MEMORANDUM

To: Ken, Pat, and Rick
From: Bob Dugger
Subject: Why We Oppose Nonbank Banks
Date: January 16, 1987

Success in our efforts to close the nonbank bank loophole will depend to a significant degree on our ability to present a unified and cogent set of arguments supporting closure, and on our ability to get witnesses, particularly Volcker, to articulate those arguments during the hearings. Supportive witness statements whether in their own testimony or, what is more likely, in response to questions, will be invaluable later.

From various sources, including some of Proxmire's statements, I have attempted below to summarize the most frequently expressed objections to nonbank banks.

Our hearing questions should be drafted to evoke responses that confirm the objections, and as we get closer to markup we should have floor and press statements that repeat these objections again and again to assure that they are well understood and remembered.

Seven objections to nonbank banks are:

1. IF ANY COMPANY CAN OWN A BANK, A BANKER CAN OWN ANY COMPANY.

The decision whether to extend credit is complicated in highly undesirable ways by the ability of virtually any company to own a bank. At present, if an entreprenure goes to a bank to borrow money for a new or to expand his venture, the bank has really only one decision -- "do we lend the money or not", and the answer depends on whether the customer is creditworthy.

If the nonbank bank loophole is not closed, the banker has several choices:

(1) He can make the loan;
(2) He can attempt to buy the man's business; that is, arrange to have the holding company purchase the business as another subsidiary; or
(3) He can pass the information in the loan application on to the holding company and arrange to set up a competing business.

The U.S. has benefitted greatly from entreprenurial freedom and a system of allocating credit soley on the basis of the creditworthiness of the borrower. Failing to close the nonbank bank loophole will bring an end to the credit allocation system that has served us so well and jeopardize American entreprenurial freedom and initiative.

2. IF ANY COMPANY CAN OWN A BANK, EVERY COMPANY WILL HAVE TO OWN A BANK.

Access to the payments system, funds at insured deposit rates, and other banking benefits make owning a bank a competitive advantage for a commercial enterprise. Competitive pressures, once any firm in an industry begins to utilize its "pocket bank", will force all the other firms to acquire or establish subsidiary nonbank "pocket banks". The result will be a proliferation of banks, many operated by companies inexperienced in banking, and needlessly and perhaps dangerously increasing the burden on U.S. regulatory and supervisory resources.

3. IF BANKING AND COMMERCIAL FIRMS CAN OWN EACH OTHER, THERE WILL BE A WAVE OF TAKEOVERS AMONG THE LARGEST U.S. FINANCIAL AND NONFINANCIAL COMPANIES AND AN INCREASE IN THE CONCENTRATION OF ECONOMIC POWER IN THE HANDS OF THE SURVIVING COMPANIES.

Failing to close the nonbank bank loophole will lead inevitably to a variety of banking and commercial cross-ownership devices. We are already hearing about "double debanking" and other means for escaping the restrictions of the Bank Holding Comany Act. The result of companies exploiting those devices will be a wave of mergers among the largest banking, insurance, securities, transportation, and manufacturing corporations. The justifications for the combinations will be numerous, including reversing declining profitability, increasing international competitiveness, attaining corporate synergisms, and even improving consumer services and reducing prices. As numerous studies have documented, however, the primary motivation of corporate managers is to increase the volume of assets under management control. The effects of the consolidations, moreover, will be no different than the consequences we usually find associated with increased concentration and oligopoly power.

4. STATE AUTHORITY TO CONTROL THE DEVELOPMENT OF BANKING WITHIN STATE BORDERS WILL BE DIMINISHED.

The nonbank bank loophole erodes the rights of the States to control their own banking structure. The U.S. Trust decision makes its possible, for example, for a New York money center bank to establish a nonbank bank in any State regardless of State law.

5. DEPOSIT INSURANCE RELATED SAFETY AND SOUNDNESS PROBLEMS WILL INCREASE AS SUPERVISORS ARE OVERWHELMED BY THE GREATER NUMBER OF SMALL "POCKET BANKS" AND THE MORE COMPLEX OPERATIONS OF THE LARGE BANKS OPERATING WITHIN FULLY DIVERSIFIED, INTERNATIONAL HOLDING COMPANIES.

In the present environment supervisory resources are heavily burdened, and the agencies' ability to spot adverse trends and halt them is limited. The rapid growth of off-balance sheet activities is a current example of agency limitations. The situation will only worsen in an environment involving far more privately owned small "pocket banks" and involving the vastly more complex activities of international bank subsidiaries of huge diversified holding companies. There is no way to separate the fortunes of a bank from the fortunes of its corporate parent. If the parent gets into trouble, the bank is in trouble. This means the agencies must be concerned not only about the safety of the bank, but the safety of the nonbank parent. There is no way the regulators can carry out that responsibility.

6. PAYMENT SYSTEM RISK WILL INCREASE AS THE NUMBER OF BANK PARTICIPANTS INCREASES.

At present companies needing payment system services obtain those services through a bank or other depository institution. The public benefit derived from this arrangement is a significant reduction in payment system risk through interposing a bank between the company and the payment system itself. The risk that is reduced is the risk that a company, say a government securities firm such as ESM, faced with severe operating difficulties would exploit the payment system access it would have through its ownership of a nonbank bank, draw a large amount of funds from the payment system and wire transfer them to some secure account in a foreign country.

7. COMPETITIVE INEQUITIES BETWEEN BANK AND NONBANK FINANCIAL INSTITUTIONS WILL GROW.

The nonbank bank loophole allows any company into the business of banking while banks and bank holding companies are still tightly limited as to what activities they can engage in by our banking laws.