The recently-issued U.S. Treasury proposals for the banking system clearly will be controversial. Two proposals, in particular -- to permit non-financial corporations to hold a substantial equity interest in commercial banks, and to permit banks to engage in traditional securities market activities -- are especially unwise.

We all know that banks are unprofitable. They need capital. But the reason they cannot raise equity is because informed investors aren't interested. Why, then, would an industrial corporation buy a bank -- except that it might provide a financing vehicle for the corporation, its suppliers, or customers which might not otherwise be available. I can think of nothing which would yet further diminish attention to prudence and credit-worthiness.

Banks are unprofitable simply because they make too many bad loans, and the good ones have little profit in them. They also have the dubious advantage of an awful set of accounting conventions which permits them to mask their mistakes and hold assets without marking their value to market. Spreads are narrow, costs are high, and there is too much reliance on insured deposits, with the accompanying incentive to take risks with someone else's money. Finally, there are too many banks. Permitting banks to engage in an already systemically unprofitable securities business will not solve those endemic problems.

Indeed, the only profitable part of the securities business in recent years was M&A and leveraged buyouts -- businesses the banks can even now engage in. Under the Treasury proposals, however, a bank affiliate would be able to provide both the front end loans as well as underwrite the junk bonds to take them out of their creditor position. Beyond that, bank asset allocation committees inevitably would be pressured to restrict lines of credit from enterprises competing with their corporate owners. The conflicts of interest, breach of fiduciary duty, unfair business practice and insider trading suits will keep us lawyers very busy. It will be like shooting fish in a barrel. Besides, why would the U.S. Treasury want to facilitate corporate financial engineering of a style which caused so much pain in the 1980's. Not a smart idea, and certainly not one which will encourage banking prudence or integrity.

But, mostly, I am concerned that the safety net provided by FDIC insurance will result in the taxpayer not only insuring depositors against the mistakes made by banks, but will end up, directly or indirectly, insuring the corporate sector. The links are tight enough as it is, but to encourage significant cross ownership will inevitably make the taxpayer the ultimate insurer of the viability of the non-banking sector. Not exactly what one would encourage in a market based economy.

We will hear a lot about firewalls. Firewalls won't work, and if they did, the banks, by definition, would not benefit from the alleged efficiencies, or synergies, or whatever, from the combination. (If the case for relaxing the constraints of the Bank Holding Company Act and Glass Steagall rests on such terms as "catalyst," "synergy," "firewalls," or "level playing field," the odds are there is trouble both in the logic and its implications for good public policy.) I cannot put this business about firewalls better than the recent Congressional testimony of E. Gerald Corrigan, President of the Federal Reserve Bank of New York -- certainly someone who wants strong banks:

*"The need for great care in this regard is strongly reinforced by case after case which illustrates that the well-being of the company as a whole cannot be safely disentangled from problems or adversities affecting an affiliated company no matter how thick the firewalls nor how well constructed the legal separation. Indeed, in times of stress, not only does the marketplace fail to generally accept these distinctions, but the directors and managers of the firms under stress don't accept them either."*

We also will hear a lot about international competitiveness. The idea of replicating the German, U.K. or Japanese banking systems -- each of which is different from the other -- is nonsense. The U.K. banks are minor players in the securities markets; the German banks have no securities firms as competitors; the Japanese banks are even more restricted than their U.S. counterparts. Moreover, given the mysteries of their accounting systems, hidden reserves, favorable tax treatments, monopolistic pricing, etc., we have no idea whether they are profitable. And if they are, it is basically because between four and ten banks control 90% of their nation's bank deposits. We cannot, therefore, clone that structure or facilitate bank profitability in the U.S. -- a country with 10,000 banks and 6000 securities firms.

If we need a market test so that banks do not go off the deep end with taxpayer-backed deposits, there are better ways than to limit the amount of FDIC insurance. First, no one will believe it. Second, a Triple-A country cannot have uninsured deposits. Third, if institutional investors truly believed there was no safety net for large depositors, they would move their money elsewhere.

A better way to provide for prudential banking is to require that banks use bonds rather than rely solely on deposits to finance themselves. Bond buyers will watch over the deployment of their investments better than an insured depositor, or even a stockholder. After all, stockholders want to see a little glitzy movement in stock prices and are not particularly risk-averse (unless, of course, the stockholders are corporate entities looking for subsidized financing to sell cars). Bond holders are a far more demanding lot.

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