

## The Parallel Banking System

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### Introduction

America's banking woes constitute one of the biggest challenges facing the Clinton administration. This challenge deserves the immediate attention of new leaders at the Federal Deposit Insurance Corporation and the Treasury Department.

Between 1985 and year-end 1990, more than 1000 banks failed, including major institutions in many parts of the country. As the recession drove up the volume of banks' nonperforming assets, the Bank Insurance Fund of the Federal Deposit Insurance Corporation (FDIC) became deeply insolvent and had to obtain \$70 billion in borrowing authority to continue operating. In 1991 and 1992, the total assets at failed banks insured by the FDIC reached record levels even though the number of bank failures dropped. Similarly, the number of banks on the FDIC's problem list diminished between September 30, **1991** and the end of 1992's third quarter, but the volume of problem bank assets soared (Rehm 1993, p. 1).

Although the banking industry as a whole booked record profits in 1992, its earnings were fashioned from huge, temporary spreads between low deposit rates and high loan yields, one-time securities sales, currency trading gains, and the bounty awarded to big banks buying insolvent institutions from the government's inventory of busted banks and thrifts. The General Accounting Office insists that accounting gimmickry further clouds the true picture of banking conditions. Many observers contend that banking's short-term profit boom masked a significant rise in interest rate risk, attributable to the industry's heavy investments in government securities.

While the sources of recent bank profits seem ephemeral, the erosion of public confidence in banks appears prolonged. In September 1991, an NBC/*Wall Street Journal* poll found that 62 percent of all respondents were concerned about the soundness of the banking system and 11 percent had withdrawn funds because of

that concern (Hart and Teeter 1991, pp. 22-29). Nineteen ninety-one also marked the first time more respondents to the Gallup Organization's annual *American Banker* "Consumer Survey" said they had "little or no confidence" in the safety of the U.S. banking and financial system than a "great deal of confidence." Gallup's next Consumer Survey, published in September 1992, revealed a small rise in the percentage of "little or no confidence" responses (*American Banker* 1992a, pp. 23-25).

In recent years, bankers have responded to these problems with an ongoing crusade for deregulation. With the election of a new president, industry groups stepped up their campaign by hiring influential lobbyists tied to the Democratic Party and placing key figures in the Clinton transition program focused on financial regulation. Speaking at the then president-elect's Little Rock economic summit, the president of the American Bankers Association promised that pruning regulation would generate \$86 billion in new bank lending (*American Banker* 1992b).

The industry's campaign is addressing a new audience in the Clinton administration and a substantially changed Congress. And it is targeting a new *bête noir*-provisions of the **1991** FDIC Improvement Act that strengthened accounting and regulatory standards. But the dynamics of the bankers' new rollback effort should be numbingly familiar to anyone who has observed the folkways of financial regulation in Washington.

Once again, a politically powerful, competitively disadvantaged segment of the financial industry is petitioning policymakers for new powers and regulatory breaks. Once again, these pleas promise to trigger similarly self-seeking countermoves by rival segments. If the past is prologue, this intramural clamoring for advantage will most likely stalemate itself, leaving untouched the deep-seated structural forces that continue to weaken banks and destabilize the nation's credit markets.

This kind of financial "reform" debate is a shadow play, acted out against a legislative and regulatory backdrop that bears little resemblance to the fundamentally changed marketplace in which the actors actually operate. Indeed, banks' problems and the erosion of consumer confidence are rooted in profound changes in the U.S. financial system.

## Summary

Over the last two decades, the U.S. system has been reshaped by the spread of multifunctional financial conglomerates and the emergence of an unregulated parallel banking system. Along with other powerful trends like securitization, these events have broken down the carefully compartmentalized credit and capital marketplace established in New Deal legislation 60 years ago.<sup>2</sup>

Today, a variety of unregulated financial intermediaries operate on the fringes of the financial system. Check-cashing and pawn shops offer expensive services to consumers bypassed by mainstream financial firms. Mortgage companies, less regulated than their thrift competitors, constitute a parallel housing finance system. Similarly, finance companies anchor the lending side of a parallel banking system. The finance companies obtain their funds from banks as well as from the money market mutual funds (MMMFS) that buy their notes, banks, and commercial papers.

Measured in terms of their aggregate assets and the size of individual companies, finance companies rank as the largest single group of unregulated intermediaries. Because of their size and their ability to lend to businesses as well as to household borrowers, finance companies affect credit markets more than do other types of less-regulated intermediaries. Finance companies are the most important nonbank intermediaries because they function like banks with virtually no regulatory costs.<sup>3</sup>

Finance companies make the same kinds of loans as do banks. Like banks, they fund their loans by issuing liabilities held directly as investments by households and businesses or by other intermediaries that accept funds from those sources. Unlike banks, finance companies need not comply with capital and reserve requirements, limits on loans to single or related borrowers, or limits on transactions with parents and affiliates. They are not bound by community investment demands under the Community Reinvestment Act (CRA) or the restrictions of the Glass-Steagall Act.<sup>4</sup> They can operate anywhere, nationwide. As a result, finance companies enjoy major advantages over banks in terms of their cost of funds, pricing of loans, and opportunities for growth and profitability.

The exploitation of these advantages—along with other factors such as increased, uneven competition from foreign-based banks<sup>5</sup>—has eroded the role of U.S. banks in financial intermediation. In 1980, outstanding assets of domestic finance companies (\$242.8 billion) amounted to 15.8 percent of outstanding assets of domestically chartered commercial banks (\$1,537.9 billion). By midyear 1992, finance company assets (\$790.4 billion) had risen to 26.1 percent of banks' assets (\$3,033.9 billion).

During the same period, commercial paper issued by finance companies tripled as a percentage of banks' time and savings deposits, jumping from 8 percent to 24.2 percent. The slower growth in bank assets and liabilities relative to those of finance companies is reflected by the decline in banks' share in credit flows. Banks held 39.1 percent of total credit market debt owed by nonfinancial borrowers in 1980. Twelve years later, their share had fallen to a low of 26.5 percent. Even more significant, finance companies' once-modest share of total credit extensions to business had

grown rapidly, to reach two-thirds of the share held by banks at midyear 1992 (FRS, *Flow of Funds*, 1992).

Some analysts welcome the rise of a parallel banking system. An economist at the Federal Reserve Bank of Kansas City recently enthused, “. . .the development of money market funds has made deposit rates more responsive to capital market rates. As a result, household savings flow more readily to the best investment opportunities, improving the efficiency of the intermediation process” (Sellon 1992, p. 67). In an October 1991 article entitled “Lending When Bankers Won’t,” the *New York Times* suggested that commercial finance companies had revived small and middle-market businesses drained by a bank credit crunch. “The longer the squeeze continues, the more companies like us will grow to fill the gap,” a finance company executive told the *Times*. “It may be hard for the larger banks to come back after they have burned so many people” (Quint 1991, p. C 1).

In fact, despite its many built-in competitive advantages, the parallel banking system has mismanaged many “investment opportunities,\*” as proven by the events of November 1992. Weaknesses in the loan portfolios of many companies suggest that the parallel system has developed in a manner that ultimately may undermine, not strengthen, U.S. credit markets and the nation’s underlying economy. Ironically, banks have increased this prospect by issuing billions of dollars of financial guarantees that nurtured the growth of their unregulated rivals while increasing their own exposure to risk.

The growth of the parallel system raises a number of new public policy concerns. The ownership of large finance companies by major nonfinancial corporations makes markets more susceptible to concentration and anticompetitive practices. A shift in lending from banks to the parallel system distorts the distribution of credit. Financial fragility increases as banks’ declining market share weakens their portfolios and exposes the deposit insurance fund to additional risk.

Most disturbing, the rise of a parallel system affects the primary role of banks in transmitting monetary policy and deploying central bank liquidity to smooth volatility, prevent disruptions, and manage crises. As banks’ role in credit markets shrinks, so does the Federal Reserve’s leverage.

The failure of policymakers so far to address these concerns is epitomized by the Bush administration’s 1991 proposal for financial restructuring. Focused primarily on the banking industry, it recommended loosening restrictions on banks to increase their profitability. Ignoring the structural problems posed by the parallel banking system, President Bush’s program sought to incorporate these fringe credit institutions formally into the financial system by offering their commercial owners expanded opportunities to own banks.

That model for restructuring will not work. By applying soundness regulation to banks but not their major competitors, the Bush proposal offered finance company owners insufficient incentives to forgo their largely unregulated status. Indeed, the plan would have perpetuated the existence of a parallel banking system, operating with the public's money outside the norms of financial regulation and reducing banks' share of total credit extensions, profitability, and soundness.<sup>6</sup>

Any serious effort to reconstitute the U.S. financial system, must begin by defining its current structure-not the structure outlined in law and regulation, but the actual framework in practice in the marketplace. All indicators confirm that banks no longer maintain a dominant place in that system. Others, obviously, have assumed their functions. Since soundness regulation clearly is needed for banks, it should be extended as well to institutions that have assumed many of the functions of banks.

It is widely agreed that the current regulatory and supervisory framework for the U.S. financial system is obsolete. But banks-meaning the functions and obligations of a banking system-certainly are not. No other set of institutions fulfills the unique and vital combination of roles-financial intermediation, money creation, and payment system operation-provided by the banking system. If that combination of roles is allowed to fade away, as some observers have suggested, banks would simply have to be reinvented.

Rather than allowing a repetition of the piecemeal deregulation experiments of the past decade, new strategies must be forged to restore the soundness of the U.S. financial system. The financial playing field must be leveled by raising, not lowering, standards of prudential supervision and public obligation. In other words, all financial institutions should be treated the same way.

To achieve this goal, we propose the establishment of a Financial Industry Licensing Act requiring all financial firms to be licensed and to comply with the same major regulations with respect to soundness. Uniform licensing requirements should be applied to any entity that:

- directly accepts funds from the public for investment:
- makes loans to the public or buys loans or securities using funds other than its own equity capital and retained earnings: or,
- sells loans or third party securities to financial institutions or investors.

A detailed proposal for achieving greater regulatory equality is presented in the concluding section of this paper. The major elements of that proposal include the following:

- uniform application of comparable reserve, capital, and liquidity requirements: comparable risk diversification standards and risk weighting techniques: and limits on concentration and prohibitions against conflicts of interest and self-dealing;<sup>7</sup>
- the establishment of intracompany **firewalls** to separate entities performing financial functions from their financial and nonfinancial parents and affiliates as well as effectively to prohibit tying and other forms of anticompetitive interaffiliate transactions;<sup>8</sup>
- systemwide compliance with the Community Reinvestment Act and other federal fair-lending statutes:
- greater systemwide transparency through the regular public disclosure of Uniform Performance Reports:
- greater harmonization of the methods and costs of supervision and examination on a domestic and international basis:
- enhanced self-regulation and consolidation of duplicative regulatory functions: and,
- licensing of financial intermediaries on a renewable basis.

Restoring soundness will require that federal regulations cover any institution operating in any form in more than one state. The nationwide operations of finance, insurance, and mortgage companies cannot be monitored with adequate attention to their overall soundness by state regulators whose ability to coordinate regulatory policy and enforcement is significantly inhibited by differences in state laws. Inefficient and insufficient regulation of large, important, financial industry groups constitutes a serious threat to soundness because of their potential for initiating crises that could spread to other institutional and market segments.

Within the framework proposed in this paper, it will be possible to apply uniform regulations to all institutions engaged in a given financial activity regardless of their institutional classification. For example, all institutions would be subject to uniform standards or definitions governing expected losses or nonperforming assets: comparable regulations would govern the establishment of reserves against problem assets.

Such a framework should encourage an ongoing evolution, innovation, and experimentation in institutional structures and products. It will also eliminate the regulatory distortions that have made the credit markets less responsive to monetary policy and less capable of promoting sustainable growth.

While the ongoing integration of financial industry activities makes it increasingly difficult to separate banking and securities operations meaningfully, this paper

does not incorporate a recommendation for repealing the Glass-Steagall Act. As most recently demonstrated in the October 1987 market crash, the separation of banking and securities functions is a proven, least-cost method of preventing the problems of one financial sector from spilling over into the other.

However, a system of uniform licensing and regulation will readily accommodate our proposal for a new financial products holding company charter. A major feature of this new charter would require firewalls legally separating the operations of multifunctional bank and nonbank financial conglomerates (i.e., firms owning affiliates that include finance companies, mutual funds, insurance companies, securities firms, mortgage banks, etc.).

Any proposal to extend consistent prudential supervision throughout the entire financial market naturally raises questions about the uneven application of public guarantees to different segments of the financial industry. Several major components of the industry—depositories, private insurers, securities firms, and pension funds—participate in financial guaranty programs. These include the deposit insurance funds, state guaranty associations, the Securities Investor Protection Corporation, and the Pension Benefit Guaranty Corporation. If entities such as mutual funds that accept money from the public are subjected to bank-like soundness regulation, should they also receive the benefit of direct public guarantees? If those same prudential standards cover finance company affiliates of industrial parent firms, will the parents gain access to an already overburdened public safety net?

In fact, the parallel banking system already benefits indirectly from that safety net. Our answer to these questions is to insure the aggregate savings of individuals up to a given amount, regardless of where they are placed, rather than insuring single accounts or entire financial firms. In addition to reducing taxpayer exposure to financial industry failures, this method also will provide stability, including protection of the payment system. The paper, *No More Bank Bailouts* (D'Arista 1991), presents a complete description of the public guaranty reforms that would complement the proposal made here.

The analysis in this paper focuses on finance companies as the sector that best explains the need to license all financial institutions and subject them to uniform soundness requirements. While other cases abound throughout the financial market, the bank-like activities of finance companies offer the clearest case of regulatory inequality because they compete with the most regulated segment of the industry.

### **The Development of a Parallel Banking System**

A parallel banking system emerged during the 1970s with the introduction of money market mutual funds. These funds helped expand the commercial paper

TABLE 1  
Regulated Affiliates of Selected Finance Companies  
(millions of dollars)

Company	Insured Deposits at 12-31-91		Insurance Company	Securities/ Investment Firm
	Commercial Bank	S&L or Savings Bank		
Associates First Capital Corp.	\$ (\$15.9)	• (see Ford)	S	
Ford Motor Credit Corporation	(see Associates)	s (\$14,051.9)		
American Express Credit Corp.	. (1,465.1)		.	
Beneficial Corp.	\$ (284.7)	\$ (75.2)	s	
GE Capital Corp.	\$ (20.7)		.	
Household Financial Corp. *	. (86.5)	. (6,542.9)	•	
ITT Financial Corp.		\$ (581.8)	.	
Sears Roebuck Acceptance Corp.	• (5,033.1)	. (3,684.6)	.	
Total Insured Deposits	(\$6,907)	(\$24,936.4)		

\* Household International reported an additional \$1.6 billion in foreign deposits at year-end 1991.

Note. S = Subsidiary

• = Affiliate within Holding Co.

Sources: Annual Reports; 10-Ks; Thomson Savings Directory (July-December 1992); Thomson Bank Directory (July-December 1992).

market and offered finance companies cheaper and more plentiful funds by purchasing their paper. The parallel system divided intermediation between two separate entities, each of which dealt directly with the public through only one side of the balance sheet.

Finance companies come in a variety of shapes (consumer, commercial, acceptance, independent, captive), sizes, and geographic arrangements.<sup>9</sup> Most take funds indirectly, rather than directly, from the public.<sup>10</sup> Some smaller finance companies rely on borrowings from banks to fund their operations. Larger firms raise funds by issuing bonds, notes, and commercial paper. They sell the bulk of their commercial paper to money market mutual funds.

Although finance companies lend directly to many of the same household and business customers sought by banks, they are not subject to legal prohibitions on



**TABLE 2**  
**Assets of Money Market Mutual Funds**  
**(billions of dollars and percent)**

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992:Q2
<b>Total Assets<sup>a</sup></b>	\$76.4	\$186.2	\$219.8	\$179.4	\$233.6	\$243.8	\$316.1	\$292.1	\$338.0	\$428.5	\$498.4	\$539.6	\$557.7
<b>Time Deposits and Other Bank-related Instruments:<sup>b</sup></b>													
<b>Amount</b>	\$33.6	\$76.7	\$81.1	\$58.6	\$66.4	\$62.1	\$94.2	\$73.5	\$104.9	\$122.6	\$118.5	\$122.6	\$126.6
<b>Percent of Total</b>	44.0%	41.2%	36.9%	32.7%	28.4%	25.5%	29.8%	25.2%	31.0%	28.6%	23.8%	22.7%	22.7%
<b>U.S. Treasury, Federal Agency and Tax-exempt Securities:</b>													
<b>Amount</b>	\$9.2	\$36.1	\$67.8	\$53.0	\$66.2	\$79.0	\$102.9	\$106.9	\$95.7	\$105.6	\$166.0	\$210.8	\$216.7
<b>Percent of Total</b>	12.0%	19.4%	30.8%	29.5%	28.3%	32.4%	32.3%	36.6%	28.3%	24.6%	33.3%	39.1%	38.9%
<b>Commercial Paper:</b>													
<b>Amount</b>	\$31.6	\$70.4	\$69.1	\$66.2	\$98.0	\$99.1	\$111.3	\$105.3	\$129.1	\$186.5	\$206.7	\$191.9	\$196.9
<b>Percent of Total</b>	41.4%	37.8%	31.4%	36.9%	41.9%	40.6%	35.2%	36.0%	38.2%	43.5%	41.5%	35.6%	35.3%
<b>Money Market Mutual Funds' Holdings of Commercial Paper as a Percentage of Total Commercial Paper Outstanding<sup>c</sup></b>	26.0%	43.7%	42.7%	36.1%	42.2%	33.7%	34.1%	28.2%	28.6%	35.7%	37.1%	36.3%	36.1%

<sup>a</sup> Note: The liabilities of money market mutual funds are their shares.

<sup>b</sup> Includes checkable deposits, large time deposits, federal funds, security repurchase agreements, and deposits abroad.

<sup>c</sup> Federal Reserve System, *Flow of Funds*.

Source: Federal Reserve System, *Flow of Funds*.

links between banking and commerce. Some of the major finance companies are owned by industrial corporations (General Motors, General Electric, Chrysler, Ford, Xerox, ITT, Westinghouse, IBM, AT&T, Whirlpool, and Textron). Many have affiliates engaged in securities and insurance activities (see Table 1).

Several of the top finance companies (GE Capital Corp., Sears Roebuck Acceptance Corp., Transamerica Finance Group, and American Express Credit Corp.) belong to the major nonbank, multifunctional financial conglomerates that have helped reshape the U.S. financial landscape. Indeed, some finance companies have become in-house banks, providing funds for other financial and nonfinancial members of the conglomerates.

Unlike finance companies, money market mutual funds (MMMFs) compete with banks in attracting funds directly from the public. But, unlike banks, MMMFs do not lend directly to households and businesses. Instead, they invest in short-term, tradable instruments—predominantly bank CDs, commercial paper, and government obligations (see Table 2).

Linking the two halves of the parallel banking system is the commercial paper market. Commercial paper is a form of uncollateralized borrowing—a promissory note issued directly by borrowers or indirectly through brokers. Since it is sold only

**TABLE 3**  
**Total Assets of Selected Financial Intermediaries**  
**as a Percentage of Outstanding Credit Market Debt**  
**Owed by Domestic Nonfinancial Sectors**

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992:Q2
Commercial Banks	39.1%	38.0%	38.2%	37.0%	34.9%	33.4%	<b>33.0%</b>	30.3%	29.5%	28.9%	28.0%	27.4%	26.5%
Finance Companies	6.2	6.3	6.2	6.2	6.2	6.3	6.8	6.8	6.9	7.1	7.2	7.2	6.9
Money Market Mutual Funds	1.9	4.3	4.7	3.4	3.9	3.5	4.0	3.4	3.6	4.2	4.6	4.8	4.9

Sources: Federal Reserve System, *Flow of Funds*, September 28, 1992; *Federal Reserve Bulletin*, various issues, Table 1.25; *Annual Statistical Digest*, 1980-1989.

**TABLE 4**  
**Outstanding Assets of Domestically Chartered Commercial**  
**Banks and Finance Companies**  
**(billions of dollars)**

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992:Q2
Commercial Bank Assets	\$1537.9	\$1639.2	\$1800.4	\$1948.7	\$2107.7	\$2314.2	\$2581.0	\$2593.0	\$2751.0	\$2913.6	\$3010.3	\$3072.0	\$3033.9
Finance Company Assets	242.8	273.2	292.3	326.5	371.3	440.2	530.6	583.9	645.5	719.3	772.1	803.7	790.4
Finance Company Assets as a Percent of Commercial Bank Assets	15.8%	16.7%	16.2%	16.8%	17.6%	19.0%	20.6%	22.5%	23.5%	24.7%	25.6%	26.1%	26.1%

Sources: Federal Reserve System, *Flow of Funds*; *Federal Reserve Bulletin*, various issues. Table 1.25; *Annual Statistical Digest*, 1980-

in large denominations, financial regulators have assumed that commercial paper will be bought by “sophisticated” investors. As a result, the instrument is not defined as a security under the Securities Act of 1933. With commercial paper issuers exempt from the Act’s disclosure provisions, MMMFs and other institutional investors must rely on private rating agencies for information on the issuers.

During the 1980s, finance companies and MMMFs fed one another’s soaring asset growth and boosted their share of total outstanding credit market debt (see Table 3). Measured as a percentage of banks’ assets, the assets of finance companies rose steadily from 15.8 percent in 1980 to 26.1 percent at midyear 1992 (see Table 4). Meanwhile, outstanding commercial paper issued by finance companies climbed from 8 percent to 24.2 percent of banks’ outstanding savings and time deposits (see Table 5).

TABLE 5  
Changes in Outstanding Commercial Paper Issued by Domestic  
Finance Companies and Outstanding Savings and Time Deposits  
of Domestically Chartered Commercial Banks  
(billions of dollars and percent)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992:Q2
<b>Banks' Savings and Time Deposits</b>	\$753.9	\$872.0	\$988.5	\$1099.6	\$1107.3	\$1195.9	\$1276.1	\$1333.3	\$1441.1	\$1554.7	\$1657.4	\$1372.7	\$1371.7
<b>Outstanding Commercial Paper issued by Finance Companies</b>	60.1	74.1	74.2	86.7	100.7	140.7	181.7	212.6	270.5	301.7	335.0	322.8	332.1
<b>Commercial Paper issued by Finance Companies as a Percentage of Banks' Savings and Time Deposits</b>	8.0%	8.5%	7.5%	7.9%	9.1%	11.8%	14.2%	15.9%	18.8%	19.4%	20.2%	23.5%	24.2%

Sources: Federal Reserve System, *Flow of Funds*; *Federal Reserve Bulletin*, various issues, Table 1.25: *Annual Statistical Digest*, 1980-1989.

While money market funds themselves compete with banks for funds, they also invest a significant share of their funds in banks' liabilities (see Table 2). However, in every year after 1982, MMMFs' holdings of bank deposits fell below their holdings of commercial paper.

Predictably, the symbiotic growth of MMMFs and finance companies set off a surge in the commercial paper market. As Table 6 shows, finance companies now reign as the primary issuers in this market. Direct borrowing by nonfinancial companies accounted for less than 27 percent of outstanding commercial paper issues in every year after 1981.

The spread of the parallel banking system is rooted in regulatory inequalities. Long after the removal of Regulation Q's formal rate restrictions, MMMFs continue to enjoy regulatory advantages over banks in competing for funds from households and businesses." Their freedom from reserve requirements applicable to banks' demand deposits gives MMMFs their principal edge.

With their monopoly on interest-free, third-party-transferable demand deposits, banks can attract substantial amounts of low-cost funding. But this capacity does not advantage banks in terms of pricing loans or maximizing spreads between the cost of and return on funds. Because reserve requirements "sterilize" \$10 (\$12 before February 1992) of every \$100 of demand deposits, only \$90 (\$88 previously) can be invested in interest-earning assets. Since MMMFs can place all their funds in interest-bearing investments, their return on total assets is higher. Thus, they can offer savers a higher yield on their liabilities.

Money market mutual funds avoid other significant costs faced by commercial banks, too. MMMFs do not pay deposit insurance premiums. Nor do they pay for developing specific information about their assets or maintaining offices and automated teller machines (ATMs) that provide services to less-affluent and less-sophisticated depositors and borrowers.<sup>12</sup> The absence of these costs to MMMFs also provides a price advantage that can be passed on to their customers.

Like MMMFs' retail customers, finance companies also benefit from these price advantages. Over the past decade, finance companies reduced their borrowings from banks and increased their outstanding issues of commercial paper as a share of total liabilities (see Table 7). Their other major source of funds—longer-term notes and bonds—also declined relative to outstanding commercial paper. In other words, finance companies grew as a sector by accessing the expanding supply of lower-cost household savings drawn to MMMFs.

TABLE 6  
Amount of Outstanding Commercial Paper  
(billions of dollars and percent)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992:Q2
<b>A. Amounts Outstanding</b> (billions of dollars, at year-end)													
All Issuers	\$121.6	\$161.1	\$161.8	\$183.5	\$231.7	\$293.9	\$326.1	\$373.6	\$451.8	\$521.9	\$557.8	\$528.1	\$544.7
Financial Companies	86.6	107.6	109.2	125.2	145.5	187.8	225.9	258.6	316.1	351.7	365.6	347.9	355.5
Bank Related Finance Companies	25.9	33.0	34.6	38.0	44.1	46.4	43.1	44.6	44.4	48.8	30.1	24.3	22.5
Nonfinancial Companies	60.1	74.1	74.2	86.8	100.8	140.7	181.7	212.6	270.5	301.7	335.0	322.8	332.1
Nonfinancial Companies	28.0	42.7	37.6	36.8	58.5	72.2	62.9	73.8	85.7	107.1	116.9	98.5	111.7
<b>B. Shares of Total Outstanding</b> (in Percent)													
All Issuers	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Financial Companies	71.2	66.8	67.5	68.2	62.8	63.9	69.3	69.2	70.0	67.4	65.5	65.9	65.3
Bank Related Finance Companies	21.3	20.5	21.4	20.7	19.0	15.8	13.2	11.9	9.8	9.4	5.4	4.6	4.1
Nonfinancial Companies	49.4	46.0	45.9	47.3	43.5	47.9	55.7	56.9	59.9	57.8	60.1	61.1	61.0
Nonfinancial Companies	23.0	26.5	23.2	20.1	25.2	24.6	19.3	19.8	19.0	20.5	21.0	18.7	20.5

Source: Federal Reserve System, *Flow of Funds*.

**TABLE 7**  
**Selected Components of Outstanding Assets and liabilities**  
**of Domestic Finance Companies**  
**(billions of dollars and percent)**

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992:Q2
<b>Assets</b>													
Total Assets (billions of dollars)	\$242.8	\$273.2	\$292.3	\$326.5	\$371.3	\$440.2	\$530.6	\$583.9	\$645.5	\$719.3	\$772.1	\$-303.7	\$790.4
Percentage of Which are Credits Extended to:													
Consumers	32.5%	32.1%	31.9%	31.8%	30.1%	30.1%	28.5%	26.4%	24.1%	20.1%	18.0%	15.8%	15.3%
Businesses	36.5	36.4	34.3	34.8	37.1	36.1	33.4	36.6	38.0	37.6	38.0	36.4	37.2
Mortgages	21.3	21.6	23.4	23.4	24.0	23.5	27.1	24.4	24.6	28.1	29.3	28.2	28.7
<b>Liabilities</b>													
Total Liabilities (billions of dollars)	\$216.6	\$245.1	\$262.2	\$293.4	\$336.3	\$404.7	\$491.5	\$551.4	\$601.5	\$664.0	\$708.4	\$738.9	\$723.3
Percentage of Which are:													
Bank Loans	11.3%	10.2%	10.1%	8.9%	8.0%	7.3%	6.8%	5.7%	4.7%	4.8%	4.7%	5.1%	5.3%
Commercial Paper	27.7	30.2	28.3	29.6	30.0	34.8	37.0	38.6	45.0	45.4	47.3	43.7	45.9
Corporate Bonds	42.5	40.8	42.9	42.5	43.3	37.0	38.1	30.7	24.3	25.7	24.2	26.7	23.7

Source: Federal Reserve System, *Flow of Funds*.

The decline in finance companies' cost of funds enhanced their profitability as well as their ability to compete with banks. In earlier decades, finance companies loaned mostly to consumers. In 1965, over 55 percent of their loans went to consumers, 30 percent to businesses, and 10 percent for mortgages. By 1975 consumer lending had dropped to 45 percent, while business lending jumped to 41 percent of the industry's total assets (FRS, Flow of Funds various dates),

As Tables 7 and 8 demonstrate, these trends accelerated in the 1980s. They also changed somewhat in composition. Business loan growth in the 1970s tended to reflect expanded lending by "captive" finance companies to affiliates and customers of their parent companies. However, the steady climb in business lending during the 1980s was fueled by noncaptive finance companies providing credit to an assortment of nonaffiliated borrowers.

By the end of the 1980s, finance companies had made deep inroads into the core business of commercial banks. Between 1980 and midyear 1992, the share of outstanding business debt owed to finance companies rose from 6.0 percent to 8.2 percent. During the same period, the share owed to banks dropped from 19.1 per-

**TABLE 8**  
**Outstanding U.S. Credit Market Debt Owed by Households**  
**and Nonfinancial Businesses**  
**(billions of dollars and percent)**

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992:Q2
Total Credit Market Debt Owed by:													
Households	1405.8	\$1521.7	\$1600.3	\$1766.0	\$1993.3	\$2271.0	\$2584.0	\$2861.3	\$3177.3	\$3508.2	<b>\$3780.6</b>	\$3938.6	\$4010.8
Nonfinancial <b>Businesses<sup>a</sup></b>	1484.3	1650.0	1775.4	1946.2	2249.5	2512.2	2806.3	3034.6	3281.6	3512.0	3618.0	3593.2	3602.3
1) Outstanding Finance Company Credit to Consumers													
a) Amount	\$78.9	\$87.8	\$93.2	<b>\$103.7</b>	\$111.7	\$132.4	\$151.0	\$154.0	\$155.3	\$144.6	\$138.7	5126.7	\$120.8
b) Percent of Total Debt Owed by Households	5.6%	5.8%	5.8%	5.9%	5.6%	5.8%	5.8%	5.4%	4.9%	3.8%	3.7%	3.2%	3.0%
2) Outstanding Finance Company Credit to Businesses													
a) Amount	<b>\$88.7</b>	\$99.4	<b>\$100.4</b>	\$113.4	\$137.8	\$158.7	\$177.2	\$213.8	\$245.3	\$270.2	\$293.5	\$292.6	\$293.7
b) Percent of Total Debt Owed by Nonfinancial Businesses	6.0%	6.0%	5.7%	5.8%	6.1%	6.3%	6.3%	7.0%	7.5%	7.7%	8.1%	8.1%	8.2%
3) Outstanding Bank Loans to Individual													
a) Amount	\$181.2	\$186.1	\$191.6	\$217.4	\$258.4	\$299.5	\$321.5	\$334.3	\$361.5	\$382.3	\$384.7	\$369.6	\$358.8
b) Percent of Total Debt Owed by Households	12.9%	12.2%	12.6%	12.3%	13.0%	13.2%	12.4%	11.7%	11.4%	10.9%	10.2%	9.4%	8.9%
4) Outstanding Commercial and Industrial Loans of Banks													
a) Amount	\$282.9	\$317.9	\$355.5	\$381.3	\$430.0	<b>\$446.6</b>	\$487.8	\$481.9	\$501.1	\$517.7	\$512.7	<b>\$464.5</b>	\$446.3
b) Percent of Total Debt Owed by Nonfinancial Businesses	19.1%	19.3%	<b>20.0%</b>	19.6%	19.1%	17.8%	17.4%	15.9%	15.3%	<b>14.7%</b>	14.2%	12.9%	12.4%

<sup>a</sup> Includes farm, **nonfarm** noncorporate sectors,

Source: federal Reserve System, Federal Reserve *Bulletin*, various issues, Table 1.25 (Assets and Liabilities of Commercial Banking Institutions). Flow of Funds.

cent to 12.4 percent (see Table 8). With one-quarter the total assets of banks, finance companies now claim more than two-thirds the business loans held by banks.

### **Banks' Role in Promoting the Parallel System**

Perhaps the greatest irony associated with the parallel banking boom is the degree to which it has been aided by commercial banks' provision of additional stability and liquidity to their unregulated competitors. Given its reliance on the commercial paper market as a source and use of funds, the parallel banking system is not

inherently stable. Each component of the system shares the banking industry's susceptibility to runs. A failure in any one segment could spread rapidly to other financial and nonfinancial companies that issue or hold commercial paper. The absence of soundness standards and supervision increases the potential for surprise events that could trigger a breakdown.

But historically, major losses and even defaults by commercial paper issuers have not resulted in runs. The reason is back-up credit lines provided by federally insured commercial banks to a variety of commercial paper issuers, including finance companies.

Banks began to offer guarantees to issuers two decades ago, when the commercial paper market foundered in the aftermath of Penn Central Railroad's 1970 default on \$83 million of maturing paper. The introduction of these guarantees expressed the banks' own self-interest. Banks themselves relied on the fragile market because the 1970 Bank Holding Company Act amendments imposed limits on lending to their parent companies and nonbank affiliates. Thus, commercial paper became the main vehicle for funding bank holding companies' nonbank activities. By offering guarantees to other issuers, banks could help restore confidence in a market crucial to their parents' funding needs. They could also create a new source of fee income in the process. During the 1980s, bank issuances of commercial paper diminished as bank guarantees for commercial paper skyrocketed (see Tables 6, 9, and 10). Gradually, those credit lines emerged as the major link between banks and finance companies. Although the guarantees funneled fee income into the banks' coffers, they also cut the cost of liabilities for finance companies, since investors accept a lower return because of the guarantee. During the 1980s, the lower cost of funds enabled some finance companies to diversify away from their captive role and become third-party lenders to a wider assortment of borrowers.

By 1990, the amount of commercial paper issued by the 15 largest finance companies and backed by banks (\$101 billion) was nearly as large as the entire commercial paper market just one decade earlier (\$122 billion). As Table 9 shows, bank guarantees for finance company commercial paper have expanded in absolute terms and as a percentage of outstanding paper. Between 1989 and year-end 1991, bank credit lines backing up paper issuances by the 15 largest nonbank finance companies rose 28 percent from \$87.2 billion to \$111.5 billion. Measured as a portion of outstanding paper, combined bank guarantees to the 15 firms soared from 65.9 percent to 90.8 percent.

A series of developments in the 1980—securitization, foreign bank lending in the U.S. market, and the growth of finance companies—worked together to under-

mine banks' asset quality. At the same time, banks' off-balance-sheet commitments to commercial paper issuers intensified their portfolio risk. If the rating on an issuer's paper is downgraded and its cost rises above the cost of the loan commitment made by a bank, the issuer will borrow from the bank. This is what General Motors Acceptance Corporation did in early 1991 after its parent reported a loss for 1990. A finance subsidiary that loses access to the market altogether, as Chrysler Financial Corporation did in 1990, also will borrow from banks.

These developments, described more fully below, suggest that bank portfolios will become more risky if the parallel system falters. But they also became more risky because of a thriving parallel system. Clearly, the parallel system as presently constituted threatens the soundness of commercial banks-and the continued viability of the intermediation function itself.

At the same time, the entire panoply of bank guarantees has become something of a parallel system in itself-an immense volume of contingent liabilities rivaling the actual volume of loans on the books of the largest banks.<sup>13</sup> While this system purports to substitute private guarantees for public support, it actually creates an explicit channel through which all issuers in the commercial paper market gain access to the public sector lender of last resort.

The development of a thickly tangled web of bank guarantees ensures that a future confidence-shaking crisis involving a major issuer would precipitate systemic consequences. Such an eventuality would require massive lending by the Federal Reserve to provide the real back-up for banks' back-up credit lines. Capping this chain of ironies is the modest nature of banks' short-term rewards. Typically, bank fees for providing credit liens range from only 25 to 75 basis points. In return for furnishing \$6 billion in guarantees to the Westinghouse Credit Corporation (WCC) in 1992, 49 major banking organizations will split the grand total of \$13 million in fees from WCC and \$91 million in origination fees from the parent company.

### **Structure and Operations of Finance Companies**

Enriched by their ties to powerful industrial and commercial parents, large finance companies have risen to the top of the financial market. But while they enjoy important advantages over banks, finance companies also face serious weaknesses. The structure, operations, and specific problems of major finance company types-as well as the best-known individual firms-are described below.

Finance companies are characterized by a considerable degree of diversity in their ownership, structure, and operations. Most of the largest companies are owned by parent corporations engaged in manufacturing or retail operations (see Table 1). Some (American Express Credit Corp., Transamerica Finance Group) are subsidiaries



**Table 9  
Commercial Paper Issuances by  
Lending Finance Companies**

Company (12-31-91 Assets billion dollars)	1991			1990			1989								
	Commercial Paper	Bank Guarantees	Commercial Paper	Bank Guarantees	Commercial Paper	Bank Guarantees	Commercial Paper	Bank Guarantees							
	Amount (billion dollars)	Percent of Total Percent of Company Liabilities	Outstanding Commercial Paper	Amount (billion dollar)	Percent of Total Percent of Commercial Paper	Amount (billion dollars)	Percent of Company Liabilities	Outstanding Commercial Paper	Amount (billion dollars)	Percent of Commercial Paper	Amount (billion dollars)	Percent Of Company Liabilities	Outstanding Commercial Paper	Amount (billion dollars)	Percent of Commercial Paper
General Motors Acceptance Corp. (\$102.9)	\$27.5	29.2%	5.2%	\$25.4	92.4%	\$30.3	32.1%	5.4%	\$20.6	68.0%	\$33.8	35.3%	6.5%	\$17.3	51.2%
GE Capital Corp. (\$80.5)	36.9	50.8	7.0	19.7	53.4	33.6	52.9	6.0	18.4	54.8	28.9	54.4	5.5	14.7	50.9
Ford Motor Credit Company (\$56.9)	18.0	34.8	3.4	10.6	58.9	22.8	42.1	4.1	9.4	41.2	18.2	36.0	3.5	9.4	51.6
Associates First Capital Corp. (\$21.6)	8.0	40.6	1.5	6.0	75.0	6.0	38.7	1.1	4.4	73.3	5.3	39.3	1.0	1.3	24.5
Chrysler Financial Corp. (\$21.3)	0.3	1.9	0.1	8.1	2700.0	1.1	4.5	0.2	8.8	800.0	10.1	37.0	1.9	8.5	84.2
Household Financial Corp. (\$17.3)	2.4	15.2	0.5	4.0	6.7	3.3	21.4	0.6	3.8	115.2	3.6	26.1	0.7	3.2	88.9
Sears Roebuck Acceptance Corp. (\$14.7)	5.3	45.3	1.0	11.8	222.6	6.9	55.2	1.2	10.8	156.5	9.9	84.6	1.9	10.8	109.1
American Express Credit Corp. (\$14.1)	7.5	61.5	1.4	3.9	52.0	7.3	58.4	1.3	3.8	52.1	5.2	46.8	1.0	3.5	67.3
ITT Financial Corp. (\$12.6)	3.7	33.0	0.7	3.3	89.2	4.4	42.7	0.8	3.5	79.5	4.1	43.6	0.8	3.2	78.0
IMB Credit Corp. (\$11.3)	2.2	21.6	0.4	0.2	9.1	2.0	19.6	0.4	—	—	1.2	13.9	0.2	0.6	50.0
Beneficial Corp. (\$10.0)	1.6	21.8	0.4	2.1	110.5	2.1	25.3	0.4	2.1	100.0	1.8	25.6	0.3	2.0	111.1
Westinghouse Credit Corp. (\$8.6)	2.2	29.3	0.4	6.0	272.7	3.7	40.7	0.7	5.3	143.2	4.0	49.2	0.8	3.8	95.0
TransAmerica Finance Group (\$7.3)	2.6	35.6	0.5	4.0	153.8	2.7	38.0	0.5	3.6	133.3	3.0	40.5	0.6	4.0	133.3
Commerical Credit Corp. (\$6.7)	2.3	34.3	0.4	2.6	113.0	2.7	43.5	0.5	3.0	111.1	1.4	32.3	0.3	1.9	135.7
American General Finance Corp. (\$5.4)	2.0	37.0	0.4	3.8	190.0	2.0	41.7	0.4	3.8	190.0	1.8	38.3	0.3	3.0	166.7
Totals	\$122.8	34.7%	23.5%	\$111.5	90.8%	\$130.9	37.9%	23.5%	\$101.3	77.4%	\$132.3	40.5%	25.3%	\$87.2	65.9%

May not add up due to rounding.

Source: Annual Reports of Companies.

**Table 10**  
**Bank Guarantees to Selected Finance Companies**

	J.C. Penney Funding Corporation	Sears <i>Roebuck</i> Acceptance Corporation	Westinghouse Credit Corporation	ITT Financial Corporation
Guarantor	• •• • •• \$500M Lines of Credit \$750M Revolving Credit Facility	• •• ••• •••• • • • • • • •• •	4.28 Revolving Credit Facility \$275M Revolving Credit Facility \$450M Revolving Credit Facility \$700M Revolving Credit Facility \$68 Credit Facility	(time of Credit Per Bank) (Million Dollars)
Bank America	•	••	(co-agent)	\$175 (inc. <b>See Pac</b> )
Citibank	•	•		\$50
Chemical Bank	•	••	(co-agent)	\$175 (inc. MHT)
Morgan Guaranty	•	•• •••	(lead agent)	\$60
NationsBank	•	•		\$60
First Interstate	•	•	(lead manager)	\$36
NBD Bank	••	•		\$20
First Chicago	•	••	(lead manager)	\$70
Credit Lyonnais	••	•	(co-agent)	\$55
Fuji Bank	•	••••		\$35
Banca <b>Nazionale</b> Del Lavoro		••	(lead manager)	\$25
Sumitomo Bank	••••	•		\$47.5

Source: Annual Reports

of nonbank finance conglomerates, while others are subsidiaries of domestic banks (Nor-west Financial Services) or foreign banks (Heller Financial, CIT Group Holdings).<sup>14</sup> The sixth and eleventh largest, Household Financial Corporation and Beneficial Corporation, are independent companies connected to an array of regulated and unregulated financial affiliates. Most other independents are smaller, regional firms.

The industry's operations can be visualized along a spectrum bounded at one end by "captive" companies and, at the other, by independent firms like Beneficial and Household. Generally, the business of captives is limited to purchasing parent companies' customer receivable balances (if the parent is a retailer) or providing loans, leases, or inventory finance for parent company customers if the parent is a

manufacturer. Some captives also provide financing for the parent's primary activities by acquiring its short-term notes.

By contrast, independent finance companies make consumer and/or commercial loans to third parties and are unaffiliated with any industrial or retail parent. At the midpoint of this spectrum stand a number of diversified finance companies engaged in a mix of activities related and unrelated to their parents' principal lines of business. The biggest and most familiar residents of this spectrum are the automobile finance companies and General Electric Capital Corporation.

At year-end 1991, General Motors Acceptance Corporation (GMAC), Ford Motor Credit Company (FMCC), and Chrysler Financial Corporation (CFC) ranked first, third, and fifth among U.S. finance companies (see Table 11). While engaged primarily in promoting the sale of parent company products, the Big Three's finance companies also are linked to affiliates conducting an array of activities.

For example, GMAC subsidiaries include a captive automobile insurance company, an industrial loan subsidiary, GMAC Mortgage Corporation (one of the largest U.S. mortgage bankers), and Electronic Data Systems (EDS)-which owns an additional layer of subsidiaries engaged in finance (Moody's *Banks and Finance Manual* 1990, p. 5447; 1991, p. 5455).

Ford Motor Credit Company started diversifying into non-auto consumer lending as early as 1966. FMCC is part of a group of finance subsidiaries that also includes First Nationwide Financial Corp., the country's fifth-largest savings and loan, and the Associates Corporation of North America, the fourth-largest U.S. finance company.<sup>15</sup> Ford acquired the Associates from Paramount Communications in 1989 to make financial services a larger part of its earnings stream and to "counter-balance . . .the cyclical nature of the automotive industry." Two years later, the Associates helped accomplish this goal (though not, perhaps, as originally envisioned) by purchasing \$2.2 billion of receivables from FMCC (*Moody's Banks and Finance Manual* 1991, p. 3039; FMCC 1991 Annual Report, p. 21).

At year-end 1991, GMAC remained the largest consumer finance operation in the nation. But its share of the market and that of the other two automobile finance companies had declined. In 1988, the assets of the three automobile finance units accounted for 28.4 percent of total finance company assets. By 1991, their share had fallen to 22.6 percent as slumping auto sales slowed the growth in receivables (see Table 11).

As the carmaker finance units lost market shares, GE Capital Corporation gained. The company's parent is one of the largest and most diversified industrial corporations in the world: it operates approximately 182 manufacturing plants in 35 states and Puerto Rico, plus 79 manufacturing plants in 19 other countries. During

**TABLE 11**  
**Top 12 Nonbank Finance Companies**  
**Ranked by Assets**

	1991		1990		1989	
	Percent of Total Amount (billions of dollars)	Percent of Total for all Finance Companies	Amount (billions of dollars)	Percent of Total for all Finance Companies	Amount (billions of dollars)	for all Finance Companies
<b>General Motors</b> Acceptance Corp.	\$102.9	12.8%	\$105.2	13.6%	\$103.6	14.4%
General Electric <b>Capital</b> Corp.	80.5	10.0	70.4	9.1%	58.7	8.2%
Ford Motor Credit Company	56.9	7.1	59.0	7.6	54.9	7.6
<b>Associates</b> Corp. of North America *	21.6	2.7	16.9	2.2	14.8	2.1
Chrysler <b>Finance</b> Corp.	21.3	2.7	24.9	3.2	30.1	4.2
Household Financial Corp.	17.3	2.2	16.9	2.2	15.1	2.1
Sears Roebuck Acceptance Corp.	14.7	1.8	15.4	2.0	14.4	2.0
American Express Credit Corp.	14.1	1.8	14.2	1.8	12.6	1.8
<b>ITT</b> Financial Corp.	12.6	1.6	11.7	1.5	10.6	1.5
IBM Credit Corp.	11.3	1.4	11.1	1.4	9.7	1.3
Westinghouse Credit Corp.	8.6	1.1	10.3	1.3	9.3	1.3
<b>Beneficial</b> Corp.	10.0	1.2	9.3	1.2	7.9	1.1
<b>Total</b>	<b>\$371.8</b>	<b>46.3</b>	<b>\$365.1</b>	<b>47.3</b>	<b>\$341.7</b>	<b>47.5</b>

\*A subsidiary of Ford Motor Company.

Sources: Annual Reports; American **Banker**, November 8, 1990, p. 14; December 11, 1991, p.11.

a major expansion and diversification drive in the 1980s GE acquired RCA, Montgomery Ward, and other firms, broadening its already imposing assortment of industry segments.

GE also expanded the range and volume of its financial services in the 1980s when it formed General Electric Financial Services, Inc. (GEFS) to acquire Employers Reinsurance Corp. from Texaco, Inc. for \$1.1 billion. GEFS was then given 100 percent interest in GE Credit Corporation: subsequently, GE acquired the securities firm Kidder Peabody. GEFS now operates in all major segments of the industry: securities, insurance, lending, leasing, and other activities closely related to banking.

General Electric Capital Corporation is the core company in this diversified financial conglomerate. It operates primarily as a finance company engaged in a full range of leasing, loan, and asset management services: it also engages in insurance activities. These various business lines are conducted through 53 consolidated subsidiaries and joint ventures with Caterpillar Tractor Co. and BMW of North America. GECC's consolidated subsidiaries include the captive finance company of Montgomery Ward—a GE affiliate.<sup>16</sup>

GE Capital competes with other major finance companies in automobile leasing and finance, mortgage credit, and consumer loans. The company's growing portfolio of business and commercial real estate loans reflects wider industry trends and illustrates the extent to which GECC and other aggressively expanding finance companies have become major competitors of banks.

While the outstanding assets of all finance companies grew rapidly in the 1980s, GE Capital Corporation grew at an even faster rate. Between 1983 and year-end 1991, GECC's total assets rose more than 400 percent, from \$15.7 billion to \$80.5 billion. During that span, GECC's assets jumped from 6.3 percent to 10 percent of total finance company assets. In 1983, GECC accounted for over 3 percent of all outstanding issues of commercial paper and for 7 percent of paper issued by finance companies. By 1991, those proportions rose to 7 percent and 11.4 percent respectively (see Table 12).

### **Problems Confronting Finance Companies**

Despite their substantial advantages, many of the biggest and best-known finance companies stumbled at the turn of the decade. Some managed to fall into the same asset-quality traps that snared regulated lenders. Others were hammered by economic forces and management failures afflicting their parent companies and the sectors in which they operated. According to the Federal Reserve Bank of New York, loan loss rates at finance companies jumped from 1.95 percent of net receivables in 1988 to 2.55 percent in 1991, outstripping loss rates at banks, which hovered around 1.45 percent of total loans in 1991 (Frydl 1991, p. 21). In late fall 1992, finance companies suffered a stunning "November Nightmare." In the space of six days, three of the nation's biggest finance companies announced moves that revealed acute problems. Wracked by huge losses at its credit affiliate, Westinghouse Electric Company decided to liquidate or sell Westinghouse Credit Corporation. Buffeted by credit rating downgrades, Chrysler Corporation sold its lucrative Chrysler First consumer finance subsidiary to NationsBank. With its access to the commercial paper

Table 12  
General Electric Capital Corporation  
Selected Components, Consolidated Balance Sheet  
(millions of dollars and percent)

	1983	1984	1985	1986	1987	1988	1989	1990	1991
Total Assets/Liabilities	\$15,719	\$18,467	\$22,469	\$27,970	\$36,644	\$47,766	\$58,696	\$70,385	\$80,528
Liabilities									
Bank Loans	53	72	37	3	3	15	2	13	41
Commercial Paper	6,156	7,216	9,204	12,654	15,901	22,568	28,898	33,614	36,932
as Percent of Total Liabilities	39.2%	39.1%	41.0%	45.2%	43.4%	47.2%	49.2%	52.9%	50.8%
Stockholders Equity as Percent of Year-end Assets	9.8	8.5	8.7	9.0	8.9	9.6	9.5	9.8	9.8
Selected Comparative Ratios									
1) GECC's Assets as Percent of Assets of all Domestic Finance Companies	6.3%	6.5%	6.4%	6.8%	8.1%	9.8%	11.3%	11.0%	10.0%
2) GECC's Outstanding Commercial Paper:									
a) As Percent of Total Outstanding Commercial Paper	3.2	3.0	3.1	3.8	4.4	4.9	5.4	6.0	7.0
b) As Percent of Total Outstanding Commercial Paper Issued by Domestic Finance Companies	7.0	7.1	6.5	7.0	7.5	8.4	9.6	10.0	11.4

Source: *Moody's Bank & Finance Manual, 1990, Vol. 2, p. 3375; 1991 Annual Report, pp. 17 and 25; see also Tables 4 and 6.*

market reduced, GMAC was forced to drop its profitable, \$6 billion portfolio of loans to non-GM customers and dealerships.

For the auto finance companies, these developments marked the latest in a series of recession-related reversals. Lower credit ratings for both the parent and its finance unit began to severely limit Chrysler Financial Corporation's access to funding in 1990; losses at General Motors and Ford in 1990 resulted in lower ratings for GMAC, FMCC, and their parent companies in early 1991. All three finance units cut their issuance of commercial paper and drew on more expensive bank credit lines.

The changing composition of short-term liabilities at Chrysler Financial dramatically illustrates what can happen to the availability and cost of funds for finance companies when their parents' fortunes decline (see Table 13). Steeper funding costs contributed significantly to a \$5.4 billion decline in CFC assets in 1990 and an additional \$3.4 billion drop in 1991. As cheaper funding sources dried up, CFC increasingly relied on securitization of receivables to finance Chrysler products. In 1990 and 1991, it sold \$15.9 billion of receivables. But it could no longer engage in promotional, below-cost financing to increase car sales. As its borrowing from banks rose, CFC lost its advantage over banks in financing car loans and dealer inventories.

Table 13  
Chrysler Financial Corporation  
Short-Term liabilities  
(million dollars, at year-end)

Funding Sources	1989	1990	1991
Commercial Paper	\$10,061	\$1,114	\$339
United States	9,233	957	271
Canada	828	157	68
Bank Borrowings	—	6,241	6,633
United States	—	5,824	6,272
Canada	—	417	361
Total Short-Term Liabilities	10,061	7,355	6,972

Source: Annual Reports: *Moody's Bank and Financial Manual*, Vol. 2, 1991, p. 3055.

With its parent company debt downgraded below investment grade, Chrysler Financial acknowledged “significant liquidity problems” and attempted to replace and restructure its bank lending facilities. The pressure of rising funding costs and constricting bank credit forced both GMAC and FMCC to follow Chrysler’s lead in securitizing more of their receivables.<sup>17</sup> As their assets dwindled, Ford and GMAC saw their share of outstanding commercial paper issues shrink from 9.6 percent (\$53.7 billion) in 1990 to 8.6 percent (\$45.6 billion) in 1991.

Compared to the automobile finance units, GE Capital appears healthy. The company’s assets have climbed steadily, with 14 percent growth in 1991. Commercial paper outstandings expanded as well, jumping from \$33.6 billion in 1990 to \$36.9 billion in 1991. However, in 1990 and 1991, rising levels of nonearning loans and losses demonstrated the firm’s vulnerability to changes in the economy.

GE Capital’s commercial real estate (CRE) portfolio was heavily concentrated in apartment and office buildings (which accounted for 65 percent of total CRE loans) and showed signs of quick deterioration. Nonperforming CRE loans nearly quintupled between 1989 and 1991, soaring from \$104 million to \$512 million. Even though credit losses on CRE loans ballooned (from \$62 million in 1990 to \$210 million in 1991), they were outpaced by commercial and industrial loan losses.

Most of the commercial and industrial loan losses—\$323 million in 1991, up from \$56 million in 1989—were on loans classified as highly leveraged transactions (HLTs).<sup>18</sup> GE Capital’s HLT portfolio amounted to \$6.5 billion—60.2 percent of its total commercial loans and 8.1 percent of its total assets. Moreover, its HLT portfolio was significantly concentrated in the communications industry (41 percent), with 22 percent of the total loaned to cable television companies (the competitors and potential acquirers of its sister affiliate, NBC): 10 percent to media firms; and 9 percent to “broadcasting and other companies” (GECC 1991, p.12).<sup>19</sup>

GE's long-time rival Westinghouse was beset by a credit-unit portfolio that made GECC's appear prudent by contrast. Leveraged buy-out loans accounted for 45 percent and commercial real estate loans 35 percent of Westinghouse Credit Corporation's \$10.3 billion of assets when the company took a \$1.48 billion third quarter loss in 1991. WCC lost \$975 million in 1990 (*Wall Street Journal* 1991, p. A1) with a single industry segment accounting for 30 percent of its leveraged buy-out loans and a single borrower accounting for 7 percent of its CRE loans.

The flamboyant failures financed by WCC ranged from hotel complexes in Coral Gables and Atlantic City to a renovated nineteenth-century office building in Pittsburgh. Westinghouse's fate now rests mainly in the hands of banks that provided WCC's back-up credit lines. They include Mellon, NationsBank, Citibank, First Fidelity, Credit Lyonnais, and Fuji Bank (see complete listing in Table 14).

Although it became the industry's most dramatic recent failure, Westinghouse is not the only large, diversified finance company to experience losses and lowered credit ratings. In 1991, Moody's downgraded Household Financial Corporation's commercial paper rating along with the long-term debt rating of HFC's parent company. Despite its name and reputation as a consumer finance firm, Household is a diversified holding company engaged in both consumer and commercial lending as well as insurance underwriting (see Table 1). During 1991, HFC's nonperforming commercial loans and foreclosed real estate more than doubled, to \$688 million.

Like the auto finance companies, HFC was forced to step up its securitization and sales of receivables (\$6.6 billion in 1990 and 1991) while paring back its commercial paper issues (reduced by a third during 1991). Like GE and Westinghouse, Household's portfolio exhibited signs of unhealthy concentration. At year-end 1991, fully 22 percent of its domestic receivables were in California, the site of a real estate collapse that jeopardized a number of major finance companies. For example, 67 percent of ITT Financial's commercial real estate receivables were located in California (up from 66 percent in 1990). At Beneficial Corporation—one of the few financial firms to receive a debt rating upgrade in 1991—California loans accounted for 23 percent of total receivables at year-end 1991. Real estate secured 90 percent of Beneficial's California portfolio—but only 58 percent of the company's total receivables (BC 1991, p. 48, note 23).

### **Public Policy Concerns**

Any effort to modernize financial regulation must address the inequalities that have helped create the parallel banking system. The following discussion outlines some of the key issues in accomplishing this modernization.



**Table 14**  
**Banks Extending \$6 Billion Guarantee to**  
**Westinghouse Credii Corporation**

HAWAII	NEW YORK (continued)
Bank of Hawaii	<b>Deutsche</b> Bank AG
	Dresdner Bank AG
ILLINIOS	First Interstate Bank of Japan, Limited
The Bank of Nova Scotia	The Fuji Bank, Limited
<b>Bayerische</b> Vereinsbank AG	The Hokuriku Bank, Ltd.
Continental Bank, N.A.	The Industrial Bank of Japan, Limited
The First National Bank of Chicago	Insituto Bancario San Paolo di <b>Torino</b>
<b>The</b> Toronto-Dominion Bank	Long-Term Credit Bank Trust Company
	The Mitsubishi Bank, Limited
MARYLAND	The Mitsubishi Trust & Banking Corporation
The First National Bank of Maryland	The Mitsui Trust Bank (U.S.A.)
	Morgan Guaranty Trust Company of New York
NEW JERSEY	The Sanwa Bank, Limited
First Fidelity Bank, N.A.	<b>Societe Generale</b>
	The Sumitomo Bank, Limited
NEW YORK	The Sumitomo Trust & Banking Company, Limited
Arab Banking Corporation	The Tokai Bank, Limited
Bank of Ireland	Union Bank of Switzerland
Bank of Montreal	<b>Westdeutsche</b> Landesbank Girozentrale
The Bank of Tokyo Trust Company	Westpac Banking Corporation
Banque Nationale de Paris	Yasuda Bank and Trust Company (U.S.A.)
Barclays Bank PLC	
<b>Bayerische</b> Landesbank Girozentrale	NORTH CAROLINA
BBL Bank Brussels <b>Lambert</b>	NCNB National Bank of North Carolina ( <b>NationsBank</b> )
Casa di Risparmio <b>delle Provincie</b> Lombarde ( <b>CARIPLO</b> )	
Chemical Bank	PENNSYLVANIA
Cttibank, N.A.	ABN <b>AMO</b> Bank, N.V.
Credit <b>Italiano</b>	Mellon Bank, N.A.
Credit Lyonnais	Pittsburgh National Bank
Credit <b>Suisse</b>	The Royal Bank of Canada
The Dai Ichi Kangyo Bank, Ltd.	

Source: Westinghouse Credit Corp. Annual Report

### **Implementing Monetary Policy and Performing the Lender-of-Last-Resort Function**

The most troubling consequences of a parallel banking system affect the Federal Reserve System. The parallel system not only stretches the central banks lender-of-last-resort function, but also may compromise its ability to implement monetary policy.

The immense volume of bank guarantees to the parallel banking system has placed banks in a no-win situation: weakened by the support they provide **already-**advantaged competitors and faced with greater risks if the parallel system falters. Clearly the risk to the banks creates risk for the lender of last resort. The symbiotic relationship between commercial banks and their rivals in the parallel banking system leaves the Federal Reserve with much less room for discretion in exercising that role.

By blanketing the parallel banking system with fee-generating guarantees, the banks have exposed the central bank to a contingent liability domino effect of major proportions and complexity. In the event of a parallel banking system crisis, the

Federal Reserve may not have the option to choose the institutions or markets to which banks will channel the liquidity it makes available. Banks have already made those choices by issuing guarantees. The Fed will have to endorse those guarantees to protect the banks.

While this lender-of-last-resort scenario may affect the Fed only in the uncertain future, America's parallel banking system is affecting monetary policy even now. To appreciate that impact, it is useful to revisit the role of reserve requirements in intramural financial industry competition as well as in monetary decisionmaking.

Complying with reserve requirements is a cost. Combined with other regulatory requirements, that cost has hampered banks' ability to compete with a growing assortment of parallel lenders. Thus the banking industry and its supporters have proposed "fixing" the problem by requiring that the Federal Reserve pay interest on reserves. Some have suggested the more radical step of abolishing reserve requirements entirely and leaving open market operations as the Federal Reserve's sole tool for implementing monetary policy. This action would require the Fed to restructure its balance sheet and to remove bank reserves as liabilities that expand or contract in response to purchases and sales of government securities.

While relaxing or removing reserve requirements might slow the decline in banks' share of credit extensions, it would beg a far more important issue. Reserve requirements can be an effective policy tool-but only if they affect a critical mass of institutions that hold the liquid funds of households, businesses, and other relevant economic sectors. The immense growth in money market mutual funds, credit card usage, and other parallel lending phenomena has narrowed the institutional mass that made this tool so effective in the past. After a brief experiment with special deposit requirements on nondepository institutions in 1980, the Fed returned to its focus on banks as the channel for policy, thus accommodating the slump in banks' credit market share that reduced the Fed's own leverage in implementing monetary policy.

In the meantime, the effectiveness of open market operations was also eroded by the size of foreign flows into and out of U.S. financial markets. The lag in obtaining information on these flows puts the Fed in the position of playing blind man's bluff in gauging the appropriate response to changes in the market. As a result of these developments, the monetary authority finds itself less able to operate by taking small, gradual steps towards its targets. The more forceful actions that it now must take to change monetary aggregates make the implementation of monetary policy less a factor in stabilizing financial markets than a component of instability.

## **Accountability and Investor Protection**

The disclosure provisions of the Securities Act of 1933—the foundation stone of U.S. investor protection law—provide the primary oversight of finance companies. These disclosure provisions also apply to other corporate entities within the financial system, including bank and thrift holding companies. However, soundness regulation, supervision, and examination augment disclosure as part of an oversight package for deposit-taking institutions.

Moreover, the information disclosed by commercial and industrial parents of finance companies is seldom comparable to that available for other financial sectors. Indeed, very little uniformity exists within the closed universe of finance company disclosure itself. Parent firms may report in detail on a finance subsidiary's loan portfolio only when it contains the significant adverse information required for investor protection under the securities laws.

This regulatory scheme does not offer sufficient protection to institutions that supply funding for finance companies owned by a commercial or industrial parent. Short-term lenders may be protected from losses by their ability to not renew funding when finance companies release adverse information. But long-term debt and equity holders may be less fortunate.

Bank guarantees will protect them in the short run, providing an alternative source of funds if the company cannot sell commercial paper. But the resort to bank guarantees will raise the finance company's cost of funding, generating additional balance sheet pressures and jeopardizing the value of long-term holdings in the firm. Too often finance companies simply do not disclose adequate portfolio composition data until it is too late to help investors.

Private ratings agencies constitute the sole independent source of investor information on finance companies. To some extent, their ratings of notes, bonds, and commercial paper reflect the performance of the parent rather than the financial affiliate that is the issuer, even when the finance company is lending to outside borrowers rather than its parent's customers. The ratings assigned to finance companies owned by nonfinancial firms also reflect an assumption that the parent will provide substantial support to offset any difficulties that might be experienced by its subsidiary.

The problem with rating services using this implicit "source of strength"\* doctrine is that losses by finance subsidiaries can also contaminate the credit rating of the parent company—as the experience of Westinghouse demonstrated. In addition to raising the parent corporation's cost of capital, those losses inhibit growth in other, more immediate ways by absorbing funds needed for ongoing operations. Over

time, these contagion effects will erode the value of investments in the parent company, substantial portions of which are held by pension funds that pool the savings of workers who can least afford losses on investments.

The growing links between nonfinancial firms and financial product providers require a reassessment of the kind, scope, and uniformity of disclosure that these conglomerates should provide to ensure investors adequate information. Greater transparency alone, however, will not solve the problems of regulatory inequality or market instability.

### **The Absence of Firewalls**

During the early evolutionary stages of America's multifunctional financial conglomerates, most nonfinancial parent firms entered the financial market through their captive finance companies. In many cases, the finance company became a diversified, even quasi-independent, lender as the parent expanded into other financial services.

Now that finance companies have become major players in intermediation, their unregulated status carries increasingly important implications for their relationships to and transactions with other financial service firms within the conglomerate. Regulators have few, if any, tools to prevent the problems of the parent or its finance company subsidiary from spilling over into and absorbing the resources of regulated financial affiliates such as securities firms, insurance companies, and insured depositories.

As the resources of such regulated affiliates expand, so do the potential problems associated with missing firewalls. As Table 1 shows, a handful of the largest finance companies control banks and thrifts that already hold more than \$30 billion in deposits. First Nationwide (the Ford subsidiary), Sears Savings Bank, and Household Bank FSB rank among the nation's top 25 insured thrifts.

The absence of firewalls may prove problematic even when the parent corporation is an independently owned finance company. For example, the condition of Household International does not suggest it is a source of strength for Household Finance Corporation's national bank or savings bank. In 1990, the parent's equity-to-assets ratio fell below the standard required for commercial banks.

Equally important, consolidated capital reported by Household International at year-end 1991 failed to match the capital levels reported separately for the firm's regulated and unregulated subsidiaries.<sup>20</sup> It is not clear whether or what regulatory leverage exists to require that Household International maintain and accurately report the resources needed to ensure the viability of its insured depository institutions.

The apparent ease of intracorporate transfers also raises questions about regulators' ability to prevent finance companies from selling poorer-quality assets to affiliated depository institutions or insurance companies. Similarly, if a conglomerate uses its securities subsidiary to underwrite instruments for a troubled borrower of its finance company, Securities and Exchange Commission (SEC) enforcement of disclosure and due diligence requirements may not guarantee the same careful scrutiny that occurs in an arms-length transaction. Only the most inquisitive, sophisticated outside investors may recognize the issuer's problems and the conflict of interest inherent in a transaction involving affiliates.

Finally, even if the problems of the parent or an unregulated financial subsidiary do not directly undermine their condition, a general loss of confidence can raise funding costs for regulated financial affiliates.

### ***Portfolio Diversification***

Judging from the meager information disclosed by finance companies, the asset side of America's parallel banking system does not maintain a diversified portfolio. By definition, captive firms concentrate their loans to a single sector and, in some cases, single borrowers (i.e., the parent companies). But there are also cases in which companies that used bank guarantees to escape captive status, then made themselves captives to undiversified lending.

Large concentrations of loans in individual sectors appear common among finance companies that specialize in financing or leasing certain kinds of equipment. For example, John Deere Capital Corp., one of the 20 largest finance companies, acknowledged in its 1991 annual report (p. 13) "significant concentrations of credit risk" with 60 percent of its receivables in the farm sector and another 22 percent in the recreation sector. However, some companies with a virtually unlimited third-party clientele have achieved much the same result. The ill-fated Westinghouse Credit Corporation, for example, filled as much as 80 percent of its portfolio with leveraged buy-out and commercial real estate loans.

What constitutes a reasonable pattern of diversification in this industry may vary in relation to a company's business objectives and expertise. But the kind and degree of concentration exhibited by the portfolios of John Deere Capital and Westinghouse Credit shows a blatant disregard for prudential standards and common sense.

### ***Concentration and Anti-competitive Practices***

In 1991, the 12 largest nonbank finance companies accounted for 46 percent of the total assets held by all finance companies (see Table 11). The five largest compa-

nies held nearly 35 percent of this sector's assets and accounted for 17.2 percent of total outstanding issues in the entire commercial paper market (see Table 9). This high degree of concentration is neither unusual nor new in the financial industry. At year-end 1984, for example, less than 1 percent of the total number of commercial banks, securities firms, and life and health insurers held over 50 percent of the assets and/or capital of their respective industries (U.S. Congress 1986, p. 226). Compared with other countries, however, the U.S. system appears extraordinarily diverse because of the immense number of small institutions that operate in local markets and hold a small percentage of the system's total assets.

Despite this apparent diversity at the bottom, rising levels of concentration at the top challenge the efficiency of an American system that depends to a unique degree on private sector competition to preserve the openness and fairness of markets. The economies of most other industrial countries function under some form of industrial policy, the most obvious being the unquestioned agreement of their public and private sectors on the need to cooperate in promoting exports.

This particular priority means that concentration is not viewed as a problem for the financial systems in those countries. Indeed, a greater number of decisionmakers with different points of view would be counterproductive. Rather than asking their domestic financial system to do the job, most export-dependent industrial nations let the global market for tradable goods select sectoral winners and losers. Funding the winners becomes the task of the financial institutions of these countries.

In the United States, national objectives have not played as forceful a role in shaping credit decisions. Instead, credit markets have been organized around the assumption that profit opportunities motivate financial institutions and that maximizing profits will result in credit decisions that increase the common wealth. Among other things, however, this assumption fails to reckon with the effects of increasing capital mobility. Propelled by technological advances, the scale of international capital flows now dwarfs underlying economic activity and enlarges the difficulties faced by national authorities in promoting sustainable growth. In the U.S., global capital mobility has exacerbated disinvestment in bypassed economic sectors, communities, and regions of the country. The results lead to a slowdown in economic activity that further shrinks the supply of funds for investment. In short, lending decisions motivated by short-term returns have undermined, not promoted, the common wealth.

The United States' continued reliance on private markets to make credit decisions requires a renewed role for government in ensuring that markets are open, fair,

and undominated by a few large market makers. The bipartisan consensus that ignored growing levels of financial industry concentration over the last two decades has contributed to some of the weaknesses in the U.S. economy.

The regal position and market power of a few large institutions in each financial sector have contributed to unusually destructive, lemming-like behavior in all sectors. During the 1980s, financial product providers of all sizes and types—banks, securities firms, insurance companies, and finance companies—followed the fads that expanded credit flows for mergers and acquisitions, leveraged buy-outs, and commercial real estate speculation. Coping with the consequences of their own excesses has undermined the ability of those same firms to fuel productive growth.

The same patterns also hindered economic restructuring in the United States. Rising levels of institutional concentration made it harder for the financial system to assist the development of small, innovative companies and processes that will mature in time to ease the disruptions caused by declining older firms and methods. Large institutions with large pools of funds deemed it unprofitable to finance small firms and lacked motivation to provide venture capital.

The lack of capital and credit for smaller enterprises stems not only from growing institutional concentration but also from shrinking levels of competition in local lending markets that ostensibly feature a large number of flourishing smaller lenders. This decline is particularly troubling because local markets continue to be the primary avenue for small businesses to access credit and other financial services. Despite the boom in debt issuances of all kinds by nonbanks, research by the Federal Reserve staff clearly shows that only commercial banks provide borrowers with the “cluster of banking services” they usually seek (Elliehausen and Wolken, FRS 1990).

Competition for this “cluster”—and for primary banking services to middle-market companies—is rapidly receding due to a number of factors that include rising, government-encouraged merger activity in the private market and government-assisted consolidation carried out by the Federal Deposit Insurance Corporation (FDIC) and Resolution Trust Corporation in resolving insolvent depositories. Given the repeatedly demonstrated effects of the concentration-price relationship, the nation’s economy is clearly a loser if its chief sources of new jobs—small and medium-sized businesses—find themselves increasingly underserved by financial concentration.<sup>21</sup>

In this context, the growing role of the parallel banking system creates an additional concern. Given the absence of disclosure and oversight for finance company loan portfolios, there can be no assurances that the parallel banking system is not replicating the kind of closed linkages that characterize the Japanese *keiretsu*.<sup>22</sup> Finance subsidiaries of commercial corporations exercise considerably more market

power than do independent finance companies, banks, securities firms, or insurance companies. One consequence is a growing potential for anticompetitive practices like self-dealing or tying—e.g., requiring that parent firm suppliers obtain funding from the parent's financial subsidiaries as a condition for access to the parent as a customer.

The operations of automobile finance companies demonstrate the hazards of enhanced market power. The Big Three have been able to offer car loans at below-market rates—indeed, rates below their own cost of funds—because they could make up the difference by boosting the price of the car. Bereft of any similar opportunity, the independent lender cannot compete. The results are reflected in the dramatic expansion in finance company credit market share during the 1980s. The opportunity to promote parent and affiliate products and services will continue to drive this growth as long as regulatory guidelines and supervisory practices mandate a standard of economic neutrality for some financial sectors but not others.

In the American system, economic diversity and innovation are likely to suffer when an expanding share of credit decisions is channeled through in-house intermediaries whose chief aim is augmenting their parents' profits. Over time, financial stability may suffer as well. The need to attract or support suppliers or customers for the parent firm—or customers for sister financial affiliates inside the conglomerate—can distort lending judgments.

The hallmark of the American intermediary system has been a set of dispersed, independent lenders whose prosperity depended solely on the success of their borrowers. However, the comfort of a potential bailout—whether from government or parental coffers—weakens the imperative to link credit decisions to the borrower's prospects for growth; it may also encourage short-term financial speculation by investors and lenders.

Meanwhile, the ability of major manufacturers and retailers to provide secure, in-house financing to market their products and services has promoted complacency at the expense of competitiveness. U.S. automobile manufacturers, for example, emphasized the competitiveness of the finance rates they could offer car buyers at a time when many of their products were not competitive with foreign autos in terms of quality. Clearly, this paper-oriented approach to competition makes losers of consumers and the domestic economy when it results in higher prices, lower quality, and industrial decline.

### **The Need for Uniform Regulation**

Regulatory equality is the answer to much of the inefficiency, unresponsiveness, and myopia that characterize the U.S. financial system—as long as it levels the



playing field by raising standards for all players. Subjecting the system to another dose of **1980s-style** laissez-faire medicine-by relaxing the rules for regulated lenders or permitting them to become niche players in the credit market-would further hamper the ability of monetary policy and private sector competition to promote greater financial stability and improve national economic performance. More deregulation would detonate, rather than defuse, the land mines that have developed in the symbiotic relationship between the regulated banking system and its shadow, parallel competitor.

While the imposition of additional rules on less-regulated lenders likely would raise their costs and those of their customers in the short term, the broader impacts would serve to steady financial markets and benefit the real economy over the long haul. In practical terms, establishing a prudential floor underneath lender behavior is the only alternative to the ad hoc, industry-driven, downward spiral of deregulation that characterized federal policy during the 1980s.

One measure of the failings of that policy is its lack of public support and its corrosive effect on public confidence as evidenced in recent polls. Financial reform should not be driven solely by poll results. However, it should respond to clear and repeated expressions of concern by the public whose participation, confidence, and full faith and credit are essential to any financial system. Recasting the balance of regulatory and market forces in any industry requires a judicious hand. Recasting them in an industry that is unique, crucial, and fragile requires special attention to the kinds of public perceptions and democratic preferences voiced by poll respondents witnessing the deterioration of their financial **infrastructure**.<sup>23</sup>

### ***A Proposal for Licensing Parallel Banking Institutions***

Accordingly, we propose a Financial Industry Licensing Act that would apply prudential standards to firms-such as finance companies, mortgage firms, and private insurers-not currently regulated for soundness at the federal level and to supersede where necessary relevant sections of existing statutes, including (but not limited to) the Bank Holding Company Act, the Investment Company Act, the Securities Acts, and the **McCarran-Ferguson Act**.<sup>24</sup>

While this proposal departs from the direction of most recent policy debates and initiatives, it does draw on a precedent from the not-so-distant past. In 1980, responding to a presidential directive issued under the Credit Control Act, the Federal Reserve System implemented a credit restraint program that went beyond the banking system and the usual boundaries of its scope of action.

The Federal Reserve program included a special deposit requirement of 15 percent on all extensions of consumer credit through credit cards, check-credit overdraft plans, unsecured personal loans, and secured loans except those issued to finance the purchase of the collateral. This deposit requirement applied to all consumer lenders, not just depository institutions, and it was extended to money market mutual funds as well. In addition, the Federal Reserve brought all finance companies, as well as depository institutions, under a domestic voluntary credit restraint program designed to limit the growth of credit to the industrial and commercial sectors.<sup>25</sup>

The Fed's program illuminated the parallel, partially regulated, banking system-but only in the most brief and incomplete fashion. And it did so at a moment of spiraling inflation, soaring nominal interest rates and great geopolitical turmoil-hardly an ideal laboratory for monetary experiments. Since that experiment, the role of the parallel system in U.S. credit markets has been ignored.

Today, it is time to end a decade of disorder in credit markets. The Financial Industry Licensing Act would achieve that goal by placing all lenders within the same regulatory sphere while maintaining the fundamental barriers between borrowers and creditors that are necessary for the effective, economically neutral functioning of the financial system. A broad outline of the Act follows.

### ***Who Should Be Licensed?***

To promote economic growth, a stable financial system, and regulatory equality, comparable soundness requirements and prohibitions against unfair competition or excessive concentration should be applied to any entity that:

- directly accepts funds from the public for investment;
- makes loans to the public or buys loans or securities using funds other than its own equity capital and retained earnings; or,
- sells loans or third-party securities to financial institutions or investors.

To ensure the impartiality of credit decisions and to further promote financial market stability, a series of protective requirements should separate entities performing the above-mentioned functions from their financial and nonfinancial parents and affiliates. These safeguards should include the following requirements:

- All parent companies of entities performing the above mentioned functions should be chartered as Financial Product Holding Companies (FPHCs) and meet the same licensing and regulatory requirements as their financial affli-

ates. However, nonfinancial FPHCs should be barred from engaging directly in any activities permitted their financial affiliates.

- Each licensed entity affiliated with a FPHC should be separately capitalized, incorporated, and managed (by independent officers and directors).
- Management interlock prohibitions included in the Depository Institutions Management Interlock Act should be applied to all licensed entities, including FPHCs.
- Each FPHC and its licensed affiliates should meet anti-tying restrictions and comply with prohibitions on affiliate transactions modeled after restrictions included in Sections 23A and 23B of the Federal Reserve Act and firewall provisions in the Securities Regulatory Equality Act proposed in 1991.<sup>26</sup>

### ***What Form Should Licensing Take?***

**Any** entity engaged in the business lines described above should apply for a renewable charter that constitutes its license to access or use funds. To receive its initial license, the applicant should demonstrate the financial and managerial resources needed for safe and sound operations.

To maintain its license, the entity should seek renewal on a regular, periodic basis. Renewal should be predicated on the applicant's ability to meet specific public obligations as well as to comply fully with soundness guidelines (see below).

Additionally, each salaried officer of the licensed financial firm should obtain a practitioner's license as a condition of employment. This certificate—also renewable at regular intervals—should indicate the individual's familiarity with laws, regulations, and business practices required for sound lending and investment.,

The administration (awarding, monitoring, suspension, revocation, reinstatement, etc.) of the practitioner's license should be the responsibility of self-regulating trade groups, just as the National Association of Securities Dealers administers its broker-dealer license. The primary federal regulator for each industry segment should oversee these self-regulatory organizations.

### ***What Public Obligations Should the License Include?***

**As** a minimum condition of its license, each entity should comply fully with the standards set forth in the Community Reinvestment Act, Home Mortgage Disclosure Act, Truth in Lending Act, Equal Credit Opportunity Act, Fair Credit Reporting Act, and other federal statutes related to fair lending.

### **Which Soundness Regulations Should the Licensing Arrangement Cover?**

Licensed entities should be held to comparable reserve, capital, and liquidity requirements where applicable. Finance companies and other lenders that do not take funds directly from the public should be subject to special deposit requirements modeled on those imposed by the Federal Reserve in 1980. These deposit requirements should apply to all lending activity, not just consumer lending. The requirements need be no more than a nominal percentage of outstanding credit under current conditions. Implementing them now will permit the kinks to be worked out in advance so they can be increased gradually at later stages in the business cycle, if and when they are needed.

In addition, assets and off-balance-sheet items should be risk-weighted in uniform fashion for all regulatory determinations of the capital adequacy of licensed entities. Similarly, all licensees should meet comparable risk diversification standards, such as limits on loans to a single borrower and restrictions on real estate lending or other sectoral concentrations.

To achieve greater systemwide transparency, each licensed entity should complete and publicly disclose at regular intervals (e.g., quarterly or annually) a Uniform Performance Report providing detailed information on its income, expenses, assets, and liabilities. The Uniform Performance Report should require licensees to report in as much detail as practically feasible the geographic and sectoral distribution of its assets and/or underwritings.<sup>27</sup>

The maintenance of vigorous market competition is critical for effective soundness regulation. In addition to complying with prohibitions against conflicts of interest and self-dealing, licensees also should operate in an environment free from excessive concentrations of market power and inequitable or inconsistent applications of antitrust law.

Unfair, market-distorting exemptions to the antitrust laws, such as the McCarran-Ferguson Act, should be repealed and replaced by new antitrust guidelines and enforcement practices rooted in the principle of uniformity and structured by actual market conditions. The needs of vulnerable borrowers, such as small, middle-market, rural, and inner-city businesses, should play a key role in determining new guidelines and practices. As long as these firms continue to require a “cluster of banking services” and lack access to national capital markets, antitrust enforcement should focus on local and regional lending markets. Additionally, state attorneys general and the U.S. Department of Justice should assume primary responsibility for enforcement, a role they currently share with banking regulators.

To further promote regulatory equality, the use of examination procedures, enforcement actions, and penalties should be harmonized across all forms of licensed

activity. In other words, standards should be developed for each industry segment that provide equivalent supervision and examination at reasonably equivalent cost.

As part of a commitment to effective and fair national treatment of internationally active firms, U.S. financial regulators and trade negotiators should seek the adoption of similar standards on a multinational basis—a global strategy of regulatory floor-setting that encourages the pursuit of distinctive national economic priorities.

### ***Who Will Do the Licensing and Regulating?***

The approach we have outlined would go a long way toward eliminating the traditional competition in laxity that has haunted domestic and international financial regulation. If this competition disappears or substantially diminishes, so will much of the imperative to rearrange the furniture of financial regulation.

To effectively modernize soundness regulation, all licensees that operate in more than one state or above a designated size threshold (i.e., more than \$1 billion in combined assets) must be subject to federal oversight. With the advent of federal regulation for these firms, such traditional benefits of the dual system as innovation and flexibility can more properly be focused on the development of smaller institutions serving state and local needs.

The recommended approach to regulatory equality could be administered by a single regulator, multiple regulators, regulators whose mission is defined by industry segments, or regulators whose mission is defined by function.

Clearly, some modicum of functional regulation will result because of the concentrations of regulatory expertise over certain segments of the financial markets. And clearly some umbrella oversight must be exercised over entities engaged in more than one financial function. Those elements of the licensing and regulatory process most liable to multi-agency duplication—e.g., disclosure—could be entrusted to a new federal Financial Licensing Office created out of overlapping departments in the existing agencies.

Enhanced self-regulation should become a vital part of any movement toward regulatory equality. Financial firms deal with one another constantly. Their ability to detect problems or wrongdoing outstrips the ability of any outside party. The obligation to self-regulate should supplement—not substitute for—the supervisory power of independent regulators. The most meritorious and time-tested elements of the securities industry's self-regulating organizations could provide a model for marketwide self-regulation.

To build on that tradition, the licensing agency(ies) should charge financial organizations with formal responsibility for reporting unlawful or anticompetitive

activities to their self-regulating trade associations. These trade groups would then bear a statutory responsibility for evaluating the information and passing on their findings to the appropriate federal regulator.

Finally, we believe the Federal Reserve System should maintain a substantial role in the overall regulation of financial entities to ensure the effectiveness of monetary policy decisions. Its unique economic responsibilities compel the central bank to monitor constantly the impact of financial regulation on economic activity: its unique institutional capacity provides the Fed with the necessary tools to evaluate and, if necessary, shape the impact.

We believe as well that monetary policy must be publicly accountable so that it enhances public confidence in financial markets and the nation's economy. A number of mechanisms--ranging from prompt and complete disclosure of Federal Open Market Committee (FOMC) transcripts to broader representation on the Federal Advisory Council and reserve district bank boards--could expedite this movement toward increased accountability. If the nation's economic welfare is too important to be left to the parallel banking system, it is also too important to leave to the private financiers who today shape the policies of America's central bank.

## Endnotes

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2. In this context securitization refers to the practice of using the income stream from a bundle of conventional loans, most often mortgages, to provide the backing for securities that are then sold in bond markets. This practice allows savings and loans, banks, or other loan originating institutions to both pass along risks to other lenders and to quickly regain their liquidity.

3. The Federal Trade Commission (FTC) is charged with regulating finance companies for compliance with federal consumer credit protection statutes such as the Equal Credit Opportunity Act and the Fair Credit Reporting Act. Under Section 5 of the FTC Act, the agency also has the authority to seek permanent injunctions and consumer redress in the event it uncovers fraudulent practices by consumer loan companies. With the exception of these consumer protection statutes, no other forms of federal financial regulation are applied to finance companies (Noonan, Buffon and Le Fevre 1991, pp. 1093-97).

While most states license consumer finance firms (typically through the office of the state banking supervisor), they require little disclosure of the firms' activities and do not regulate the companies for soundness. State laws regarding usury and consumer credit (e.g., statutes covering truth-in-lending, revolving sales and loans, installment sales and loans, credit cost disclosure, etc.) are largely a patchwork: ten states have adopted a Uniform Consumer Credit Code intended to promote consistent consumer protection statutes across the U.S. (Commerce Clearing House 1991, pp. 1083-98).

4. The CRA requires regulated depositories to make an affirmative effort to reinvest in the communities from which they draw their funds. Enforcement of the CRA has been weak and penalties for noncompliance merely restrict the expansion of offices or activities. However, the CRA and a companion statute, the Home Mortgage Disclosure Act, do require significant record keeping and information disclosure about lending practices. The disclosure of this information can lead to public pressure to alter lending practices.

Among other provisions, the Glass-Steagall Act prohibits banks from moving into nonfinancial activities and other types of financial activity, including the underwriting of stock issues.

5. For additional details on foreign bank lending in the U.S. market, see McCauley and Seth (1992, pp. 52-65).

6. Indeed the Administration proposal amounted to a "heads I win, tails you lose" invitation to financial instability. Had the Bush plan somehow succeeded in inducing commercial firms to expand their direct ownership positions in banks, the resulting

combinations would have jeopardized further the impartiality of credit decisions. The sizable risk posed by such combinations is reflected in the fact that no major industrialized nation currently permits commercial firms to control banks having access to a safety net of public insurance.

7. Self-dealing is the practice whereby a financial institution carries through a transaction with an affiliate or subsidiary that would not be justified by ordinary market criteria.

8. "Tying" refers to a practice in which: a) the customer is encouraged or required to purchase one product or service as prerequisite for obtaining another product or service; or b) the price of a good or service is linked to the purchases of another good or service.

9. See SNL Securities (1992, pp. 3-21) for a useful description of finance company types and the environments in which they operate.

10. Two notable exceptions are American Express, which offers savings plans to charge card customers, and IBM Credit Corporation, which takes funds directly from uninsured money market deposits for its commercial lending (Zuckerman 1991, p. 6).

11. Regulation Q was a set of interest rate ceilings on bank deposits set up under the Glass-Steagall act in 1933. The ceilings made it impossible for banks and thrifts to offer interest rates that were as high as those available from MMMFs. They were eliminated by the Monetary Control Act of 1980.

12. As Table 2 shows, money market mutual funds invest in liabilities of banks, governments, government agencies, and commercial paper issuers. These assets are rated by rating agencies and the cost of information is minuscule compared with the information costs involved in lending to households and businesses.

13. Bank lines of credit to commercial paper issuers constitute only a fraction of total off-balance-sheet activity by banks. Total commitments and contingent liabilities for domestic banks could range from \$1.4 trillion to \$5.6 trillion. The larger estimate, based on data submitted to the U.S. Senate Banking Committee by federal financial regulators, includes interest rate and foreign exchange swaps omitted from the smaller estimate.

14. As part of its effort to stave off collapse, Manufacturers Hanover Trust sold CIT to Dai-ichi Kangyo Bank in 1989. Heller Financial and its parent company, Heller International Corp., are wholly-owned subsidiaries of Fuji Bank.

15. First Nationwide's expansion has been financed in part by taxpayers. According to Resolution Trust Corporation estimates, the Federal Home Loan Bank Board committed \$4 billion in promissory notes, capital loss and yield maintenance agreements, and other payments when it transferred four thrifts with \$8.6 billion in combined assets to First Nationwide in December 1988 (RTC 1990).



16. According to GE, "Virtually all products financed by GE Capital are manufactured by companies other than GE" (GECC 1990, p. 65). In fact, the parent company makes direct loans to purchasers of its aircraft engines and finances those loans with borrowings in the commercial paper market that are separate from those of its finance subsidiaries. At the same time, GECC lends to the commercial airline industry, indirectly supporting the parent's commercial and manufacturing activities.
17. In 1990, finance companies began to feel the impact of the imposition of capital adequacy requirements on commercial banks in both the cost and availability of bank credit lines and the number of banks willing to provide back-up lines for finance companies' commercial paper (Kramer and Neihengen 1991, p. 55).
18. HLTs are loans for leveraged corporate restructuring, management buy-outs, and recapitalizations.
19. NBC lobbied vigorously to remove barriers prohibiting cross-ownership of cable systems and television networks. Those efforts paid off when the Federal Communications Commission eliminated the ban on June 18, 1992. As a result, NBC is now positioned to acquire some of the cable companies financed by GECC. The implications may be troubling, according to accounts of GE's interventions in NBC's journalistic practices. Ben H. Bagdikian (1992, p. 51) writes that "Lawrence Grossman, former head of NBC News, revealed recently that following the stock market crash of 1987, Jack Welch, CEO of NBC's owner, General Electric, called to say that he did not want the networks newscasts to use language that might depress GE stock."
20. According to year-end 1991 data reported in the Thomson Bank Directory, Thomson Savings Directory, Best's Insurance Reports, and Household Financial Corporation's annual report, the aggregate equity capital and paid-in surplus of Household International's four main subsidiaries totaled \$2.64 billion. The parent company's annual report disclosed consolidated capital of \$2.03 billion.
21. Elliehausen and Wolken (1990) confirm the local nature of lending markets for small business and the continuing relevance of the "cluster of banking services\*" in measuring competition levels in those markets. Dunham (1986) points out the dilemma of middle-market borrowers that depend on an already small universe of lending institutions and lack access to national capital markets. The Southern Finance Project (1991) found that, as a result of the huge BankAmerica-Security Pacific merger, nearly two-thirds of all primary banking relationships with middle-market firms in the Puget Sound area would be controlled by a single lender. Hannan (1991) reviews the concentration-price relationship.
22. *Keiretsu* are sets of interlocked firms and financial institutions that carry on long-term cooperative relationships. These networks own controlling interests in the firms within the group and often engage in inter-firm transactions between purchasers and suppliers or borrowers and lenders that could not be justified based on strictly market criteria, although they may promote the interests of the network as a whole.

23. In a September 1991 NBC/ *Wall Street Journal* poll, 51 percent of all respondents said banking regulation was too lax; 52 percent felt the same way about insurance industry regulation. Only a small percentage thought regulation was “too strict” (6 percent for banks, 9 percent for insurers) (Hart and Teeter 1991, pp. 26-29). In 1991, only 15 percent of the respondents to the Gallup Organization’s 1991 Consumer Survey for *American Banker* said they had “a great deal of confidence in the safety and security of the U.S. banking and financial system.” For the first time in Gallup’s polling for *American Banker*, more people said they had “little or no confidence” in the system than “a great deal of confidence.” The results of Gallup’s 1992 survey were virtually unchanged from the previous year (*American Banker* 1991 and 1992 surveys).

24. The Bank Holding Company Act of 1956 governs the activities of companies that own banks and nonbanking affiliates, restricting the permissible activities of the parent company and its nonbanking affiliates to those “closely related in banking.” It also imposes restrictions on transactions between a parent company or its nonbanking affiliates and the affiliated bank(s), and gives the states authority to prohibit or permit companies to own banks in more than one state.

The Investment Company Act of 1940 provides protection for investors in mutual funds by prohibiting major changes in investment policy without shareholder approval, by providing that shareholders elect the directors of the investment company, and by providing statutory guidelines for advertising. Shares in investment companies are regulated under the Securities Act of 1933 which requires that all material facts about a mutual fund be disclosed to shareholders to prevent misrepresentation, deceit, or other fraudulent acts and practices.

The McCarran-Ferguson Act of 1945 affirmed the authority of the states to regulate private insurance companies and exempted insurers from the anti-trust laws.

25. For additional discussion, see Wolfson (1986, pp. 79-80).

26. Sponsored by the bipartisan leadership of the U.S. House of Representatives Committee on Energy and Commerce, the Securities Regulatory Equality Act addresses such issues as independent directors and borrowing from affiliated banks.

27. This would require reporting by zip code and by the three or four-digit Standard Industrial Classification (SIC) code.

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