the states' ability to establish conditions of entry because they operate outside the Bank Holding Company Act. A key benefit from closing the loophole would be to prevent the circumvention of state credit access safeguards.

Sincerely,

Ralph Nader

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Jonathan Brown

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BankWatch