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Beware Treasury's Bank Reform Plan

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By EUGENE H. ROTBERG

THE recently issued Treasury Department proposals for the banking system clearly will be controversial. Two proposals — to permit nonfinancial corporations to hold a substantial equity interest in commercial banks and 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 that informed investors are not 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? I can think of nothing which would further diminish prudence and credit-worthiness.

Banks are unprofitable because they make too many bad loans, and their good loans have little profit in them. They also have the dubious advantage of an awful set of accounting conventions that 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 the banks to engage in the securities business will not solve these problems. Indeed, the only profitable part of the securities business in recent years was mergers and acquisitions and leveraged buyouts — business the banks can now engage in. Under the Treasury proposals, however, bank affiliates would be able to provide the initial loans in these deals as well as underwrite the "junk bonds" that could be used to pay off the loans. Beyond that, banks would be pressured to restrict credit from enterprises competing with their corporate owners. The conflicts of interest will keep us lawyers very busy.

But my greatest concern is that the safety net provided by the Federal Deposit Insurance Corporation will result in the taxpayer insuring not only depositors, against the mistakes made by banks, but also the corporate sector. The links are tight enough as it is, but to encourage significant cross-ownership will make the taxpayer the insurer of the nonbanking sector.

WE will hear a lot about "firewalls" between banking and nonbanking operations. Firewalls will not work, and even if they did, the banks by definition would not benefit from alleged efficiencies or synergies from the combination. If the case for relaxing the constraints of the Bank Holding Company Act and Glass Steagall rest on such terms as "catalyst," and "synergy," the odds are there is trouble.

We also will hear a lot about international competitiveness. The idea of replicating the German, British or Japanese banking systems, each of which is different from the other, is nonsense. Moreover, given the mysteries of their differing systems it is impossible to tell whether they are really profitable. And if they are, it is basically because 4 to 10 banks control 90 percent of their nation's bank deposits.

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 F.D.I.C. insurance, as the Treasury proposes. The United States must have insured deposits. In a global economy, if institutions were denied a safety net, they would move their money elsewhere.

A better way to provide for prudent banking is to require that banks use high-quality bonds rather than rely on deposits to finance themselves. Bond buyers will watch over their investments better than an insured depositor or even a stockholder. Bondholders are a demanding lot.

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