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The Profitability and Risk Effects of Allowing Bank Holding Companies to Merge With Other Financial Firms: A Simulation Study (p. 3)

John H. Boyd
Stanley L. Graham

Explaining the Demand for Free Bank Notes (p. 21)

Arthur J. Rolnick
Warren E. Weber

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In This Issue

Risky Business

Should bank holding companies (BHCs) be allowed to engage in other lines of business? A key argument of those answering yes is that broader diversification of investment activities would reduce the risk of BHC bankruptcy. However, diversification need not reduce risk when the new activities are inherently more risky than the old. The outcome then depends on how the returns from the activities move over time; they could, for example, move together and build instability or move inversely and moderate it.

John H. Boyd and Stanley L. Graham empirically investigate the likely outcome of BHC diversification in "The Profitability and Risk Effects of Allowing Bank Holding Companies to Merge With Other Financial Firms: A Simulation Study" (p. 3). Boyd and Graham use data on the profitability and risk of actual U.S. financial firms in 1971–84 to simulate mergers between randomly selected pairs of BHCs and firms in the securities, insurance, and real estate businesses. They then compute measures of profitability and risk for the hypothetically merged industries they have created and compare those measures to the historical measures for BHCs alone. They find that the effects of BHC diversification are fairly clear: although mergers with life insurance companies might reduce the risk of BHC bankruptcy, mergers with securities or real estate development firms likely would increase it.

For a Few Dollars More

Do people holding uninsured bank liabilities keep informed about the riskiness of the issuing banks? Many economists would answer no, basing their response on an interpretation of U.S. banking history. They observe that in the mid-1800s, risky bank notes circulated as a medium of exchange generally at par with much safer gold and silver coins. This failure to distinguish between risky and safe assets indicates that people were uninformed, these economic historians have argued.

Arthur J. Rolnick and Warren E. Weber challenge the conventional view in "Explaining the Demand for Free Bank Notes" (p. 21). Based on their examination of the evidence, Rolnick and Weber found bank notes in most instances to be about as safe as gold and silver coins, so the fact that those notes circulated at par does not suggest an uninformed public. But in another instance, in Minnesota,

some bank notes really were risky. In this case Rolnick and Weber uncover evidence that people were well-informed of the risk and properly discounted the notes. That is, a Minnesota smithy, for example, would sell a horseshoe for risky bank notes as well as coins, but for a few dollars more. Rolnick and Weber's finding that people kept informed of the riskiness of banks whose liabilities were uninsured could have implications for how much protection people need today in terms of deposit insurance and bank regulation and supervision.

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