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Banking Powers & Structure:
Affiliates vs. Subsidiaries

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A relatively new issue is beginning to dominate the current debate regarding financial modernization: Should banking organizations be allowed to engage in new types of businesses -- such as broader securities and insurance activities and even some amount of non-financial activities -- only in subsidiaries of holding companies (holding company affiliates), or should banks be allowed the choice to conduct these new activities in either holding company affiliates or bank subsidiaries? There are compelling public policy and efficiency reasons why banking organizations should be allowed to choose the organizational form that best meets their business needs. The reasons given for not allowing this choice are obscure and, ultimately, unpersuasive.

Why Allow A Choice In Structures?

The current debate is not about whether banking organizations should be allowed to engage in new activities. The issue is whether Congress should restrict product and service innovation to holding company affiliates, rather than giving banking organizations the choice of structure in which to conduct new activities. Why is this choice important?

The opportunity to make a choice is important in itself because it reflects a basic attitude toward the role of government. An approach that allows banking organizations to choose the organizational structure -- whether it be bank subsidiary or holding company affiliate -- they conclude is best for their individual business strategies, would reflect the view that government should not dictate business decisions to banking organizations, unless there is a compelling public policy or safety and soundness reason to do so. As discussed below, none is present in this case.

In practice, the subsidiary option offers operational and public policy benefits. Use of bank subsidiaries, for example, allows banking organizations to focus their capital and earnings strength on their banks, or a lead bank, rather than removing capital and channeling earnings away from the bank. Use of

subsidiaries also allows the benefits of activities diversification to flow to and strengthen the bank, rather than being scattered outside the bank around its holding company. FDIC Chairman Helfer recently testified before a House Banking Committee subcommittee in this regard that allowing a bank to put new activities in a bank subsidiary "lowers the probability of failure and provides greater protection to the insurance funds."

Moreover, forcing new lines of business that are responding to the newest customer needs to be conducted in holding company affiliates has troubling long-term ramifications for the health of banks generally. Depriving banks of direct access to profitable new activities will have a destabilizing effect, ultimately producing a destabilized, shell bank that could prove fragile in bumpy economic conditions.

The kind of structure allowed for new bank activities also has profound implications for the application and scope of public interest banking statutes, such as the Community Reinvestment Act. If growth and new lines of business in banking organizations are forced to occur in holding company affiliates and not allowed in bank subsidiaries, that growing base of activities and earnings is not available to support a bank's CRA efforts. The source of support for CRA will shrink, and, in the worst case, the CRA may become functionally obsolete.

The subsidiary option should also help banks of all sizes compete more effectively. For large and mid-size banks, competition is increasingly global. Most of the foreign banks with which U.S. banks compete are able to engage in broad securities, insurance and other activities, which they provide efficiently and conveniently through subsidiaries, (or in some cases directly through the bank itself). This structure is particularly notable in the European Community, where many formidable financial conglomerates are taking shape. For U.S. banks that must compete against these firms, the subsidiary option gives them an organizational mode that puts them on more equal competitive footing.

For community banks, use of subsidiaries can be a simpler, less costly structure for providing new products and services. Community banks today face multi-faceted competition -- ranging from non-bank competitors that have lower regulatory costs, to credit unions with significant tax advantages. Community banks simply need to be able to choose the organizational form that enables them to compete most effectively to meet these challenges. Diversification through subsidiaries may be their only practical alternative for survival in an increasingly competitive marketplace.

Why Not Allow A Choice In Structure?

A complex rationale has recently been offered by the Federal Reserve Board (FRB) for why banking organizations should not be allowed this choice between affiliates and subsidiaries as structural alternatives for new activities, but rather should be

required to restrict their product and service innovation to holding company affiliates.

Notably, the FRB has not argued that allowing the structural choice is a safety and soundness issue. Rather, it has contended that banks enjoy what it has termed a "sovereign credit subsidy" that allows them to borrow at lower rates than their parent holding companies and that this subsidy should not be allowed to spread to new activities conducted within the banking organization. In order to prevent the spread of this subsidy, it is then argued, the new, expanded activities must be isolated in holding company affiliates. In other words, leakage of the subsidy can be stemmed with suitable safeguards between the bank and its holding company affiliates, but, implicitly, cannot be similarly stemmed when those same safeguards are imposed between the bank and a subsidiary.

The issue of a "sovereign credit subsidy" sounds daunting. Upon close analysis, however, it fails to hold up as a reason to deny banks a choice between affiliate and subsidiary corporate structure.

First, the extent of any "subsidy" is debatable. Although banks may be able to borrow funds at rates a notch more advantageous than their parent holding company, the rating agencies cite basic market factors for the difference. For example, in most bank holding companies, the subsidiary bank is the primary operating entity that is the source of debt service payments. Bank regulation generally seeks to strengthen the bank, and to do so, bank regulators can restrict a bank's ability to pay dividends to its holding company -- thereby endangering the holding company's source of funds to service its debt. Even the FRB's own holding company "source of strength" doctrine is devoted to pushing capital from a holding company, to its subsidiary bank. In other words, lending to a holding company is slightly more risky than lending directly to a bank. The different market rates for bank and bank holding company reflect this fact.

Second, even if a gross difference in funding costs exists, the amount that has been cited is quite small -- some say currently as low as 4 to 7 basis points (that is, between 4 and 7 one-hundredths of one percent). This difference is dwarfed by the various regulatory compliance costs that banks bear -- CRA, compliance requirements, exam fees, the obligation to hold a portion of their deposits in non-interest-bearing sterile reserves, and FICO interest payments, to name a few. In 1992, for example, a study by the inter-agency Federal Financial Institutions Examination Council estimated the annual cost to the banking industry of regulatory compliance burdens at between 6 to 14 percent of non-interest expenses. Expressed in terms of average deposits at commercial banks during 1995, this figure translates into roughly 30 basis points. Thus, it is hard to see where any net subsidy exists at all.

This conclusion is made more obvious by considering how banks actually behave -- they don't act as if they are

subsidized. If banks thought that their funding was subsidized, one would expect them to concentrate funding efforts at the bank level. This is not what is occurring in the marketplace. In fact, banking organizations raise debt at both the bank and holding company level. Further, when given a choice of where in the corporate family to conduct an activity, banks currently place activities in holding company affiliates, bank subsidiaries, and in the bank itself. No clear pattern emerges. If the banking industry thought a unique bank funding advantage existed, they would take advantage of it by concentrating on both funding and activities at the bank level. In fact, this is not what is happening.

Moreover, if there were a net subsidy, it defies logic to argue that the measures that contain "leakage" of the subsidy between banks and their affiliates won't work to contain the same leakage between banks and their subsidiaries. If the safeguards and arms-length standards of sections 23A and 23B of the Federal Reserve Act contain leakage to affiliates, why don't they work the same way if they are applied to a subsidiary?

In fact, the transference of the hypothetical subsidy should be more contained with respect to a subsidiary: section 23A applied between a bank and a subsidiary will limit a bank's aggregate loans to and equity investments in a subsidiary, it does not limit the amount of equity, in the form of dividends, that a bank may transfer to its holding company parent. Thus, it is the affiliate structure, not the subsidiary structure, that offers the greatest potential for transference of the hypothetical subsidy. This potential will be exploitable to a significantly enhanced extent as expanded activities are permitted for holding company affiliates, particularly so if expanded activities are permitted only in holding company affiliates.

Conclusion

In sum, there are sound efficiency and public policy reasons to allow banking organizations the choice of where in their corporate family they elect to conduct new activities. Allowing the choice does not present risks to banks' safety and soundness -- indeed, the structural option enhances banks' long-term viability and competitiveness and provides greater protection for the federal deposit insurance funds. The policy argument being advanced in opposition to permitting this choice is unconvincing and, ironically, self-defeating.