

Bank Holding Companies, Cross-Bank Guarantees, And Source of Strength

By William R. Keeton

Regulators have long been concerned about unsafe practices by bank holding companies. Their concerns intensified in the late 1980s with the sharp increase in bank failures in Texas, a state where multibank holding companies are especially common. In several cases, holding companies with troubled banks behaved in ways regulators considered irresponsible. In particular, holding companies refused to use the resources of their healthy banks and nonbank subsidiaries to cover the losses of their troubled banks, forcing the Federal Deposit Insurance Corporation (FDIC) to pick up the tab when the banks subsequently failed.

Whatever advantages bank holding companies (BHCs) may have as a form of organization, the Texas experience emphasizes they can also reduce bank safety and soundness. Three problems in particular stand out. First, geographic and product diversification through BHCs may not significantly reduce the rate of bank failures if profits and losses are not pooled. Second, BHCs may encourage their banks to

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engage in transactions with affiliates that boost the holding company's profits at the expense of the FDIC. Finally, BHCs may rely too heavily on debt as their source of funds, reducing their incentive to manage their banks prudently.

Responding to these concerns, regulators and legislators have tried to make BHCs more responsible for the health of their banks. Last August, on the urging of the FDIC, Congress provided for a new system of "cross-bank guarantees" in the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). Under this provision, BHCs can be required to use the net worth of their healthy banks to reimburse the FDIC for the losses from their troubled banks. A more comprehensive approach advocated by the Federal Reserve is to make BHCs serve as a "source of strength" to their troubled banks. That is, a BHC must assist its troubled banks before failure is imminent and, if necessary, draw on both its bank and nonbank resources. In a variation of this approach, some legislators have proposed BHCs be legally liable for all losses incurred by the FDIC in closing their banks.

This article reviews the recent efforts by regulators and legislators to protect the banking system from unsafe practices by BHCs. The article concludes that cross-bank guarantees are beneficial, but that some kind of source-of-strength policy is probably necessary to more completely address all the safety-and-soundness problems posed by BHCs. The first section of the article reviews the BHC form of organization and explains the ways BHCs can reduce bank safety and soundness. The second section shows how cross-bank guarantees can alleviate some of these problems. The third section explains how a source-of-strength policy solves those problems not addressed by cross-bank guarantees.

I. BHCs and Safety and Soundness

Both cross-bank guarantees and the source-of-strength policy are intended to alleviate safety-and-soundness problems associated with the BHC form of organization. To provide a background for evaluating these policies, this section briefly reviews the BHC form of organization, explains its potential adverse effects on the safety and soundness of the banking system, and outlines alternative remedies.

What are BHCs?

Holding companies are a common form of organization in banking and other lines of business. A holding company is a company that owns or controls other companies and operates those companies as separately incorporated subsidiaries. An important feature of all holding companies is that they enjoy limited liability against the claims of private creditors on their subsidiaries. In other words, with very few exceptions, an individual or business cannot go after the assets of the holding company to satisfy a claim against the subsidiary.

A BHC is a holding company that owns or controls a bank. Three types of BHCs can be

distinguished, depending on what the company owns besides a bank.

A one-bank shell is a BHC that owns only one bank and has no other assets. One reason investors create such shells is to borrow the funds necessary to acquire a bank without assuming personal liability for the loan. Another reason is to take advantage of the tax deductibility of interest on BHC debt (Eisenbeis 1983).

A multibank holding company (MBHC) is a BHC that owns more than one bank. Because such companies share many of the advantages of a branch system, they are especially common in states like Texas where branching is prohibited or restricted.

The third type of BHC is one that not only owns one or more banks but also owns nonbank assets—usually in the form of shares in a nonbank subsidiary. BHCs often set up nonbank subsidiaries to carry out activities prohibited for banks. However, BHCs are also restricted in the activities they can pursue outside their banks. Specifically, the Glass-Steagall Act prohibits BHC subsidiaries from being “principally engaged” in securities underwriting, and the Bank Holding Company Act restricts BHC subsidiaries to activities “closely related to banking.” As a result, BHCs typically have few nonbank assets relative to bank assets (Liang and Savage 1990).

While similar in form to other holding companies, BHCs differ in a crucial respect—the liabilities of their bank subsidiaries are federally insured. In most industries, there is little need to worry about the safety and soundness of a holding company’s subsidiaries because the failure of a subsidiary imposes no cost on the public. Only the creditors of the subsidiary are hurt by failure, and they can be trusted to protect their own interests. In contrast, the failure of a bank subsidiary of a BHC imposes an external cost on the public by increasing FDIC losses and depleting the insurance fund. This external cost justifies some form of government regula-

tion to limit practices by BHCs that increase their banks' risk of failure.

How BHCs can reduce safety and soundness

BHCs can impair the safety and soundness of their banks in three principal ways. One way is by preventing diversification from reducing the risk of bank failures. Another is by encouraging improper transactions among banks and affiliates. A final way is by allowing the parent company to become undercapitalized. All three problems reflect rational responses by BHCs to the current deposit insurance system, which places much of the burden of bank failures on the FDIC.¹

Reduced benefits from diversification.

Banking analysts have long argued that greater geographic and product diversification would increase the stability of the banking system and reduce the incidence of bank failures. For example, a bank with branches in many regions could spread its lending among the branches, enabling it to use profits from loans to prosperous regions to offset losses from loans to depressed regions. This pooling of profits and losses would make the bank less likely to fail than if its lending were concentrated in one region. Similarly, a bank offering a variety of products besides traditional banking services could use profits from successful products to cover losses from unsuccessful products, reducing its probability of failure.

Although greater diversification by banks could significantly reduce their risk of failure, future diversification is more likely to occur within BHCs than within banks. Under current law, banks cannot open branches in more than one state. Consequently, the only way a banking organization can diversify across state lines is by forming an MBHC with separate subsidiaries in each state. The other form of diversification—product expansion—also seems more

likely to occur within BHCs than within banks. Advocates of expanded powers often argue that new activities like securities underwriting be restricted to the nonbank subsidiaries of BHCs, thereby insulating banks from the risks. The most recent effort by Congress to repeal the Glass-Steagall Act adopted this approach, and future efforts will probably do the same.²

Diversification within BHCs will not necessarily reduce the risk of bank failures because diversified BHCs may choose to let their troubled banks fail. Consider a bank subsidiary suffering heavy losses because it specialized in loans to a region in a severe but temporary slump. If the bank has a good chance of returning to profitability in the future, it will be in society's interests for the BHC to use the profits of its healthy banks and nonbank subsidiaries to cover the bank's current losses and keep it open. However, if the bank's current losses are large relative to its future expected profits, it may well be in the BHC's interest to let the bank fail. Letting the bank fail forces the BHC to give up the bank's future expected profits but has the advantage of shifting the bank's current losses onto the FDIC.

Improper transactions between affiliates.

A BHC with more than one bank or with nonbank operations has an incentive to encourage improper transactions between affiliates—transactions that raise the BHC's expected profits but also increase the chance that some of its banks will fail. Such improper transactions fall into two categories, those between sister banks and those between banks and nonbank affiliates.

Because the costs of failure are borne largely by the FDIC, MBHCs have an incentive to transfer resources from troubled banks to healthy banks through mispriced business deals. For example, an MBHC may encourage a troubled bank to charge too low a rate on loans to healthy sister banks. Or the MBHC may encourage the troubled bank to purchase loans from healthy sister banks at book value even though the market

value has fallen due to a lower probability of repayment. The MBHC will neither gain nor lose from such transfers if the troubled bank remains in business. However, if the troubled bank fails, the MBHC will gain from the transfers because the cost to the troubled bank will fall on the FDIC while the benefit to the healthy banks will accrue to the company.

BHCs with nonbank operations have similar incentives to promote improper transactions between banks and nonbank affiliates. First, by shifting resources from banks to nonbank affiliates, BHCs can reap the same benefits as by shifting resources from troubled banks to healthy banks. Suppose, for example, that a BHC induces a bank to undercharge nonbank affiliates for loans or to overpay them for management and data processing services. Then if the bank fails, the cost of the mispricing will be borne by the FDIC. Second, BHCs can profit from excessively risky bank loans to nonbank affiliates. When a bank lends to an outside firm, the BHC will want the bank to make sure the borrower avoids projects with a high payoff but low chance of success. But when the bank lends to an affiliate, the BHC may be quite willing for such risky projects to be undertaken. If the projects succeed, the BHC will reap all the profits. And if the projects fail, the cost will fall on the FDIC.³

Current controls on interaffiliate transactions are unlikely to eliminate the various abuses described above. The most important controls are those in Sections 23A and 23B of the Federal Reserve Act. These laws limit the total amount a bank can lend to nonbank affiliates, require loans to nonbank affiliates to be fully secured, and prohibit banks from buying "low-quality" assets from either bank or nonbank affiliates (Miles 1988).⁴ One problem with the laws is that they do not cover certain types of transactions, such as loans between sister banks and daylight overdrafts on banks by nonbank affiliates. Some parts of the laws are also difficult to enforce. For example, a BHC may be able to transfer bad

assets to a troubled bank without detection by regulators because it has private information about the quality of the assets. Finally, a BHC may be caught in a violation of the laws, but only after the damage has already been done.

Undercapitalization of the parent company. Even if each bank of a BHC is highly capitalized, the parent company may have so little capital and so much debt that it is tempted to manage its banks imprudently. Some BHCs may borrow heavily to make equity investments in their banks—the practice known as "double leveraging" (Rose 1978, pp. 169-75 and Sinkey 1986a). Other BHCs may borrow only moderately but suffer heavy losses in their nonbank operations that sharply reduce their net worth. Whatever the cause, a BHC owing significantly more than the value of its nonbank assets will be tempted to have its banks take big risks in order to pay off its debt. If the gambles succeed, the BHC will stay in business and earn a positive profit. And if the gambles fail, causing the BHC and its banks to go under, the FDIC and the BHC's creditors will bear the losses.

BHCs have an incentive to borrow and a disincentive to raise capital because their creditors care only about their own losses and not those of the FDIC. Creditors will realize that the more a BHC borrows, the greater will be its incentive to have its banks take big risks. But in deciding how much to lend and what rate to charge, creditors will take into account only the adverse effect of the additional risk-taking on their own return. They will ignore the adverse effect of the additional risk-taking on the FDIC.

Alternative remedies

How can policymakers solve the three problems BHCs pose for the safety and soundness of the banking system? Since the cost of bank failures to the FDIC is the main reason for worrying about unsafe BHC practices, cutting back on deposit insurance might seem a natural

solution. However, reducing deposit insurance could heighten financial instability by increasing bank runs and making it harder for banks to provide liquidity during crises. Another possibility would be to replace BHCs with “universal” banks—banks that can branch freely and exercise new powers directly. This approach would ensure that diversification reduced the risk of bank failures and would eliminate concerns about improper interaffiliate transactions and inadequately capitalized BHCs. But banning BHCs would force banking organizations to give up a convenient way of decentralizing their operations. And allowing banks to exercise new powers directly would expose the FDIC to greater risk of loss than if new powers were confined to separate BHC subsidiaries.⁵

Fortunately, there are other remedies for the safety-and-soundness problems of BHCs that do not require giving up the benefits of deposit insurance or the BHC form of organization. Cross-bank guarantees are one such remedy and source-of-strength policies another.⁶

II. Cross-Bank Guarantees

Last year when Congress enacted FIRREA, it included a provision requiring each bank in an MBHC to guarantee the FDIC’s claims on its sister banks. This section concludes that the new cross-bank guarantees will solve some of the safety-and-soundness problems posed by BHCs and will not have excessively serious side effects.

What are cross-bank guarantees?

The main impetus for cross-bank guarantees was the difficulty regulators encountered in the late 1980s closing Texas banks belonging to MBHCs. During the recent energy and real estate recession, it was common for some banks in an MBHC to become insolvent while others retained positive net worth. Although these MBHCs had

operated as integrated entities, much like multi-branch banks, they made little or no effort to use the resources of their healthy banks to cover the losses of their troubled banks. In one case, that of First RepublicBank Corporation, regulators negotiated an agreement that made it possible to close all the banks in the company, including those that had been solvent. But in other cases, such as that of MCorp, regulators could not negotiate such agreements and thus were unable to touch the company’s healthy banks.

In response to these problems, Congress included a provision in FIRREA making the healthy banks in an MBHC responsible for the FDIC’s losses from failing banks (House of Representatives 1989).⁷ In particular, whenever the FDIC incurs a loss closing or assisting an insured bank or S&L, the other insured banks and S&Ls in the company can be required to reimburse the FDIC up to their net worth. If the healthy banks are unable to pay the FDIC in full and are forced to close themselves, the FDIC receives whatever is left over after paying off the bank’s depositors and subordinated debtholders.

FIRREA allows two major exceptions to the new guarantees. For failed S&Ls acquired by BHCs before last August, the guarantees do not go into effect for five years. Also, the FDIC can waive the guarantees for a particular bank or S&L, in which case transactions with sister banks must satisfy the same Section 23A and 23B restrictions as transactions with nonbank affiliates.

Favorable effects on safety and soundness

One way cross-bank guarantees alleviate the safety-and-soundness problems posed by BHCs is by ensuring that greater geographic diversification by BHCs will reduce the risk of bank failures. Under the old system, an MBHC with both successful and unsuccessful banks had an incentive to let the unsuccessful banks fail and

keep the profits from the successful banks to itself. With cross-bank guarantees, however, an MBHC cannot avoid using the profits of its healthy banks to cover the losses of an unsuccessful bank. If the MBHC lets the unsuccessful bank fail, the MBHC will still have to use the profits of its successful banks to reimburse the FDIC. Thus, a highly diversified MBHC will let a troubled bank fail only if it should fail—that is, only if it has little chance of returning to profitability.

Another way cross-bank guarantees increase safety and soundness is by eliminating an MBHC's incentive to transfer resources from its troubled banks to its healthier banks. Under the new law, an MBHC has nothing to gain by having a troubled bank overpay for assets or services purchased from its sister banks or undercharge for assets or services sold to its sister banks. If the troubled bank remains open, its increased losses will just offset the increased profits from the healthy banks, leaving the MBHC's total profits unchanged. And if the troubled bank fails, the MBHC must use the increased profits of its healthy banks to reimburse the FDIC.

Possible adverse effects

Cross-bank guarantees will ensure that geographic expansion by BHCs reduces the risk of bank failures, but they may also discourage such diversification. Suppose, for example, that two groups of banks in different regions are considering merging under the same MBHC. Before merger, shareholders benefit from the fact that the FDIC will bear part of the banks' losses if the banks fail. That is, no matter how big the banks' losses are, shareholders in each group cannot lose more than their equity investment, leaving the FDIC to make up the difference. When the two groups merge, however, some of this benefit will be lost. If the banks in either group fail, a smaller portion of their losses will

be borne by the FDIC, because the MBHC will have to use the profits from the other group to reimburse the FDIC. Indeed, the FDIC will not have to pay anything if the banks in one group fail and the banks in the other group earn enough to cover the failed banks' losses. Thus, a merger will force shareholders to bear more of the banks' losses, making the two groups of banks more valuable independent than merged.

Cross-bank guarantees may also slow the growth of MBHCs that have already diversified geographically. Because the FDIC will bear a smaller share of their losses, these MBHCs will not be able to promise as high a return to shareholders, making it harder for them to attract the new capital they need to grow.

These adverse effects on the formation and growth of geographically diversified MBHCs are potentially serious but can be mitigated by varying insurance premiums or capital requirements to reward diversification. Under the current system, a bank's insurance premium and capital requirement are independent of the degree of geographic diversification. But with cross-bank guarantees, it may be appropriate to set lower premiums or capital requirements for MBHC banks spread over many different regions than for independent banks located in the same areas. The justification for varying premiums or capital requirements in this way is that it will generally cost the FDIC less to insure the deposits of the MBHC banks than the deposits of the independent banks. Of course, like all risk-based schemes, such an approach would unfairly penalize some banks (independent banks with diversified loan portfolios) and unfairly reward others (MBHC banks with loans concentrated in the same industry). On the positive side, though, the scheme would give banks in different regions more incentive to merge and make it easier for geographically diversified MBHCs to sell new equity.

Another adverse effect of the new guarantees may be to increase the government's cost of

disposing of the assets of failed banks and S&Ls (Klinkerman 1989, and Silverberg 1989, p. 23). These institutions tend to have assets whose future returns are highly uncertain. In many cases, the least costly way to dispose of such assets is to persuade someone to take over all the assets and liabilities of the failed institution in what is called a “whole-bank” transaction (Bovenzi and Murton 1988). Resolving failures in this way helps preserve customer relationships and maintain the institution’s value as a going concern. The problem with cross-bank guarantees is that they discourage BHCs from undertaking such whole-bank acquisitions by forcing BHCs to risk their investment in healthy banks.

One way of addressing this problem is to waive cross-bank guarantees for failed banks and S&Ls but subject them to closer supervision. Under FIRREA, the FDIC can exempt a failed bank or S&L from the guarantees if such action would reduce the net cost to the insurance fund. To be sure, a BHC might then be tempted to transfer resources from the acquired institution to its other banks, especially if the institution performed worse than expected and was about to fail. But by monitoring exempt institutions more closely, regulators could probably limit such abuses.⁸ And even if increased supervision did not limit the abuses, a BHC’s incentive to exploit the acquired institution would be no greater than under the old system, while its incentive to exploit its other troubled banks would be less. Thus, even if increased supervision were not successful, the new cross-bank guarantees would still be an improvement over the old system.

III. Source of Strength

Cross-bank guarantees address some of the safety-and-soundness problems posed by BHCs, but they do not address all the problems. The guarantees do not ensure that BHC product diversification will reduce the risk of bank failures. They do not curb improper transactions between

banks and nonbank affiliates. And they do not prevent undercapitalization of the parent company.

A more comprehensive approach addressing these remaining problems would be to require BHCs to serve as a source of strength to their banks. This section considers two versions of the source-of-strength policy—the policy the Federal Reserve has attempted to enforce, plus a proposed variation that would make BHCs legally liable for FDIC losses. It is argued that source-of-strength policies would increase safety and soundness and that their adverse effects have been overstated.

What is source of strength?

The Federal Reserve’s source-of-strength policy has two components. The first is that a BHC should have sufficient managerial and financial resources to assist its banks in case they get into trouble. The second is that a BHC should *use* those resources to assist its troubled banks.⁹

Until recently, most of the Fed’s efforts were directed toward the first part of the source-of-strength policy—ensuring that BHCs have the financial and managerial resources to support their banks. In the early 1970s, the Fed began invoking its authority under the Bank Holding Company Act to deny applications for mergers or acquisitions by companies unable to serve as a source of strength to their banks—for example, BHCs with heavy debt-servicing requirements.¹⁰ Another way the Fed tried to ensure that BHCs would be capable of assisting their troubled banks was to impose capital guidelines on BHCs. At first, these guidelines were informal. Then in 1981, when the Fed, FDIC, and Comptroller of the Currency imposed minimum capital requirements on banks, the Fed simultaneously imposed explicit minimum capital requirements on BHCs. As capital requirements were modified in subsequent years, the Fed continued to maintain separate requirements for BHCs.¹¹

During the recent upsurge of bank failures, the Fed has had more occasion to worry about the second component of the source-of-strength policy—ensuring that BHCs assist their banks when they get in trouble. To date, however, the Fed has had difficulty enforcing this part of its policy.

The first publicized effort to require a BHC to come to the aid of its banks came in early 1987, when the Fed ordered Hawkeye Bancorp of Iowa to inject capital into one of its failing agricultural banks. Hawkeye refused and the bank failed, prompting the Fed to initiate disciplinary action. Because the Fed later dropped the charges, however, its authority to order assistance remained unclear.

A second test of the policy came in 1988 when many of the banks owned by MCorp of Texas appeared on the verge of failure. At the time, MCorp had roughly \$400 million in nonbank assets. The Fed and the Comptroller pressured MCorp to draw on these assets to assist its failing banks, but the company resisted. Several months later 20 MCorp banks were closed, and the holding company declared bankruptcy without having used any of its nonbank assets to recapitalize the banks.¹²

The Fed's recent difficulties in getting BHCs to assist their troubled banks suggest the source-of-strength policy may need to be formalized to be effective. The House Government Operations Committee (GOC) advanced one such proposal in a report considering how BHC powers could be expanded without threatening the safety of their banks (Committee on Government Operations 1987). Like other studies, the GOC report concluded that new powers should be conducted only by nonbank subsidiaries of BHCs. In a departure from other studies, however, the GOC recommended BHCs also be made legally liable for any losses incurred by the FDIC in closing or liquidating their banks. Under this approach, BHCs would be allowed to close their banks in order to limit their losses. That is, in contrast

to the Fed's policy, BHCs would not be asked to recapitalize troubled banks to keep them open. The GOC also recommended that BHCs continue to be subject to minimum capital guidelines. These guidelines would be set by the oversight agency for BHCs and would be enforced by raising capital requirements for any bank whose holding company fell below the guidelines.

Favorable effects on safety and soundness

One beneficial effect of source-of-strength policies is to help ensure that product diversification by BHCs reduces the risk of bank failures. Without any source-of-strength policy in effect, a BHC with successful nonbank subsidiaries but unsuccessful banks may well prefer to let the banks fail rather than use its nonbank profits to recapitalize them. The Fed's source-of-strength policy addresses this problem by forcing BHCs to use their nonbank resources to keep troubled banks open. The GOC proposal would make BHCs liable for FDIC losses after a bank fails, giving BHCs an incentive to support troubled banks that are expected to be profitable over the long run. Thus, under either source-of-strength policy, BHC expansion into new activities should reduce the risk of bank failures.¹³

A second favorable effect of source-of-strength policies is to eliminate a BHC's incentive to transfer resources from banks to nonbank affiliates through mispriced business deals. A BHC can benefit from such transfers only if the banks fail and the cost of the transfers is shifted to the FDIC. Under the Fed's source-of-strength policy, however, the BHC must draw on its nonbank assets to prevent its banks from failing. And under the GOC proposal, the BHC can let its banks fail but must then reimburse the FDIC for its losses, preventing the cost of the transfers from being shifted to the FDIC. Thus, with either policy, the BHC gains nothing from the transfers.¹⁴

The last way source-of-strength policies in-

crease safety and soundness is by making parent companies hold enough capital that they manage their banks prudently and avoid excessive risks. The Fed has made the capital adequacy of BHCs a key part of its source-of-strength policy, refusing to approve expansion plans by overleveraged BHCs and imposing explicit capital requirements on BHCs. As noted earlier, the GOC proposal also calls for minimum capital guidelines for BHCs, though the guidelines would be enforced somewhat differently.¹⁵

Possible adverse effects

One criticism levied against the Fed's source-of-strength policy is that it forces BHCs to "throw good money after bad" (Shadow Financial Regulatory Committee 1987). The Fed's source-of-strength policy prevents BHCs from letting their banks fail for the purpose of shifting losses onto the FDIC. In some cases, however, the policy may also force BHCs to prop up banks that ought to be closed—banks that have little hope of returning to profitability in the future. This criticism of the Fed's policy is a valid one. However, the problem can be overcome by adopting the GOC approach—that is, by permitting BHCs to let their banks fail, but forcing them to reimburse the FDIC for the cost of resolving the failures. Under this approach, a BHC would let a bank fail only if it believed the bank was not viable over the long run.

A second adverse effect may be to discourage product diversification by BHCs and slow the growth of those BHCs that have already diversified (FDIC 1987, 1989; and Silverberg 1989, pp. 50-51). The disincentive to diversify could exist under either the Fed's policy or the GOC proposal. For example, suppose a BHC is considering acquiring a nonbank firm. If the BHC's banks suffer heavy losses but the nonbank firm earns high profits, owning the nonbank firm will reduce the amount of the banks' losses the BHC can shift onto the FDIC. The

BHC will have to use the profits of the nonbank firm either to prop up the banks (the Fed's policy) or to reimburse the FDIC for its losses (the GOC proposal). Thus, the nonbank firm will tend to be worth less to the BHC than to the firm's current owners, discouraging acquisition. By the same token, BHCs already owning nonbank firms will not be able to promise as high a return to their shareholders, making it harder for such BHCs to raise the extra capital they need to grow.

As in the case of cross-bank guarantees, regulators may be able to reduce the adverse effect on BHCs' incentive to diversify by varying insurance premiums or capital requirements in the appropriate manner. Currently, insurance premiums and capital requirements are independent of the degree of product diversification. But if a BHC with substantial nonbank assets is required to use those assets to cover a subsidiary bank's losses, the expected cost to the FDIC of insuring the bank's deposits will generally be lower than the expected cost of insuring other banks' deposits. Thus, under a source-of-strength policy, it will be fair to set a lower premium or capital requirement for banks whose holding companies have substantial nonbank assets. Admittedly, such a scheme would account only imperfectly for differences in product diversification across banks. On balance, however, BHCs would be more adequately compensated for the beneficial effects of product expansion on banking stability.¹⁶

A final criticism of source-of-strength policies is that they arbitrarily subject corporate shareholders to greater liability than personal shareholders (Shadow Financial Regulatory Committee 1987, and FDIC 1987). Under current law, the personal shareholders of banks enjoy limited liability against all claims on the bank. That is, their liability is limited to their investment in the bank, putting the rest of their assets out of reach of creditors. In contrast, source-of-strength policies subject the corporate shareholders of banks to unlimited liability

against claims by the FDIC. Thus, unlike personal shareholders, a corporation that owns a majority of a bank's shares can lose not only its investment in the bank but also its entire net worth. Some critics of source-of-strength policies argue such a distinction between the liability of personal and corporate shareholders is arbitrary.¹⁷

The distinction is not necessarily arbitrary, however. One justification for the distinction is that an effective unlimited liability policy reduces the liquidity of bank shares, which harms BHCs less than individual shareholders. To see why an effective unlimited liability policy reduces the liquidity of bank shares, suppose a bank is in danger of failing. With unlimited liability, shareholders will try to escape liability for the bank's losses by selling their shares. But the only investors willing to buy the shares will be those with few personal assets to lose. Thus, the new shareholders will be unable to reimburse the FDIC, defeating the whole purpose of the policy. This example illustrates that an unlimited liability policy will be effective only if regulators carefully screen each sale of bank shares to make sure the buyer has enough resources to satisfy future claims against the bank. This screening process will be inconvenient for any bank shareholder needing to sell shares. But the process will be less onerous for a BHC than an individual bank shareholder because the BHC's shareholders will still be relatively free to sell their shares.¹⁸ Thus, contrary to the claim of source-of-strength critics, imposing unlimited liability on BHCs but not on individual bank shareholders may be justified.

The argument that it is arbitrary to treat corporate and personal shareholders differently also ignores that imposing unlimited liability on personal shareholders may force some investors to bear excessive risk. Making the individual owners of a closely held bank personally liable for the bank's losses would force the owners to risk their entire wealth and face extreme financial insecurity. By contrast, when only BHCs are subject to unlimited liability, the most any indi-

vidual can lose is his investment in the BHC—a more efficient allocation of risk-bearing between the FDIC and investors.¹⁹

IV. Conclusions

Dissatisfaction with the way BHCs in Texas have handled their failing banks has led Congress to enact a new system of cross-bank guarantees and has increased demands that BHCs serve as a source of strength to their banks. This article has evaluated cross-bank guarantees and source-of-strength policies in terms of their ability to solve three important problems posed by BHCs. One problem is the failure of geographic and product diversification by BHCs to reduce the rate of bank failures. Another is the incentive of BHCs to have their banks engage in improper transactions with sister banks and nonbank affiliates. The final problem is the disincentive of undercapitalized BHCs to manage their banks prudently.

Cross-bank guarantees solve some of these safety-and-soundness problems but not all. The guarantees will ensure that interstate expansion by BHCs reduces the risk of bank failures and will eliminate the incentive for BHCs to transfer funds from their failing banks to their healthy banks. But the guarantees will not ensure that BHC product diversification reduces the rate of bank failures. Nor will they decrease improper transactions between banks and nonbank affiliates or ensure that BHCs hold adequate capital.

To address these remaining problems, a good case can be made for implementing a source-of-strength policy. Both the Fed's source-of-strength policy and the variation proposed by the Government Operations Committee would help fill the gaps left by cross-bank guarantees. However, the Committee's proposal to make BHCs legally liable for FDIC losses has the important advantage over the Fed's policy of letting BHCs decide which of their banks to keep in business.

Both cross-bank guarantees and source-of-strength policies have disadvantages. For example, cross-bank guarantees may discourage the formation of interstate multibank holding companies, while source-of-strength policies may dissuade BHCs from taking advantage of expanded powers. Also, cross-bank guarantees and source-of-strength policies may reduce BHCs' interest in acquiring failed banks and S&Ls. This article has argued that such adverse

effects can be mitigated. For example, regulators can waive the guarantees for failed institutions but supervise them more closely to prevent abuse by the holding company. And regulators can vary insurance premiums and capital requirements to make sure BHCs are more adequately compensated for the risk-reducing effects of diversification. Assuming such steps are taken, cross-bank guarantees should be beneficial on balance, and source-of-strength policies better still.

Endnotes

¹ For alternative discussions of the effect of BHCs on bank safety and soundness, see Rose 1978, Sinkey 1986b, and Saunders 1988. It should be noted that BHCs can have other adverse effects besides the three considered here. For example, banking analysts have long worried about the "contagion" problem—the possibility that heavy losses at a nonbank subsidiary will generate runs by the uninsured depositors of a BHC's banks (Flannery 1986). Banking analysts have also worried that courts might "pierce the corporate veil" and hold a BHC's banks responsible for the debts of a failed nonbank subsidiary (Black, Miller, and Posner 1978). Such concerns may be justified, but because they are not addressed by either cross-bank guarantees or source-of-strength policies, they will not be discussed further.

² In April 1988, the Senate passed a bill that would have allowed BHCs to underwrite securities through nonbank subsidiaries. The House version was never passed but would also have restricted new powers to separate subsidiaries.

³ It might seem that a bank lending money to an outside firm with a highly risky project could always charge a high enough loan rate to make the loan attractive despite the high risk of default. But charging a higher loan rate may be self-defeating. For example, a higher loan rate may increase the probability the borrower will default and the bank will have to incur collection costs. Or, a higher loan rate may induce the firm to alter the project in a way that raises the payoff but reduces the chance of success. When a bank and nonbank firm are owned by the same holding company, such considerations are irrelevant. Instead, the bank and firm can act together to increase their joint expected profits at the expense of the FDIC.

⁴ Besides having to comply with Sections 23A and 23B, banks are subject to regulatory restrictions on overpayment for services from affiliates and on tax accounting practices

that divert funds to the parent (Board of Governors 1990, 4-870 and 4-876, and Wall 1985).

⁵ Although it may be undesirable to let banks exercise new powers directly, a better case can be made for letting them branch across state lines. The only disadvantage would be to complicate the regulation of state-chartered banks. Even if interstate branching were allowed, however, some banking organizations could choose the MBHC method of expansion in order to shift their losses onto the FDIC. Thus, there would still be a need for policies like cross-bank guarantees.

⁶ Other remedies that would not require giving up the benefits of deposit insurance and BHCs include a) raising capital requirements for banks and monitoring their capital more closely and b) tightening controls on interaffiliate transactions. The first option would encourage BHCs to manage their banks more prudently and make it easier to close a BHC's failing banks before the burden on the FDIC became very large. However, it would not solve all problems due to the difficulty of determining a bank's true capital in a timely manner. The second option also has merit, especially for transactions like daylight overdrafts that are now unrestricted. But tighter controls could be difficult to enforce, and if too strong, could eliminate any synergies between banking and nonbanking activities. Tighter controls would also do nothing to solve the diversification problem or prevent BHCs from becoming undercapitalized.

⁷ In 1988, the FDIC suggested a different approach, proposing that the Federal Reserve be given authority to force the merger of healthy and failing banks in a MBHC. The Fed expressed some reservations about the proposal, and nothing came of it (Banking Expansion Reporter 1988).

⁸ Abuse would also be limited by the requirement in FIRREA that exempt institutions satisfy tougher restric-

tions on transactions with sister banks—in particular, the same restrictions as on transactions with nonbank affiliates.

⁹ The fullest official explanation of the policy is in an April 1987 statement reprinted in Board of Governors 1990, Section 4-878. The Fed had already incorporated the source-of-strength policy in its official rules in 1983 (Section 225 of Regulation Y), but the 1987 statement was more specific.

¹⁰ The Fed's authority to deny applications on these grounds was challenged in court but upheld by the Supreme Court in 1978 in the case of the Board of Governors versus First Lincolnwood. For further details on the early history of the Fed's source-of-strength policy, see Cornyn and others 1986.

¹¹ The Fed's capital requirements for BHCs apply not to the parent company but to the "consolidated" company—the organization obtained by lumping together all the assets and liabilities of the parent and its subsidiaries and netting out all intracompany relationships. The justification for imposing requirements on the consolidated company is discussed in note 15 below.

¹² After bankruptcy was declared, the Fed tried to get MCorp to transfer assets to its failed banks on the grounds it had abused the source-of-strength policy. As this article was going to press, a federal appeals court blocked the Fed's action, ruling that the Fed has no authority under the Bank Holding Company Act to force BHCs to inject capital in their banks (BNA Banking Report 1990).

¹³ Even with a source-of-strength policy in effect, expanded BHC powers could fail to reduce the risk of bank failures for two reasons. First, the returns to the new activities could be highly correlated with the returns to banking. In this case, a BHC's nonbank subsidiaries would tend to suffer losses at the same time as its banks, preventing the BHC from helping the banks. Second, the new activities could be highly risky. Because source-of-strength policies do not require a BHC to use the profits of its banks to cover the losses of its nonbanks, the pursuit of highly risky nonbank activities would not directly increase the banks' risk of failure. However, the new activities would increase the chance of the BHC suffering a decrease in net worth sometime in the future—a decrease that could reduce its incentive to manage the banks prudently. Most empirical studies conclude that the kinds of nonbank activities likely to be allowed are neither highly correlated with bank activities nor exceptionally risky (Saunders 1988, pp. 169-73).

¹⁴ It is important to note that source-of-strength policies do not eliminate the incentive for excessively risky bank loans to nonbank affiliates. This incentive will remain as long as there is some chance the BHC will be unable to

cover the lending bank's loss if the affiliate defaults on the loan. In other words, as long as the holding company itself can fail, the FDIC will bear part of the cost of risky loans to nonbank affiliates, preserving the incentive to make such loans. For this reason, restrictions on loans to nonbank affiliates would continue to be necessary under either source-of-strength policy. The GOC report even suggested banning such loans entirely.

¹⁵ As noted earlier, the Fed's capital requirements apply to the consolidated holding company rather than the parent. The lower the capital-asset ratio of the parent, the lower the capital-asset ratio of the consolidated company will tend to be. However, even if the parent is highly capitalized, the consolidated company can have a low capital-asset ratio due to heavy outside borrowing by nonbank subsidiaries. One reason for restricting such borrowing—and thus one reason for imposing capital requirements on the consolidated company—is that highly leveraged nonbank subsidiaries have a greater chance of suffering losses that reduce the parent's net worth to an unacceptably low level.

¹⁶ As suggested earlier, BHC expansion into new activities could fail to reduce the risk of bank failure if the returns to the new activities were highly correlated with the returns to banking or if new activities were highly risky. On average, however, banks belonging to BHCs with substantial nonbank assets would probably cost the FDIC less to insure than other banks, justifying a lower premium or capital requirement.

¹⁷ For the general case against using different liability rules for personal and corporate shareholders, see Posner 1976. It should be noted that corporations do not always enjoy limited liability against claims on their subsidiaries. An interesting exception noted by Mayer 1988 is the Pension Benefit Guaranty Corporation (PBGC), the government agency that insures private pension plans. If a subsidiary of a holding company terminates its pension plan, the PBGC can hold each other subsidiary of the company liable up to 30 percent of its net worth. For further details, see Ippolito 1989.

¹⁸ Under the Change in Bank Control Act of 1978, sales of bank stock and BHC stock are both subject to regulatory control. In particular, any group seeking to raise its stake in a bank or BHC above 25 percent must give at least 60 days' notice (Spong 1985). With unlimited liability for all bank shareholders, regulators would need to screen sales of bank stock more closely. But since BHC shareholders would still enjoy limited liability, there would be no need to screen sales of BHC stock more closely. It should be noted that imposing unlimited liability on the shareholders of other firms would also reduce share liquidity (Halpern, Trebilcock, and Turnbull 1980; Easterbrook and Fischel

1985; and Woodward 1985). The only difference is that restrictions on the transfer of shares would be imposed by private creditors seeking to protect their own interests rather than by regulators.

¹⁹ This argument against unlimited liability for personal shareholders may not apply to widely held banks. If a bank's shares are spread among many investors who are sure of contributing equally to the FDIC's claim against them, the potential loss to each shareholder will be small. But at a bank with many shareholders, unlimited liability has another cost—each investor must monitor the others to make sure

they do not spend their wealth or sell out to less wealthy investors (see Jensen and Meckling 1976 and the references above). Also, at such banks, there is less benefit from unlimited liability. One reason for imposing unlimited liability on bank shareholders is to discourage "insider deals" that benefit a bank's shareholders at the expense of the FDIC. The scope for such deals is smaller at a bank owned by many investors with diverse business interests than at a bank owned by a small group of investors who control other businesses that are potential customers of the bank.

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