

# Why We Can't Allow Banking and Commerce to Mix

*We've tried before, and the result was the costly S&L crisis*

## Executive Summary

In December 2005, the Office of the Comptroller of the Currency (OCC) issued three Interpretive Letters, giving three banks – two of them among the nation's largest – expanded authority to invest in real estate projects involving the development of office buildings, hotels, residential condominiums, and windmill farms.

This paper shows why this dangerous precedent needs to be rescinded. Instead, a clear and unambiguous barrier must be built and maintained that keeps banks from owning and running commercial businesses.

The reasoning is straightforward:

- Banks operate with a safety net that protects our national payments system.
- It's extremely difficult, if not impossible, to keep the safety net from being extended to other parts of a banking organization, even nonfinancial areas.
- The extension of the safety net to commercial functions disrupts the usual discipline enforced by the marketplace.
- Without effective market discipline, the losses and inefficiencies of the banks' commercial functions are allowed to take root and grow.
- Additionally, allowing banks to own commercial interests generates inherent conflicts of interest. A bank considering loan applications for firms that compete with the bank's own commercial interests can't be expected to treat the applications objectively.
- Because a commercial business owned by a bank may have easier access to capital than an unaffiliated competitor, these businesses will not compete for capital on a level playing field.
- The safety and soundness of the banking system – a fundamental requirement for the smooth functioning of our economy – is imperiled by the potential losses banks may suffer in their commercial businesses.
- To preserve a sound financial system, banking and commerce must be kept separate.

This isn't a theoretical assertion. At great taxpayer expense, this principle was illustrated by the costly savings and loan crisis of the 1980s and early 1990s. During this period, over 1,000 thrift institutions failed, representing over a half-trillion dollars in assets. Taxpayers were forced to spend \$124 billion bailing out these private-market failures.

Japan's ineffective banking structure offers another too-real demonstration. The unwieldy banking configuration, which also allowed banks into nonfinancial areas, kept the Japanese economy at a standstill for virtually the entire decade of the 1990s.

Allowing banks to offer commercial activities subverts the ordinary and effective market discipline of our commercial system. It would risk the safety and soundness of the banking system, generates a huge potential taxpayer liability, and promotes economic inefficiency. This approach, embraced by the OCC's December 2005 Interpretive Letters, is inappropriate and potentially very costly.

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This paper shows why this dangerous precedent should be rescinded. Instead, banks need to be kept away from owning and running commercial businesses.

The reason is simple: Banks operate with a safety net that protects our national payment system, and it's extremely difficult, if not impossible, to keep the safety net from being extended to other parts of a banking organization. To be effective, the division between banking and commerce must be complete. At great taxpayer expense, this principle was illustrated by the costly savings and loan crisis of the 1980s and early 1990s.

## **Background: Congress Says No to Mixing Banking and Commerce. . .**

The Gramm-Leach-Bliley Act (GLB), enacted into law in 1999, was landmark legislation that allowed banks to own banking, securities and insurance entities through a financial holding company.<sup>2</sup>

But, significantly, GLB did not grant real-estate development and ownership powers to national banks. GLB deliberately maintained the separation of banking from nonfinancial activities.

This was hardly an oversight, as many of the architects of GLB argued purposefully for financial reform only on the condition that banking and commerce not be allowed to mix.<sup>3</sup>

Indeed, Sen. Tim Johnson (D-SD) was unequivocal on the point during the debate over GLB. From the Senate floor, he said that he sought “to close a loophole that permits the dangerous combination of banking and commerce. Under current law, commercial firms can own and operate unitary thrifts. That is the only breach of the banking and commerce firewalls currently allowed under our financial services law. . . [T]his bill is carefully structured to prevent the mixing of banking and commerce and closes the single loophole that remains where banking and commerce can mix.” Congress agreed with him, and the unitary thrift exception ended with the enactment of GLB.

## **. . . But the OCC Allows It Anyway**

Despite this clear indication of intent from Congress, the OCC crossed a significant line with its December 2005 letters by allowing banks to own and develop luxury hotels, build and sell residential condominiums to make the rest of a project economically feasible, and even to own windmill farms.

Because these are not financial services, these are prohibited by GLB. These are commercial activities, and, through these letters, the OCC is mixing banking and commerce.

Numerous banking experts regard the OCC's actions as a significant expansion of real-estate powers of national banks.<sup>4</sup> Moreover, two former Comptrollers, Eugene Ludwig and John D. Hawke, Jr., have publicly acknowledged that the OCC letters move the bar.<sup>5</sup>

By mixing banking and commerce, the OCC's letters unleash tremendous forces inside the banking industry that are dangerous for the banking industry itself, for our nation's system of payments, for taxpayers, and for economic growth.

This paper illustrates how these seemingly innocuous letters imperil our banking system and the economy at large. Moreover, it shows that we already have two case studies where mixing banking and commerce led to disastrous results: the U.S. savings and loan crisis in the 1980's and early 1990s, and the Japanese banking debacle of the 1990s.

### **Banking's Unique Role Requires Barriers**

Because of their unique role in our financial system, banks are special. Specifically, three unique characteristics of banks were identified by Gerald Corrigan, a senior Federal Reserve official, that make bank failure particularly concerning:

1. Banks offer transaction accounts.
2. Banks are the back-up source of liquidity for all other institutions.
3. Banks are the transmission belt for monetary policy.<sup>6</sup>

Because of the banks' place in the nation's system of payments, the government provides deposit insurance to prevent banking panics, such as the bank runs seen in the 1930s.

Additionally, not only can banks borrow overnight funds from each other in the federal funds market, but they can borrow from the Federal Reserve itself, through its discount window. These borrowing opportunities are only available to banks because they help protect the economy's payment system. These protections should be contained to banking activities, and the best way to do that is to prevent banks from owning and controlling commercial interests.

### **The Role of Deposit Insurance**

Without deposit insurance, depositors would be at risk of losing their savings whenever a bank failed. Moreover, from a national policy standpoint, the emerging threat of a bank failure in the absence of deposit insurance would lead large numbers of depositors to pull their money out of a bank overnight. Because a bank, healthy or not, can't refund a substantial portion of its deposits at once, the institution would have to sell assets quickly to generate sufficient liquidity to meet its depositors' demands. This sudden asset liquidation may cause the bank to fail, even if it were healthy before the bank panic began.

Deposit insurance is also designed to prevent a panic caused by a failing bank from spreading to a healthy bank. In such a case, solvent banks could become insolvent, the payment system could be

severely disrupted, the money supply might contract, and the economy could fall into a serious recession. Consequently, deposit insurance is critical in protecting the economy from the fallout of bank failures.

But its automatic availability introduces the problem of “moral hazard” into the marketplace. Moral hazard is the incentive to take bigger risks due to the provision of insurance. If the potential loss is mitigated by another party (the insurer), the insured individual has the incentive to take bigger risks. The insured gets the entire payoff if the riskier venture pays off, and shoulders only a portion of the cost if it fails. More simply put, it’s a variation of the “Heads, I win; tails, you lose” proposition.

Because depositors don’t have the incentive to monitor bank behavior due to deposit insurance, the usual marketplace relation between risk and return is short-circuited. Financing for risky projects is mispriced, because the bank has less incentive to take account of a project’s additional risk when determining the financing. In effect, banks are able to receive a subsidy when raising funds for risky projects, and this mispricing leads to distortions in the allocation of resources, and, if prominent enough, bank failures.

To combat this, banks’ risk management has to be carefully analyzed and regulated by the government. One of the long-standing and best-serving prohibitions is the restriction that keeps banks out of nonfinancial businesses.

### **Inviting Conflicts of Interests. . .**

Additionally, allowing banks to own commercial interests generates inherent conflicts of interest. As businesses seek financing to expand, they’ll look to banks. But a bank’s loan committee considering loan applications for firms that compete with the bank’s own commercial interests can’t be expected to treat the loan applications objectively. The bank faces a conflict of interest. For example, if the bank owns a local hotel, as the OCC letter allows, would it make a loan to a local hotel franchisee to build a competing hotel?

### **. . .While Removing the Level Playing Field**

If the bank decides to make the loan, at what terms? Will they be at the same terms the bank-owned hotel would receive? What will the loan servicing be like? Would loan forbearance be the same between a bank-owned hotel and a hotel that competes with the bank?

Access to capital can’t be assumed to be identical for bank-owned and nonaffiliated commercial enterprises. Even if the banks declare that they would deal with such situations fairly and at arm’s length, it’s critical to remember that, over time, incentives tend to trump intentions.

### **Keeping Banking and Commerce Separate: The Seal Needs to Be Tight**

By mixing banking and commerce, the safety net protecting banking activities is extended to commercial activities. This not only creates an unfair competitive disadvantage for private businesses competing against the bank-owned commercial activity (for example, the hotel across the street from the bank-owned hotel), but it puts U.S. taxpayers at risk.

The failure of a bank-owned hotel or another commercial activity can be transmitted to the bank itself. Should the bank become illiquid, the federal government would be obligated to make good on all insured deposits. In the past, the government has used taxpayer funds to ensure that even uninsured deposits are covered.

Of course, regulators seek to keep nonbank failures from infecting the health of the bank itself. Firewalls and other regulatory apparatus are used in attempt to seal off the purely banking activities of a bank from the nonbanking activities of its affiliates. But, under financial stress, firewalls fail. This was noted by Federal Reserve Chairman Alan Greenspan in a response to a question before the House Banking and Financial Services Committee in 1995:

“I think that under stress [firewalls] tend to melt inordinately. . . . And I think that in large measure both the corporate veil and firewalls get very shaky in a crisis. When you really want them to function in a crisis, they don’t.”<sup>7</sup>

To be effective, this seal between banking and commerce has to be extremely tight. A bank is allowed to own the property containing its own premises, but owning a hotel, residential condos or a windfarm is an entirely different matter. Entering the hospitality, residential brokerage and energy industries is not necessary for accommodating its business, the standard applied by current law.

When thinking of how tight the seal must be, it’s useful to think of an engineering analogy. Only a miniscule portion of the levee failed in New Orleans during Hurricane Katrina last year – and the force of the waters devastated the city. Finance works the same way as water. Just as water seeks its own level, it’s simply human nature to press for the weak spots in the law and find ways to keep a financially ailing bank viable until circumstances improve. If the bank is failing because of its commercial activities, the financial firewalls – just like the New Orleans levees – can’t be counted on to work effectively. Taxpayers will be left picking up the pieces.

So a regulatory system that’s 99 percent effective simply isn’t good enough. Mixing banking and commerce is dangerous because of the strong incentives banks would have to skirt even the most carefully thought-out regulatory firewall. And technical innovation, fluid markets, slow-moving legislative and regulatory responses, and the differing incentives faced by bankers and regulators should assure us that a breach in the firewall is likely to be found and exploited.

### **It’s Already Happened: The S&L Crisis**

The taxpayer has already bailed out the banking industry after it began mixing banking and commerce, paying an estimated \$124 billion to clean up the savings and loan crisis of the late 1980s and early 1990s.<sup>8</sup>

During this time, 1,043 institutions, holding a total of \$519 billion in assets, were closed by regulators.<sup>9</sup> The number of federally insured thrift institutions open at year-end 1995 was only half the number open ten years earlier.

There were a number of causes of the S&L crisis, including high and volatile interest rates, falling oil prices, changes in tax laws, and inappropriate regulatory oversight. But thrifts were also given expanded powers to move beyond simple banking and into commercial activities. As the FDIC reports:

In some states, direct investments in real estate, equity securities, service corporations, and operating subsidiaries were allowed with virtually no limitations. S&L's invested in everything from casinos to fast-food franchises, ski resorts, and windmill farms.<sup>10</sup>

With so much swirling around the thrift industry at the time, it's difficult to pull out the threads and say exactly how much each element contributed to the total mess. But it's clear that allowing banks into commercial businesses was an important factor.

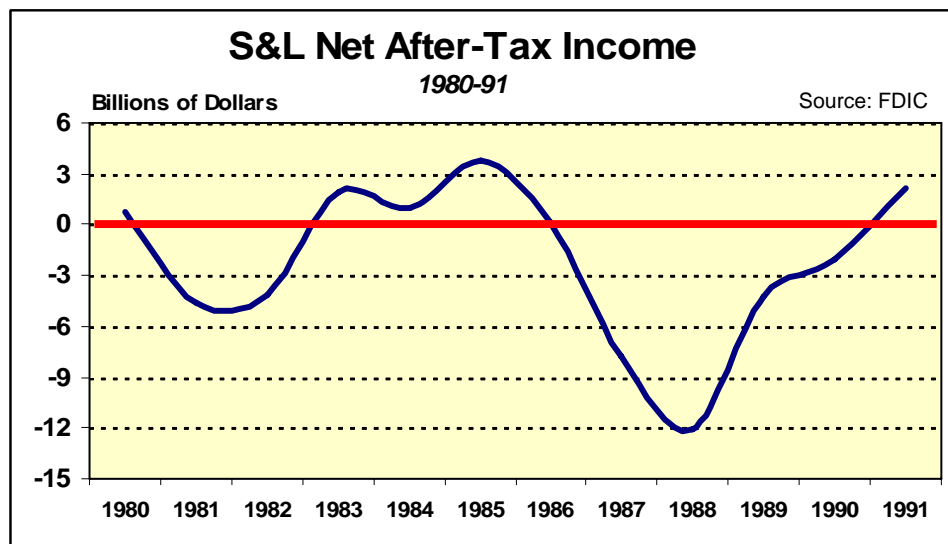
By granting these expanded powers, Congress and federal regulators extended the safety net to virtually all banks in the system. And although the insurance ceiling was raised in 1980 from \$40,000 to \$100,000 per account, in practice there was no ceiling. In fact, regulators explicitly covered uninsured deposits of several large banks that failed, including Continental Illinois, Bank of New England and MCorp banks.<sup>11</sup>

<b>Thrift Failures, 1986-1995</b>		
<i>Millions of Dollars</i>		
<b>Year</b>	<b>Number</b>	<b>Assets</b>
1986	54	\$16,264
1987	48	11,270
1988	185	96,760
1989	327	135,245
1990	213	129,662
1991	144	78,899
1992	59	44,197
1993	9	6,148
1994	2	137
1995	2	435
<b>Total</b>	<b>1,043</b>	<b>\$519,017</b>

**Source:** Timothy Curry & Lynn Shibus, "The Cost of the Savings & Loan Crisis: Truth and Consequences," FDIC Banking Review, Vol. 13, No. 2, 2000, pg 27.

### Perverse Incentives

During the 1980's, thrift institutions changed their business models in response to the new operating environment created for them, including the expanded ability to mix banking and commerce. The incentive structure in commercial real estate was especially skewed, with the government absorbing most of the risk of new commercial real estate ventures.



This led to the vast overbuilding detailed in the table below. During the first half of the 1980's, for example, the supply of new office space far outstripped the demand, or absorption, for new office space. In fact, the amount created was more than 50 percent greater than the amount absorbed in 31 of the top markets from 1980 through 1984.

<b>Production of New Office Space</b>		
<b>31 Major Markets, 1975-94</b>		
<b>Annual Averages, in Millions of Square Feet</b>		
<b>Period</b>	<b>Completions</b>	<b>Absorption</b>
1975-79	33.6	44.3
1980-84	97.8	64.2
1985-89	100.7	73.6
1990-94	28.1	33.3

Absorption: The difference in occupied space over a defined period.

**Source:** FDIC, "History of the Eighties – Lessons for the Future," Chapter 3, "Commercial Real Estate and the Banking Crisis of the 1980s and early 1990s." pg 145.

This huge divergence was, over time, resolved, but only after Congress set up the Resolution Trust Corporation to clean up after the greatest collapse of financial institutions in the U.S. since the Depression. As mentioned earlier, the taxpayer was left on the hook for \$124 billion.

### **Japan's Banking Crisis**

Japanese banks expanded with a wave of lending based on rapidly rising land values during the 1980s, but when land values declined in the early 1990s, the value of bank loans imploded. With a staggering amount of troubled real estate loans on their books, Japanese banks limped through the 1990s, and the Japanese economy became stagnant for virtually the entire decade. In fact, the Japanese banking industry was so troubled and under-capitalized that, a year after the collapse of Yamaichi Securities in 1997, the government had to intervene to become part-owners of the 11 largest Japanese banks through the issuance of preferred shares.

Again, there are many origins of the Japanese banking problems: over-reliance on real estate lending, which became especially critical when land prices declined precipitously; a sluggish regulatory response to the banks' troubled loans; and monetary policy decisions that exacerbated rather than mitigated the economic crunch.

Another cause of the abysmal economic performance during the 1990s was the mixing of banking and commerce through the *keiretsu* system. This allows a network of corporations to link together through extensive stock cross-ownership, including the participation of a bank. The bank performs a centralized coordinating and monitoring function and is a stockholder in the other members. This arrangement clouds the line between the market discipline required for commercial activity and the regulatory oversight necessary to protect the banking system.

## **Conclusion**

Banks are different than typical commercial activities because of their special roles in the economic system. To ensure the high reliability of our payment transactions and the liquidity of the overall economy, the government provides deposit insurance and access borrowing privileges (i.e., the discount loan window) unavailable to commercial enterprises. The need for safety and soundness in the banking system makes them different from commercial operations in our free-market economy.

The bank safety net, designed to protect the nation's depositors, was extended to protecting the banks' forays into commercial businesses during the S&L crisis, as it inexorably always will be. Allowing banks to own and operate commercial concerns is a threat to the smooth functioning of our nation's payment system and to the taxpayers' wallets.

The lessons are simple: let banks be banks, and don't allow banks to own or control commercial enterprises. Bank ownership of commercial firms subverts the normal, effective market discipline that has made us the world's strongest economy. The seal between banking and commerce must be extremely tight to be effective. In terms of sound banking, economic efficiency and protecting the taxpayer, the OCC's December 2005 letters embrace the wrong approach.

Ignoring the wide understanding that banking is different, the OCC letters carve out new areas in which banks can own and operate commercial enterprises. As Interpretive Letters, they'll have an impact well beyond just the specific cases cited. By allowing other national banks to make similar deals, the OCC letters set a costly precedent.

## Endnotes

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<sup>1</sup> OCC Interpretive Letter No. 1044 (December 5, 2005); OCC Interpretive Letter No. 1045 (December 5, 2005); OCC Interpretive Letter No. 1048 (December 21, 2005).

<sup>2</sup> Mark Olson, Governor, Federal Reserve Board, *Are Banks Still Special?*, Remarks to the Institute of International Bankers, March 13, 2006. Page 4. <http://www.federalreserve.gov/boarddocs/speeches/2006/20060313/default.htm>

<sup>3</sup> John Krainer, *The Separation of Banking and Commerce*, **Economic Review**, Federal Reserve Bank of San Francisco, 2000. Page 15.

<sup>4</sup> “Banks Might Widen Real-Estate Role,” Wall Street Journal (January 9, 2006); “OCC Moved the Line on Realty in UBOC Letter,” American Banker (January 11, 2006); “Tough Enforcement Belie Effort to Expand Bank Powers,” Financial Services Policy Bulletin, Stanford Washington Research Group (January 25, 2006); “Will Banks Become Land Developers?,” CNN Money (January 9, 2006) at [http://money.cnn.com/2006/01/09/news/companies/banks\\_real\\_estate](http://money.cnn.com/2006/01/09/news/companies/banks_real_estate).

<sup>5</sup> “In Focus: Firm, But Not Specific, On Banks in Real Estate,” American Banker (January 23, 2006).

<sup>6</sup> E. Gerald Corrigan, President, Federal Reserve Bank of Minneapolis, *Are Banks Special?*, **1982 Annual Report**, Federal Reserve Bank of Minneapolis. Page 2.

<http://minneapolisfed.org/pubs/ar/ar1982a.cfm>

E. Gerald Corrigan, Managing Director of Goldman Sachs & Co, Past President, Federal Reserve Banks of Minneapolis and New York, “*Are Banks Special? A Revisitation*,” *The Region – Special Issue 2000*, Federal Reserve Bank of Minneapolis. Page 2.

<http://minneapolisfed.org/pubs/region/00-03/corrigan.cfm>

<sup>7</sup> Alan Greenspan, in response to a question from Rep. Bachus, after delivering testimony on the Financial Services Competitiveness Act of 1995 (H.R. 18), February 28, 1995.

<sup>8</sup> Timothy Curry and Lynn Shibut, Division of Research and Statistics, Federal Deposit Insurance Corporation, “*The Cost of the Savings and Loan Crisis: Truth and Consequences*,” **FDIC Banking Review**, December 2000. Page 33. Estimate of the cost to taxpayers is through December 31, 1999. Another \$29 billion came from the thrift industry.

<sup>9</sup> Timothy Curry and Lynn Shibut,. Page 26.

<sup>10</sup> FDIC, **History of the 80s—Lessons for the Future**, 1997, Volume 1, Chapter 4

<sup>11</sup> Robert Litan, “*Panel 3: Comments on Lessons of the Eighties: What Does the Evidence Show?*,” FDIC, **History of the 80s—Lessons for the Future**, 1997, Volume 1, page 66.