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Statement by

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I appreciate the effort of this Subcommittee to undertake a full review of the basic approach toward banking, and bank holding company legislation and regulation. This is a large subject, filled with controversy in its particulars and with new questions arising about the philosophical underpinnings. In addition to the Bank Holding Company Act itself, the issues are relevant to the Savings and Loan Holding Company and the Glass-Steagall Acts. This statement, supplemented with detailed appendices, is an attempt to place the issues in a broad perspective, with full treatment of the underlying public policy issues. I hope you find it useful.

I have repeatedly expressed my conviction that Congress should move with a sense of urgency to reform the existing statutes governing banking organizations. The public is entitled to the assurance that the powerful forces of change at work today in the financial services marketplace are channeled in a manner consistent with the broad public

interest -- the need to maintain a safe and sound financial system, to assure equitable and competitive access to financial services and credit by consumers and businesses large as well as small, to maintain an efficient and safe domestic and international payments system, and to preserve an effective mechanism for transmitting the influence of monetary, credit and other policies to the economy.

The simple fact is that such assurance is lacking today. The Congress has been debating the issues for several years, but every attempt to address them has been stymied due, at least in part, to the efforts to block legislative change by those who perceive a strong particular interest in one part or another of the status quo or in exploiting an existing loophole. However, our concern has to be about the coherence and wisdom of the whole. And changes in the financial system will not wait on legislation. The system is changing - haphazardly and without direction -- in response to a variety

of economic and other forces. What is clearly lacking is Congressional guidance to assure that the important public policy concerns are dealt with in a constructive manner.

Before turning to a review of the fundamental financial industry policy issues, I want to stress that there is, in my view, an opportunity for Congressional action this year in important areas. Comprehensive banking legislation, including provisions to close unintended and unwise loopholes in banking and thrift holding company statutes and to provide certain new products and services for bank holding companies, has been thoroughly debated, reviewed and analyzed over a number of years and is long overdue. The recently introduced emergency acquisition legislation for institutions in danger of failing is urgently needed and currently being debated. T should be ready for action shortly, as is the case with legislation to strengthen the FSLIC.

I sense a theme in these hearings of frustration at the lack of Congressional action, which I clearly share. There is danger that this frustration would drive the legislative process to accept a direction of change that would not be constructive, but would instead further undermine some basic principles that have stood the test of time.

For instance, one reaction to the legislative gridlock is to suggest that it is appropriate and even desirable that the evident anomalies of the nonbank bank loophole should be resolved by allowing any kind of business to own banks, rationalized as a service to consumers and a source of funds to capital-starved institutions. We find some commercial banks willing to tolerate and even encourage use of the nonbank bank loophole for their own purposes, particularly to achieve interstate entry. At the same time, those banks, quite unrealistically and dangerously from my perspective, may feel that Congress, overwhelmed by loophole exploitation, will in

the end and for that reason alone, lower the legal barriers on bank holding company entry into nonbanking activity. But instead, that course would be a process of legislation by loophole exploitation, with a strong possibility that the issue of new products and services for existing bank holding companies will be by-passed indefinitely, with the result of weakening the banking system.

That would be a most unfortunate result, abandoning useful principles that have worked well to strike out on a course that has clearly foreseeable pitfalls. We should not be beguiled by claims of what has been termed by some as a "Brave New World" for banking without examining just what we would be getting into. That was precisely the warning delivered by Aldous Huxley's famous fable about the future.

As regulators and legislators, our task is to respond to real needs in the marketplace, while assuring that the system remains sensitive to abiding and valid concerns of the

public interest. There is still time, but not much time. But I cannot emphasize too strongly that left unattended the process of change now underway is not adequately addressing these concerns.

Basic principles of public policy are being bypassed or ignored as market pressures and competitive instincts play against a legal and regulatory structure that has been undermined by officially sanctioned conduct designed to evade its basic tenets. The longer we postpone difficult decisions about the direction in which change should be encouraged or discouraged by public policy, the more difficult those decisions will ultimately become, and the greater the risk that continuing policy concerns -- including the safety and soundness of the banking system -- will be eroded.

In reviewing these matters with you today, I would like to focus on underlying strengths as well as weaknesses of the present system, the problems for the future, and the

fundamental policy considerations that should be our beacons as we navigate through uncharted, and possibly stormy seas. will stress the reasons why I feel it continues to make good sense to maintain a basic separation between banking and commerce, even though the line of separation is inevitably fuzzy at the edges. Finally, I would like to broadly describe the changes we would like to see made to maintain a stable and efficient banking industry, able to compete effectively and respond to the needs of a rapidly changing economy. It is important, as we look at the future of banking, that we approach the problems with care, both preserving what is essential, while making changes where change is necessary.

The Role of Banks and the Importance of the Banking Structure

At the outset, I referred to some general criteria that should guide the process of change. I would like to be more specific about certain basic points against which proposals for changes in the depository institution holding company acts should be tested:

first, the unique role of banks in the economy;

second, the related needs for federal surveillance and federal support, given the key role of banks; and

third, the linking of the parts of a bank holding company organization into an intregal whole.

Commercial banks, and increasingly thrifts as they have gained banking powers, are operators of the payments system, custodians for the bulk of the liquid savings in the economy, still by far the most important suppliers of credit, and the link between monetary policy and the economy. All of these functions are imbued with a public interest, and in combination account for the explicit public concern over the years with the strength and stability of depository institutions.

The nation's payments systems -- the clearing of checks, wire transfers, automated payment arrangements, and

securities clearances -- collectively process over a trillion dollars in transactions each day. The orderly, quick, and assured operation of that system is essential to the efficient operation of markets and the economy as a whole.

Because these systems have operated without really significant disruption for almost as long as we can now remember, we have come to take their effectiveness for granted. Certainly, a high degree of automation has made the system more efficient. But it is also true that there are inherent risks in operating the system and the speed and volume of payments increase those risks. That is why as supervisor, regulator, and participant in the system, the federal government has to be concerned about who operates this system, the terms of access to it, and the kinds of risks being undertaken. The consequences of breakdown and collective miscalculation are serious.

These concerns derive in substantial part directly from the fact that the individual components of the banking and payments system are closely linked and, to a large extent, mutually dependent. A sudden failure of one institution, particularly of substantial size, can interrupt a long chain of payments and dramatically and unexpectedly affect other unrelated institutions, some of whom may not even have a business relationship with the institution in difficulty and have themselves been well managed and sound. While secondary and tertiary effects are, of course, present in some degree in the failure of any business firm, the effects are never so potentially contagious or so disruptive as when the stability of the banking system or the payments mechanism is suddenly called into question. Then, serious implications for overall output, employment, and prices -- indeed, for the entire fabric of the economy -- are apparent.

Because of their critical role in the economy, the deposit liabilities of banks, and the stability of depository institutions generally, have long been protected to a degree by official supervision and regulation and by a governmental "safety net." Of course, the first and most important line of defense for a safe and sound banking system must be the interest of banking institutions themselves in maintaining the confidence of their customers. But long ago, in establishing national banks, the Federal Reserve System, the FDIC, and the FSLIC, the government determined that normal market incentives and protections needed to be supplemented by official supervision and, later, by a support apparatus. Because of the interdependence of the system, the necessity for confidence, and the nature of banking liabilities, experience repeatedly showed that the market alone could not be relied upon to assure banking stability and the stability of the economy as a whole. Indeed, if market discipline were to become fully effective,

the government would have to be prepared to see a banking crisis spread widely through the system. It has been a long time since that has been the case.

The support apparatus provided the banking system -- importantly reflected in access to the discount window at the Federal Reserve and to deposit insurance -- provides advantages in the competition for the public's funds. But there are offsetting costs as well in, for instance, reserve requirements, insurance premiums and compliance with regulatory standards. Achieving a balance between those costs and benefits is one of the continuing challenges of public policy.

More broadly, the protection provided by deposit insurance and the discount window lessens the discipline of the marketplace, potentially changing attitudes and behavior over time with respect to risk-taking. Consequently, the logical extension of the public concern with the stability of the banking system is a continuing interest in limiting certain

risks and in increasing the level of supervision. There are a number of restrictions on how banks (or thrifts) and their holding companies can do business. The operations and assets of banking institutions are also examined periodically as part of a continuing supervisory process. Concern about the activities of a bank holding company as a whole flows from the earlier points.

In the nature of things, parts of an organization under common management and in public perception related to each other, will, to a considerable degree, be affected by the fortunes of other important parts of the same organization. Consequently, concern about the activities undertaken within a bank holding company is a natural and legitimate extension of interest in the safety and soundness of the bank itself. The nonbanking activities need not be frozen in a fixed historical pattern. They may not require the same intensity or degree of supervision as a bank, and they may be regulated differently.

But experience and logic alike strongly point to the need for surviellance and limitations on the range of activities of the entire organization.

Implications for Depository Institutions Holding Company Acts

The concerns outlined above about the role of banks in the economy are widely acknowledged. Some have, however, come to challenge the proposition that the presence of a supervised, regulated and protected bank within a larger business structure requires a degree of surveillance of the larger organization and concerns about the range and nature of its activities. The argument is made that perhaps the relationship between the bank and its affiliates can be so closely regulated that the safety and soundness of the bank can be insulated and other abuses effectively forestalled. To properly evaluate this argument, I believe we need to review again the objectives Congress was trying to achieve through the Bank Holding Company Act and to see whether these same objectives, if still valid, can in fact

be accomplished by relying entirely on insulating a bank from its parent and affiliates.

The United States has had a long tradition of legislative separation of banking and commerce (See Appendix A). The Congresses that enacted holding company legislation, beginning in 1933, continuing in 1956, and again in 1970, built on this tradition. They were essentially concerned about potential threats to the critical role that banks play in the economy and to safety and soundness. In the face of a new thrust toward linking banking with commercial activities made possible by the bank holding company, they foresaw the possibility that credit would be abused for the benefit of the owners and they were concerned about possible discrimination in the allocation of credit to the benefit of other parts of the holding company.

In transmitting one bank holding company legislation to Congress in 1969, the Administration articulated a related trend of continuing concern:

> Legislation in this area is important because there has been a disturbing trend in the past year toward erosion of the traditional separation of powers between the suppliers of money -- the banks -- and the users of money -- commerce and industry.
>
> Left unchecked, the trend toward the combining of banking and business could lead to the formation of a relatively small number of power centers dominating the American economy. This must not be permitted to happen; it would be bad for banking, bad for business, and bad for borrowers and consumers.
>
> The strength of our economic system is rooted in diversity and free competition; the strength of our banking system depends largely on its independence. Banking must not dominate commerce or be dominated by it.

In making the judgment that the health of the banking system and the economy required the regulation of companies that own banks, and the limiting of the range of their nonbanking activities, the Congress also rejected the alternative of allowing the diffuse ownership relationships to exist, but regulating them to prevent abuses. Congress has, in fact, provided rather explicit direction as to how relationships between a bank and its affiliates should be monitored and controlled. But it also limited bank holding companies in 1970 to banking and managing and controlling banks and to activities

that are "so closely related to banking as to be a proper incident thereto." These words, as interpreted from the start, conveyed a limited grant of authority but also a somewhat unusual requirement that these activities meet a public benefits test -- that any adverse effects be outweighed by public benefits.

In effect, the compromise that was struck was to permit bank holding companies to engage in a range of financial activities, but, even within that framework, with strong limitations on underwriting and insurance activities. Congress also provided the Federal Reserve authority to supervise the nonbanking activities to assure managerial adequacy and financial soundness.

The Board has administered its mandate by authorizing a variety of activities "closely related to banking" and meeting the public benefits requirements that Congress laid down as a prerequisite. I have attached, as Appendix B, a

description of the evolution of this supervisory role from 1970 to the present.

Our practical experience in supervising bank holding companies confirms the Congressional concerns. We have found that the practical realities of the marketplace and the internal dynamics of a business organization under central direction drives bank holding companies to act in greater or lesser degree as one business entity, with the component parts drawing on each other for marketing and financial strength. Certainly the market conceives of a bank holding company and its components in that way. And if market participants tend to consider the bank holding company as an integrated entity, problems in one part of the system will inevitably be transmitted to other parts.

The evidence of leading bankers themselves on the point seems to me rather conclusive. Walter Wriston, former chairman of Citicorp, said ". . . it is inconceivable that any

major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way." More recently, in a thoughtful lecture dealing with new directions in banking, Sir Jeremy Morse, the Chairman of Lloyds Bank and distinguished ex-Deputy Governor of the Bank of England, strongly stressed the obligation of banks entering into rapidly evolving and highly competitive new markets to stand behind their affiliates.

Business theory and empirical evidence indicate that holding company managers, to attain real or perceived efficiencies in production, operations, marketing, and funding will want to coordinate all of these activities. For instance, bank holding companies acquiring commercial finance companies have typically leveraged those subsidiaries much more than independent finance companies, suggesting implicit or explicit

reliance on the strengths of the related bank and holding company, even if there are no other business relationships among them.

Indeed, if such linkages did not exist, it is not entirely clear what benefits bank holding company managers would perceive from expansion into new activities (or from commercial firms entering into banking) other than perhaps satisfying a pure size or growth objective. In any event, effective coordination of the various operations of bank holding companies and their bank subsidiaries will necessarily link the financial fortunes of the banks to the rest of the organization. I know that when we, as regulator, question the capital adequacy of a particular subsidiary of a bank holding company, its managers inevitably point to the capital of the consolidated enterprise as evidence of the necessary financial strength. Nevertheless, to gain the maximum benefits from distancing the bank as much as possible from the nonbank

activities of its holding company, the Board has sought, in considering applications for approval of new activities, to require that the holding company have the managerial capacity to undertake the activity and the financial resources to capitalize it in accordance with standards prevailing in that industry generally, with the aim of assuring, to the extent feasible, that the new activity can support itself on a stand-alone basis.

Experience clearly indicates, however, that when a subsidiary or even a related business enterprise (such as a real estate investment trust) of a bank holding company experiences financial problems, strength will be drawn from other parts of the organization (including banking subsidiaries) to protect the reputation of the entire organization. Examples are described in a paper attached as Appendix C. That paper concludes, after examining the evidence, that the financial problems of a parent or its

nonbank affiliates will typically affect the financial position of affiliated banks even though certain provisions of law provide a degree of insulation.

Perhaps most pointedly, those of us who live in this area are familiar with the problems encountered in the Maryland and Ohio thrifts. Those institutions were not federally regulated, but their problems strongly emphasize the temptations to exploit depository institutions for the benefit of parent companies and their affiliates. Maryland and Ohio had few limitations on the activities of the owners of financial institutions, a situation that itself made supervision of the depositories more difficult. In the event, a number of those depositories were used as a financing tool and to provide credibility and support to poorly conceived, poorly executed, and even fraudulent commercial and financial schemes of their owners and their affiliates. It is suggested that the blatant abuses found in Ohio and Maryland reflected an

absence of sufficient legal and regulatory insulation between the depository institution and its affiliates. I would agree. But regulators and supervisors cannot be everywhere, and the relevant question is how many temptations and how much pressure events will put on management and the system as a whole.

There is the sad story of the Amoco Cadiz, a large oil tanker that spilled its cargo on the beaches of France after breaking up in a storm. Its owners had been careful to incorporate the ship's operation and separate its corporate structure. In the ensuing litigation over liability, I was intrigued to find that as the drama unfolded, crisis management took over, corporate forms were ignored, and the top leadership of the parent directed all of the activities of the ship-owning subsidiary. The court found the parent fully liable for its subsidiary's environmental disaster.

Is it reasonable to expect different approaches when a financial disaster faces a bank holding company? I think not.

Congress can of course legislate barriers between a bank and its affiliates, and has in fact done so by limiting inter-affiliate loans under section 23A of the Federal Reserve Act. But, under pressures to maintain the viability of their organization, management can and does find ways to support an affiliate that does not involve intercorporate lending. Simply strengthening section 23A in the expectation that this would enforce true corporate separateness is naive, particularly where the parent and its affiliates are unregulated and unexamined so that enforcement is much more difficult.

Only if Congress required such limitations as completely different names for holding companies and affiliates, no management interlocks, explicit disclaimers on affiliate obligations, no tandem operations, and other such efforts to enforce true corporate separateness, would market participants -- including management itself -- really begin to think of bank subsidiaries as separate and not put at risk by

the activities of their affiliates. Such limitations, however, would turn the nonbank affiliates of regulated bank holding companies into portfolio investments. Without the perception or reality of synergy between the bank and its affiliates, interest in such affiliates would surely decline sharply. Conversely, the strong interest by some commercial or financial firms in banks, or by bank holding companies in a more fully diversified financial services structure, reflects the perception of "synergy" and inter-relationships.

Evaluation of the Arguments for Linking Banking and Commerce

Much criticism of the present regulatory approach toward banking emphasizes the narrowness -- and arbitrariness -- of the definitions of activities that are "closely related to banking." It is argued that the basic structure and the protections built into law can be maintained while expanding the permissible range of activities of the owners of banks to areas of related activity and expertise,

thus allowing the owners of banks and other financial businesses to be more competitive with firms that offer a broad array of financial services to the public. Essentially, this position recognizes on the one hand the need to maintain the protections of present arrangements and on the other hand the feasibility and desirability of expanding the scope of bank holding company activities. As I stressed at the outset, and will explain at the conclusion of my testimony, we strongly support legislation to adapt by that means the present system to a changing environment.

There are others who would go much further -- they seem to question the basic premises of any limitations on the activities of owners of banks and would permit any enterprise to own a bank or bank-like thrift. They essentially question whether the safeguards built into the present system to protect depositors' funds and banks from abuse need to be implemented

through limitations on ownership. I would like to analyze the major arguments that have been advanced in that connection:

that banking, as we know it now, is no longer competitive as evidenced by the trends in bank profitability and market share and, accordingly, banking must be combined with other businesses to make it successful;

that technology has made it impossible to segregate banking from other businesses;

that the synergies created by combining banking with other products are competitively too strong to resist;

that the present system has been irretrievably undermined by market developments such as nonbank banks, and the present situation is irreversible; and

that it is essential to bring down the barriers between the linking of banking and commerce in order

to obtain an infusion of commercial capital into the capital-strained thrift and banking industries.

- Banking Industry Performance in Perspective

With increasing frequency, some serious analysts of banking have expressed concern about the future viability of banks as effective competitors. They point to increased competition from other financial and "nonfinancial" institutions facilitated by improvements in computers and communications, to inroads into banking through loopholes and exploitation of other anomalies in the system, to statutory and regulatory restraints on banking, and to data on a decline in profitability and market share for banks.

Clearly banking is facing problems. One obvious symptom is the fact that bank failures have been running at record rates in the past few years and overall, profitability has been declining, at least until 1985. These are serious problems that require careful attention, but it is, of course,

necessary to examine the data carefully to diagnose accurately the problems and to develop effective remedies.

During the first half of the 1980s, commercial bank profitability slid rather persistently from the recovery peaks reached in 1979 (Chart 1). During that period, overall bank profitability remained well below its 1979 level, and there were particularly acute problems for some very small and very large banking institutions.

To some extent, these developments may be cyclical, but both the deregulation of interest rates and the adjustments in the 1980s to disinflation clearly played a role. Certainly banks have been adversely affected by a substantially changed economic climate; an unusually large number of borrowers, especially energy, agricultural, real estate and international borrowers, sustained dramatic reverses. To deal with this problem, provisions for loan losses were raised sharply (Chart 2). By last year these provisions were being added at

more than five times the 1970 pace. In fact, loan loss provisions to average assets has reached a new peak for all sized banks (Chart 3).

The result has been pressure on earnings, even though interest margins and fee income have been relatively well maintained. What no statistical analysis of that sort can demonstrate is the extent to which banks, induced by years of relatively fair lending weather and inflationary expectations, engaged in unduly risky lending practices at home and abroad. To that extent, an ultimate penalty on profits is a natural market discipline.

It is also important to note that for a major portion of the banking system -- all banks with over $100 million in assets -- profitability over the past ten years, as measured by the return on assets, has varied in a relatively narrow range. The lowest rate of return on assets for this group was 0.60 percent in 1984, a year that was distorted by the net loss

of one billion dollars by a single company -- the largest loss in banking history. This bad year for this group was immediately followed, however, by a year which, even after substantial interest rate deregulation and additional very large but isolated losses, provided the highest rate of return on assets during this decade. The only pronounced downward trend has been in the return on equity for the largest money center banks, declining each year for the past five years. Even here the trend is reversed when the data excludes certain banks experiencing exceptional losses.

Considering the underlying economic difficulties and imbalances, the ability of the banking industry to build reserves and capital and maintain profitability does not suggest an irreversible loss of competitive strength. There are other indicators of underlying resiliency: for example, apart from one data series heavily weighted with some large troubled banks, most indexes of bank stocks have performed as

well as or better than broader stock market indicators thus far this decade (Chart 4). Net returns on assets of the largest banks have remained within historical ranges despite record loan loss provisions (Chart 5). It is also significant that large regional banks, as a group, recovered so well last year that measures of their profitability now equal or exceed recent peaks. In sum, the data summarized in Appendix D do not support an assumption of irreversibly declining bank profits. However, one must be careful in judging the level of profitability solely based upon the raw statistical measures of ROE and ROA as they may not fully gauge the relative change in the level of risk in bank portfolios. Certainly, the extent of any increase in portfolio risk must be taken into account in evaluating the profitability data.

Those risks must also be taken into account in reviewing the data on banks' share of the credit markets. In general, those data suggest an ability of banks "to hold their

own" in a number of markets despite increasingly tough competition. In the last four years, the bank share of credit extended to domestic nonfinancial businesses has, on average, exceeded that of the preceding two decades (Chart 6). In the credit market for households, both consumer installment and residential mortgage credit shares have declined modestly since the late 1970s, but remain higher than throughout most of the 1960s. The loss in consumer installment lending share has been mostly at the expense of thrifts given new consumer lending powers by the Garn-St Germain Act.

The bank share has declined sharply in the markets for credit extended to the Treasury and state and local governments. These are not areas that those who want to enter banking have indicated that they find particularly attractive. Nonetheless, the apparent choice of banks not to acquire such assets -- or their ability to do so profitably -- does have implications for their overall liquidity posture.

Moreover, in one area, the record does demonstrate a strong adverse trend. The bank share of short- and intermediate-term business credit markets has declined (Chart 7). Larger prime borrowers -- traditionally the strongest customers of money market and other large banks -- have shifted to the cheaper commercial paper and Euro markets and to foreign banks in the United States.

The impact on the biggest "money center" banks is particularly notable; from 1975 to 1985, the C&I loans of the nine largest banks dropped from 25 to 15 percent -- a relative decline of 40 percent -- of one broad measure of short-term credit extended to nonfinancial businesses (Chart 8). It is this area that has been the source of much concern; apart from loss of profitable business, the erosion of one traditional lending area may have the effect of driving lending into other areas of substantially greater risk than in the past.

The contrast between declining shares of short- and intermediate-term business credit and maintained shares of total business credit appears to reflect lower sales of long-term debt by corporations in recent years. Moreover, the effects of "securitization" of corporate lending on the largest banks have been accompanied by a strong effort to participate in "off-balance-sheet" financial guarantees to support short-term market borrowings.

Many bankers have begun to question, however, whether the returns on their off-balance-sheet guarantees, and perhaps on commercial mortgages as well, fully compensate for the risks involved. Moreover, direct credit extensions by banks may be concentrated more largely among borrowers with lower credit ratings than formerly.

The domestic bank loss of short-term credit market share is explained by an increase in the shares of <u>both</u> commercial paper and foreign banks. The commercial paper

market has grown rapidly in recent years, and increased as a percentage of short- and intermediate-term credit to nonfinancial businesses from just under 6 percent in 1975 to nearly 15 percent last year. U.S. agencies and branches of foreign banks also have made significant inroads into this market, doubling their market share to 8 percent in the period from 1972 to 1985. Viewed in a broader perspective, including the 25 percent or more owned U.S. subsidiaries of foreign banks, as well as their U.S. branches and agencies, the share of total nonfinancial business credit of these banks substantially exceeded that of commercial paper.

The appropriate public policy response to marked changes in the relative shares of domestic and foreign banks may be quite different with respect to the commercial paper market. For instance, foreign bank competition might point to the need for intensified international cooperation on capital

adequacy standards. Account should also be taken of the U.S. bank penetration in foreign markets.

More fundamentally, it is essential to ask why U.S. banks may be more expensive suppliers of credit than others to large corporations. Banks bear certain costs -- reserve requirements, deposit insurance premiums, and a regulatory compliance burden -- that are not applicable to other lenders. On the other hand, banks are the beneficiaries of the federal safety net that is undoubtedly a factor in reducing their borrowing costs. Whatever the reasons, a significant cost differential appears to exist today.

If banks are at a long-term basic competitive disadvantage in supplying short-term funds to borrowers, there would of course be major implications for the structure and size of banking, for the safety of the financial system as a whole, and for monetary policy. So far, the data does not unambiguously indicate that this is the case, but developments

do need to be carefully studied and the implications appreciated. Such implications would not seem to include a need to change the longstanding policy of separating commerce and banking, a development that could well aggravate the trend.

Certain approaches responding to the increased "securitization" of the short-term credit market -- not just for business credit -- does seem relevant to the legislative process. The Board has long supported an approach that, within the scope of appropriate rules to limit potential conflicts of interest and to assure safe and sound operation of securities affiliates, would permit subsidiaries of bank holding companies to engage in underwriting and distributing commercial paper. The Board has similarly supported authorization for underwriting mortgage-backed securities, revenue bonds, and mutual funds. We have held this view for some time. The area of corporate underwriting, in which U.S. banks do participate abroad, is much more difficult; I must point out that the

integration of international capital markets, and the growth of U.S. bank participation in the Euro markets, make the present difference of treatment between domestic and foreign markets stand out.

In closing this section of my testimony, I would like to note the rapid movement of the states toward expanded interstate banking. The expansion of the regional arrangements has proceeded faster than anticipated. Twenty-six states have adopted some kind of regional authorization.

I am also encouraged by the movement in many states toward phasing out the regional arrangements and opening their borders to nationwide banking -- fourteen states (including seven with initial regional pacts) have now removed most restrictions on interstate acquisitions or will soon do so. The task is now for the states to complete the effort and avoid the possible Balkanization of the banking industry that initially seemed to be the consequence of limited regional

compacts. A transition to interstate banking should help assure that banks are able to compete with other firms, operating nationwide, that can bring the most advanced technology to bear in serving customer needs.

2. The Role of Technology

Another concern that needs careful analysis is that advances in technology somehow place the banking industry at a major competitive disadvantage. It is said burgeoning developments in building computers with extraordinary power, and high speed communications systems permitting instantaneous transmission of voice, data and documents, make it much easier to manage and process a broad range of financial transactions, thereby permitting nonbanking companies to compete in areas previously within the exclusive domain of banks.

In considering the kinds of changes in public policy that are necessary to respond to these developments, it seems to me that we should bear in mind that banking institutions are

already primary beneficiaries of computer and communications technology. They have creatively applied these technologies to global markets and have made possible almost instantaneous payments of hundreds of billions of dollars every day. They have permitted banks to respond to the market place with new services to meet the demands of corporate cash managers and for a broad array of new consumer products -- including 24-hour banking through ATMs, home banking, telephone bill payment, and credit and debit cards. Some banks may have been a little slower to adapt to the very latest technology because, as premier financial data processors, they had invested so heavily in the technology of an earlier time and because of branching and interstate restrictions. But they are bringing their systems to the "state of the art," and developments suggest that banks can be as adept at harnessing new technology as any other business.

Moreover, the long experience and direct presence of banks in local markets, for all its imbedded costs, carries advantages as well. I was interested to see that one company that publicly reported it intended "to develop and market innovative financial services on a nationwide basis" relying principally "on direct marketing, mail and telephone rather than on branches and salesmen" later decided to sell its nonbank bank because it was unable to "get a piece of the market." One mistake doesn't make a case, but certainly the relative competitive advantages and disadvantages remain an open question.

- Synergy

Technology may also make possible a melding of products and cross selling to establish synergies unavailable to those who are limited by law to banking or certain financial services alone. That thought has apparently spawned acquisitions of nonbank banks, nonthrift thrifts or other

financial service firms by retailers, insurance underwriters, securities brokers and underwriters, and now industrial firms.

We need to be cautious about whether these claims justify abandoning the broad separation of banking and commerce. I am bemused when nonbanking firms, including retailers, seek in banking the growing markets and profitability that they apparently question in their own industries, when at the same time, banks raise red flags about prospects in the banking industry.

Synergism is hard to measure and demonstrate. Some skepticism seems to be justified by the mixed results that conglomeration appears to have achieved in nonfinancial areas, where, over the past several years, we are seeing the spin-off and sale of a great many companies that had been brought under a single management. Newly combined financial enterprises have complained about the difficulties of coordinating the joined

activities, and do not appear to have demonstrated consistent higher levels of profitability.

4. Anomalies and Irreversibility

There is also the argument that things have already gone too far to reverse, that too many nondepository institutions are already in the banking business and that these companies with their superior range of product offerings will simply outcompete the remaining banks. But despite all the publicized acquisitions and product introductions, the facts on market share, profitability, and technological innovation do not seem to support this thesis.

Certainly there are large anomalies in the present system. The acquisition of nonbank banks by insurance, securities and commercial firms, while bank holding companies cannot do the opposite, is surely competitively unfair. Nonthrift thrifts and state grants of powers to their own institutions for interstate competitive reasons even when those

powers are questionable from the point of view of safety and soundness and ruled out for bank holding companies are other examples. At this point, these developments are still minor in their overall impact. They are an indication of the need for action, but they do not point to the inevitability of accepting and enlarging what has happened. In fact, the announced intention of the Banking Committees of the Senate and House to have a retroactive grandfather date provides fair warning to those who have exploited the nonbank bank loophole.

At some point, the process could be practically difficult to reverse or end. Again, that is an argument for decision and action, not in itself an argument for reversing basic principles that have guided the system.

5. Fulfilling Capital Needs

The final argument for allowing any company to own a bank or thrift seems to me a counsel of despair; only

commercial businesses can and will provide necessary capital to troubled thrifts and banks.

In fact, any expectations that nondepository institutions are eager and prepared to invest large amounts in resuscitating large troubled institutions is questionable. In many cases, the objective seems to me to obtain access to federally insured deposits, payments system services, and the ability to export a uniform credit card interest rate throughout the country without taking on large fixed costs. The emphasis often seems to be on acquisition of a new or small institution with relatively minimum initial capital requirements, particularly as compared with the size of its parent commercial firm. Moreover, if companies are generally permitted to own nonbank banks, or if access to bank ownership is to be more open to commercial firms more generally, existing interest in taking on the heavy capital and management burden of acquiring large troubled thrift institutions would

presumably drop away, sharply limiting any contribution to easing the burden faced by the FSLIC.

More basically, it would be anomalous to recommend a solution for the difficulties of problem institutions by potentially creating a situation fraught with adverse consequences for the system as a whole. To take just one example, many of the most serious problems among thrifts do not arise today because of their traditional business but because those businesses have been combined with risky real estate development. Increasing the ties between depository and commercial firms more broadly could well aggravate matters.

The Consumer Bank Question

The argument is made that so-called consumer nonbank banks are needed in order to make available to consumers products and services that are not otherwise available to them. As typically proposed, these banks could engage in all the functions of banks except making direct commercial loans

(they could make loans through the purchase of commercial paper and money market instruments). They would be different from ordinary banks in as much as they could be owned by commercial firms and engage in cross selling of affiliates' products and services.

It is, of course, an essential objective of any banking system to provide efficient, competitive and innovative services and products to the consuming public. Any banking structure must be designed to assure the achievement of this goal. But it is difficult, indeed, to argue the United States banking system, without commercial ownership, can not or will not meet that need.

Federal and state policies have encouraged a multiplicity of small depository institutions that serve a public that is almost completely composed of small businesses and families. A country that has over thirty-five thousand depository institutions -- banks, thrifts and credit unions --

can hardly be said to ignore the needs of consumers. In fact, the overwhelming number, more than 95 percent, of these institutions are none other than family banks serving the needs of small business, families and individuals. Almost one-quarter of commercial banks have 5 percent or less of their assets in C&I loans and over three-quarters have less than 20 percent of assets in these loans.

However beguilingly labeled, so-called consumer banks are essentially a device for breaching the wall that now separates banking and commerce. Those who would breach it in the presumed interest of competition and the consumer should, it seems to me, be asked to carry a heavy burden of proof. Do we really want, for example, a retail business to be able to gather deposits under the protection of federal insurance and to use those deposits to fund a credit card they sponsor more cheaply than retailing competitors? Is it wise policy to encourage banking arrangements in which a retailer has an

incentive to prefer its customers in the provision of loans? Is the converse -- favoring retail customers of a particular bank -- any better? Are there risks in reducing credit standards in an effort to induce nonbanking business, with the financial risks passed on in part to the federal safety net? Do we want to encourage joint marketing efforts and "tie-ins," implicit or explicit?

Obviously, we can try to write complicated laws to deal with these possibilities. But it strains credulity about human behavior to suggest they would be entirely effective, any more than restrictions on intra-corporate affiliates. That is particularly true in the event the parent holding company and its nonbanking affiliates are unsupervised and unexamined.

I believe that, should Congress authorize the so-called consumer bank or make it clear that it did not intend to close the nonbank bank loophole, some rather dramatic changes in our banking structure would occur in relatively

short order. Some banks, in reassessing the circumstances, could be induced to take the radical step of formally dividing their existing banking institution into two pieces, placing demand deposits and consumer banking in one subsidiary and commercial lending in another. Neither subsidiary would be a "bank" according to the definition of the Bank Holding Company Act, and the holding company would then be free to engage in any business activity.

New entrants into a market are ordinarily associated with more competition, at least for a time. But there is essentially free entry into banking today, and any firm can provide credit cards and consumer loans. The question is whether there are significant added gains by marrying banking and commerce. Certainly policy judgments cannot reasonably be made based upon the activities of the few, and perhaps unrepresentative, commercial companies participating in banking today.

Implications for the Payments System

I emphasized earlier the importance of dealing with risks to the nation's payments system. Advocates of broader access to that system argue that risks arising from increased direct access by nonbanking firms can be adequately controlled through restrictions such as section 23A of the Federal Reserve Act which limits extensions of credit to, and other transactions by insured banks with their regulated, supervised and examined affiliates, or through overdraft limits under the Federal Reserve Board's Policy Statement Regarding Risks on Large-Dollar Wire Transfer Systems.

These arguments fail to take into account a number of crucial aspects of the payments system: the immediacy and finality of wire and book-entry transfers, the importance of independent credit judgments in protecting the integrity of the system, the difficulty of monitoring compliance with rules to prevent abuse by affiliates without substantially and

unacceptably delaying all payments and without examination authority, and the potential for opening access to the discount window to commercial firms generally.

Fedwire transfers are made in very large dollar volumes. They involve over 181,000 large dollar payments every day with a total daily value of over $400 billion. Similarly, there are over $200 billion in book-entry securities transfers every day. Most of these transfers are processed through on-line linkages to the Federal Reserve, by terminals or computers on banks' premises, immediately and finally.

These systems can generate large overdrafts -- in the multi-billions of dollars -- in a very short period of time. The main protection against the rippling effects of a default is both the standing of the bank itself and its capacity and willingness, in its own interest, to make an independent credit judgment about its customers. Such an independent judgment is hardly feasible when a bank is ordered to make payment by a

parent or an affiliate. And, in the last analysis, if the bank or its parent is unable to cover the payment, the public, through the Federal Reserve and the FDIC, bears a large part of the risk.

The risks inherent in parent-affiliates relationships would be exacerbated by the financial formula likely to be followed by a commercial parent seeking access to the payments system through ownership of a nonbank bank: token capitalization of the bank relative to both the size of the parent and affiliates and to the very high dollar volume of transactions functioned through the bank. Such an arrangement seems to be implied by a number of actual or proposed nonbank banks.

The combination of banking and commerce in the provision of payment services would also raise important questions about the availability of Federal Reserve credit, now essentially reserved for supervised and regulated depository

institutions under carefully circumscribed conditions. In a situation in which commercial firms had direct access to the payments mechanism through captive nonbank banks, the Federal Reserve would be put in the dilemma of either funding large overdrafts generated by a nonbank bank parent or rejecting funding requests at the risk of impairing payments to innocent third parties and the functioning of the overall system. Any competitive advantage of access to Federal Reserve credit would certainly push more firms toward bank ownership; yet, I do not believe that Congress intended that the safety net should inure to the advantage of nonbanking companies.

It has been suggested that the exceptional provision of payments system facilities to the Chrysler Corporation during the period when the government guaranteed loans to that company demonstrates that this technique can be safely used. But that rescue to me is the exception that proves the rule. Payments facilities were provided to the Chrysler Corporation

in 1981 when it was already in a real sense under government protection. That access was provided in recognition of the fact that banks exercising independent credit judgments would not accept Chrysler payment orders in the normal course. Direct access to the payments system through a specially chartered bank was provided only because Congress had established a policy of supporting the survival of the Corporation, and because its debt had been guaranteed by the United States by an act of Congress. That does not seem to me any precedent for firms without official support.

Appendix E discusses payments system risks in some detail as well as why regulatory approaches to deal with these risks, particularly as they are presented by nonbank banks, are not satisfactory. This is a technical, detailed matter. But it is nonetheless a matter that lies at the heart of maintaining an efficient, safe financial system.

Foreign Experience

As a matter of law and tradition, combinations of banks and other businesses are present in some countries. Those very few countries that have banking systems in which such arrangements are prevalent are generally characterized by the dominance of a relatively few large banks. Such a situation presents a very different regulatory and supervisory framework, among other things making it possible for bank supervisors to maintain a direct review of, and close contact with, those who are operating the banking system.

But there also appear to be major costs in this kind of a system in terms of tendencies toward cartelization, slower innovation, and narrower financial markets. These are not patterns that we would wish to emulate.

Policy for the Future

The burden of my testimony is that the basic banking system is sound, embodying important principles -- important

for safety and soundness, for competitive open markets, and for innovation. This system has withstood enormous strains and demonstrated resilient strength in recent years. Certainly, the technological and market forces pressing upon the structure are significant and important. But I believe they can be channeled in a manner consistent with longstanding purposes of public policy toward banking and consistent with a more competitive, responsive, and stable financial system.

Congress has the capacity to choose the kind of system that we are to have. The time to exercise that choice is now.

You can refrain from action, but that will not stop change. Then we will see a proliferation of nonbank banks and nonthrift thrifts; increasing combinations of banking and commerce with only limited safeguards to prevent excessive risk, conflicts of interest and concentration of resources; and more anomalies and uneven competitive conditions. In sum, a failure to lead, a failure to establish an orderly environment

for the conduct of financial business, will have consequences that are both serious and real.

Alternatively, Congress could decide to legalize combinations of banking and commerce, regulating that relationship in such a way as to limit the scope for risk, conflicts of interest and concentration of resources. Much of my testimony is that I do not believe that that arrangement will work effectively. If the restraints on intra-corporate relationships are so strong as to deal with the risks, the competitive benefits from, and incentives to create, such relationships will be exceedingly small. Alternatively, a closely regulated bank as part of an unregulated bank holding company would dwindle in importance. It would be used only to provide such services as could only be provided in the form of a bank -- insured deposits and access to the payments system. Other services, financial or otherwise, would gravitate outside

the supervised framework. I cannot see how that can be good for banking, for business, or for stability.

You have a third choice -- to preserve the basic elements of the present system, while adapting it to meet the requirements of changed circumstances. There is nothing static about the bank holding company concept; Congress intended to allow it to be adapted over time. We and others came to the conclusion some years ago that this could best be done by broadening somewhat the scope of permissible nonbanking activities of bank holding companies to include a greater variety of financial and brokerage services, all within a framework that assures that the public interest in safe and sound banking is maintained. We have urged that bank holding companies, through their affiliates, be able to engage in a variety of activities such as underwriting commercial paper and other instruments I mentioned earlier, real estate and insurance brokerage and travel services.

We believe that the holding company and its affiliates should be subject to official surveillance, with the right of inspection. Indeed, most of the proposed activities are, one way or another, already subject to official supervision, and that should be rationalized.

Such an arrangement would be perfectly neutral and reciprocal, favoring neither bank holding companies nor the financial industry competitors. If it is permissible under the law for bank holding companies to own an insurance, brokerage or securities firm, it would be equally permissible for these firms to own banks.

It has thus far not been possible, for a variety of reasons, for Congress to adopt this approach. Within the Congressional forum, it is difficult to resolve specific competitive issues. That was true in 1970 when Congress could not decide to adopt either a positive list of specific bank holding company activities, or a list of those that were

specifically prohibited. Instead, the Gordian knot was cut by Congress giving the Federal Reserve Board the administrative discretion to determine specific activities under a general, but limited, standard that required the careful weighing and balancing of the public interest.

Perhaps one way to break today's gridlock would be, sixteen years later, to adopt the same approach. Instead of the Congress trying to resolve specific industry issues, the Board might be given a somewhat expanded, but still circumscribed, mandate to allow broader ownership of financial businesses by bank holding companies and for these same kinds of financial businesses to own banks. To protect the reasonable interest of all parties, including both applicants and protestants, any such new authority should be limited by the same public interest standard as required by present law, with the same procedural protections provided by the right to an administrative hearing as well as judicial review of Board

decisions. In addition, I believe a new safeguard would be desirable: the effective date of any new activity approved by the Board should be delayed for six months so that the proposed action could be reviewed by Congress before it went into effect.

However, that would be a second choice. We look to Congress to provide more specific legislative direction, including review of the present restrictions of the Glass-Steagall Act.

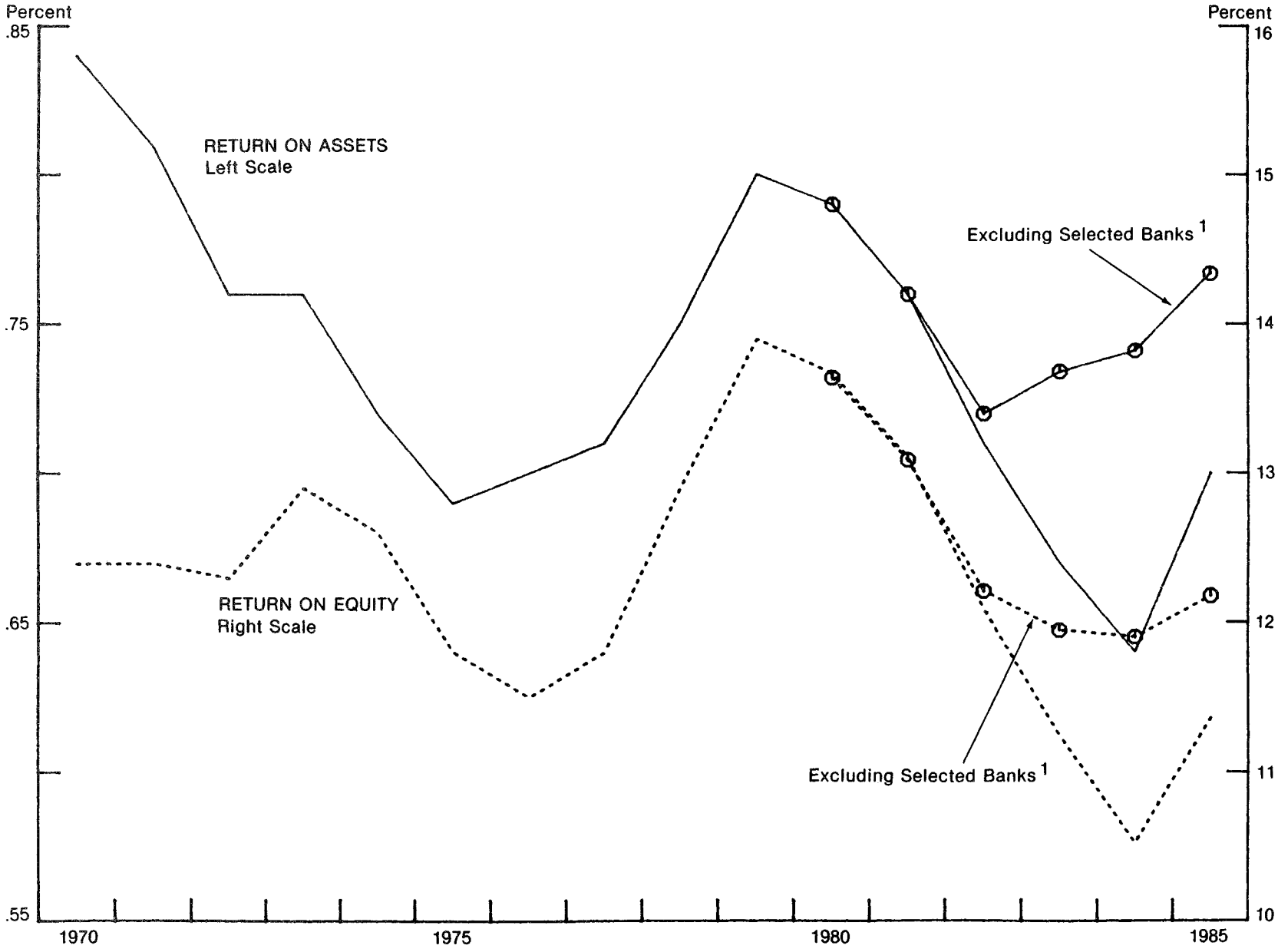
In any event, I hope Congress will act, and act soon. The financial system is too important, too interwoven into the fabric of the economy as a whole, to be allowed to evolve in a haphazard manner.

* * *

Chart 1

Net Income after Taxes

Insured Commercial Banks



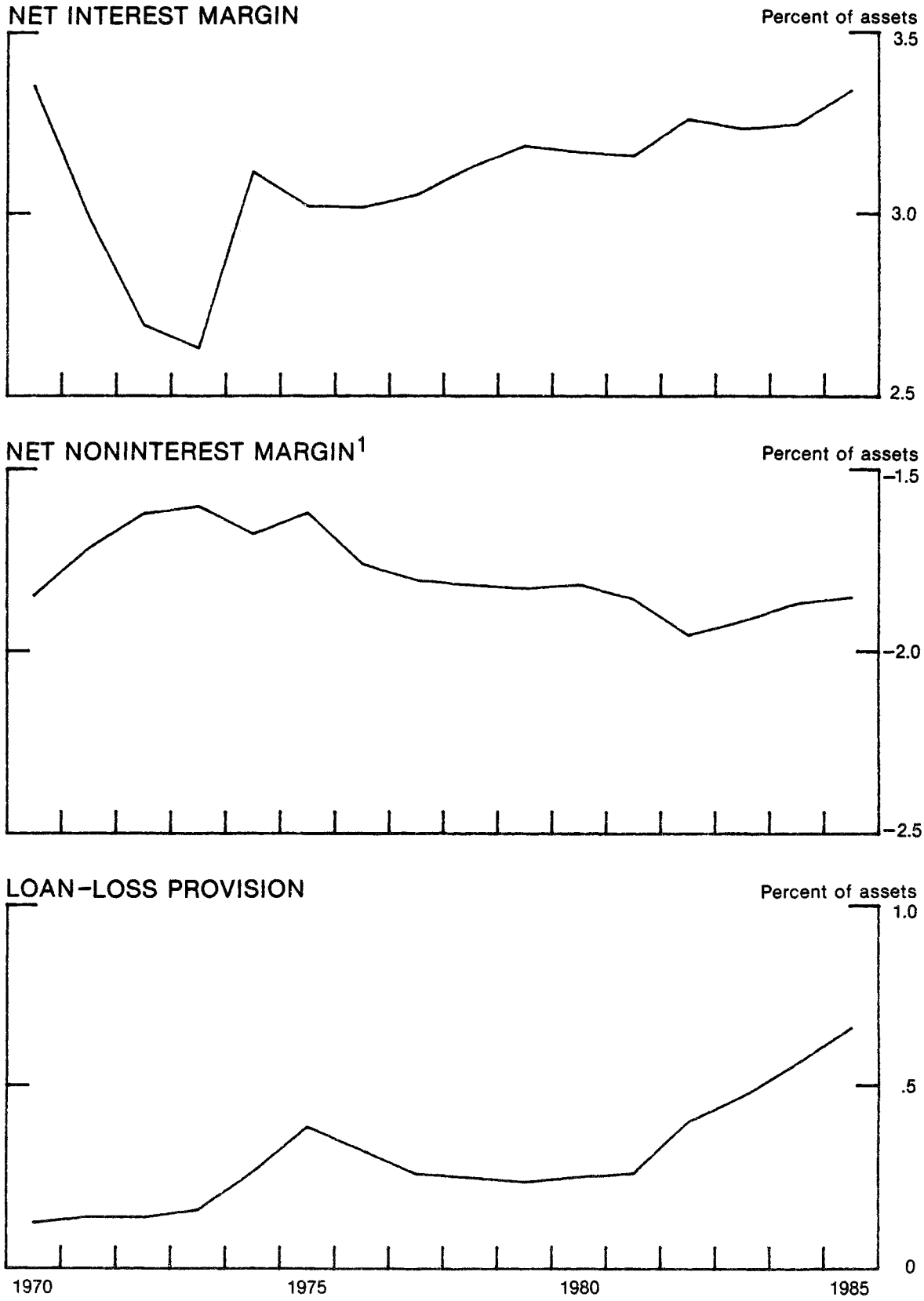
1. Excluding six banks that sustained significant earnings shortfalls in 1983, 1984, or 1985.

Source: Report of Condition and Income.

Chart 2

Components of Net Income

Insured Commercial Banks



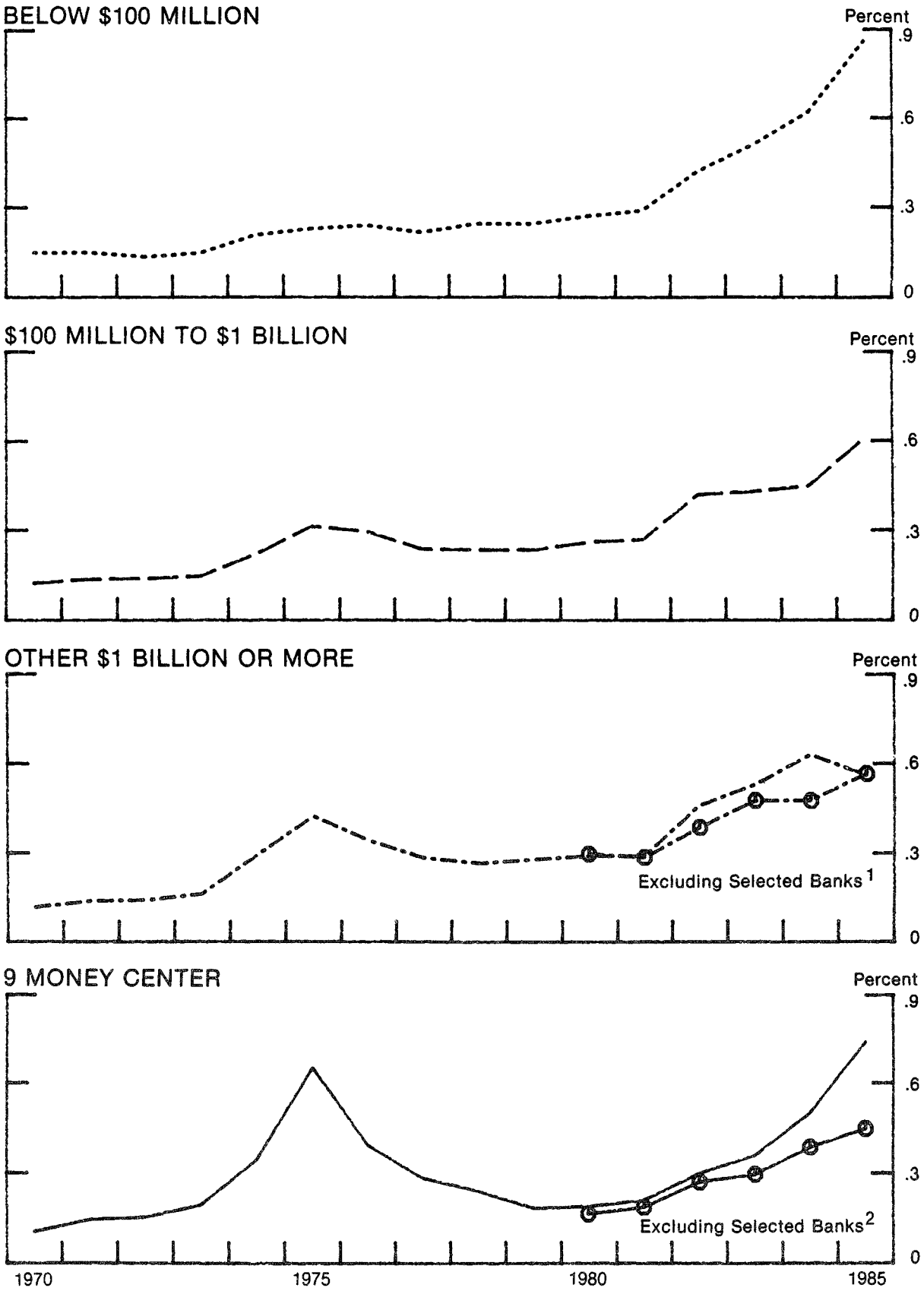
1. Excluding loan-loss provision.

Source: Report of Condition and Income.

Chart 3

Loan Loss Provision

Insured Commercial Banks
(By Size of Bank)



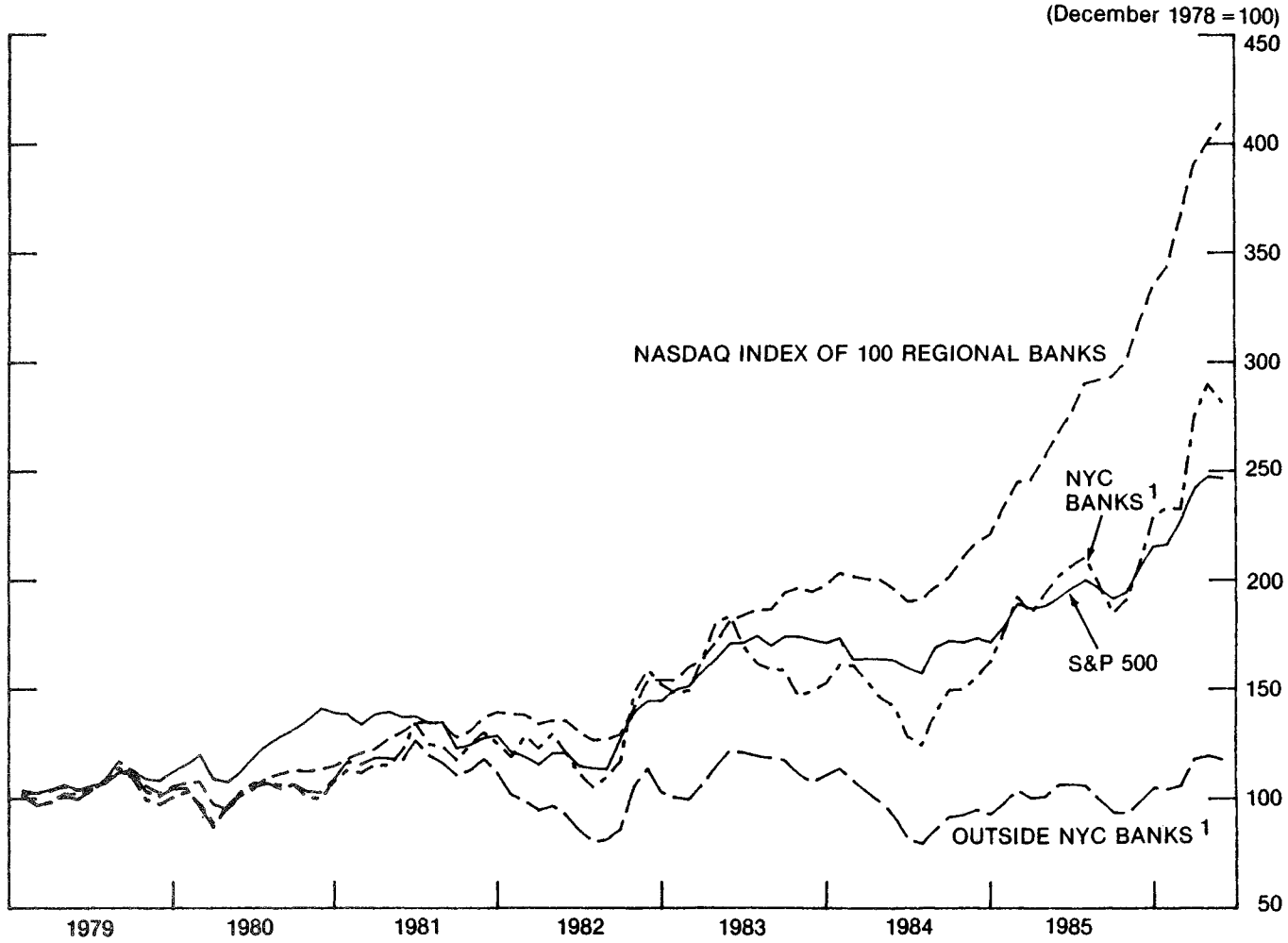
1. Excluding four banks that sustained significant earnings shortfalls in 1983, 1984, or 1985.

2. Excluding two banks that sustained significant earnings shortfalls in 1983, 1984, or 1985.

Source: Report of Condition and Income.

Chart 4

Levels of Selected Stock Indexes



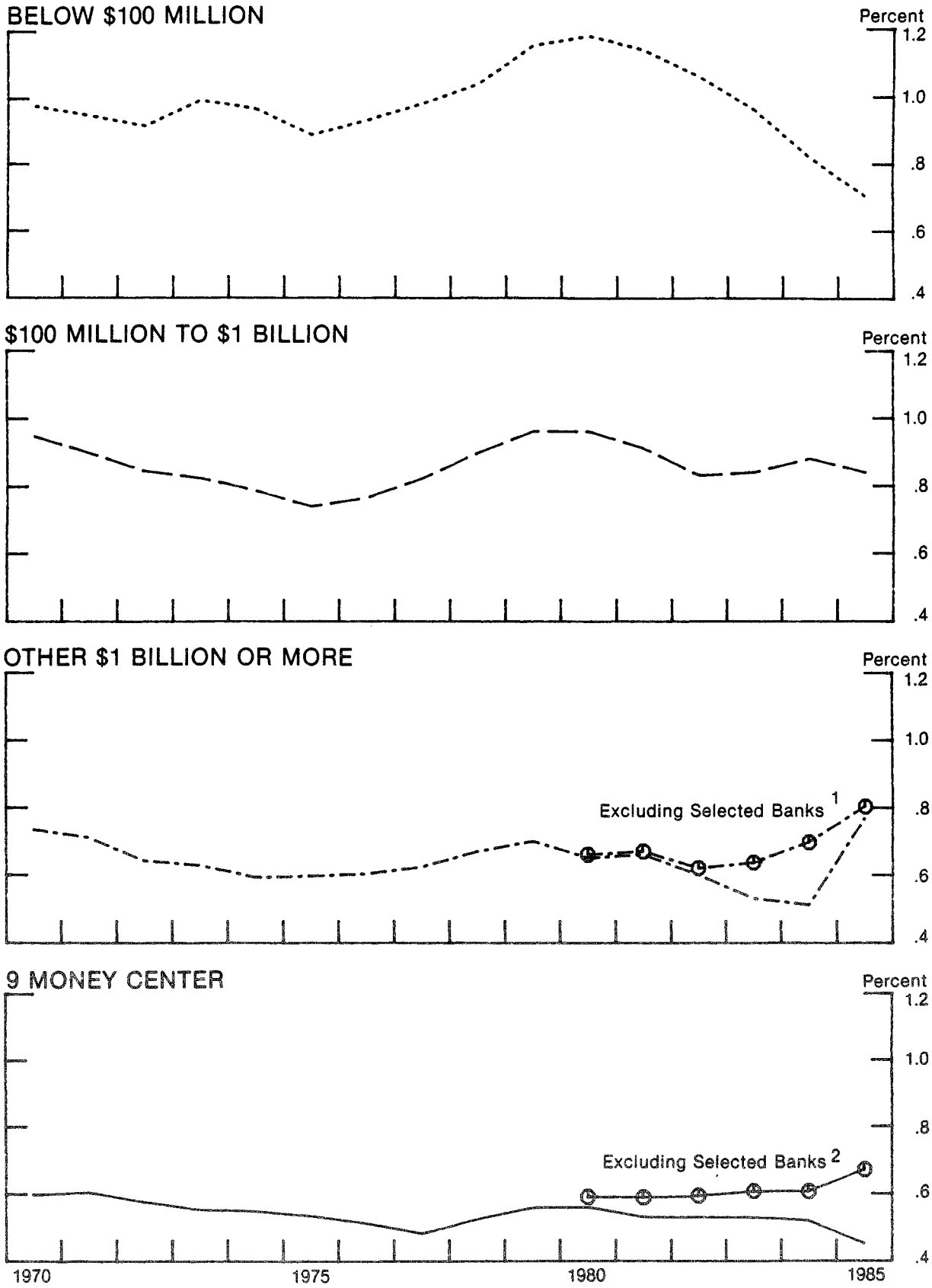
1. S&P Indexes of six New York City banks and ten large banks outside New York City, weighted by shares outstanding.

Chart 5

Return on Assets

Insured Commercial Banks

(By Size of Bank)



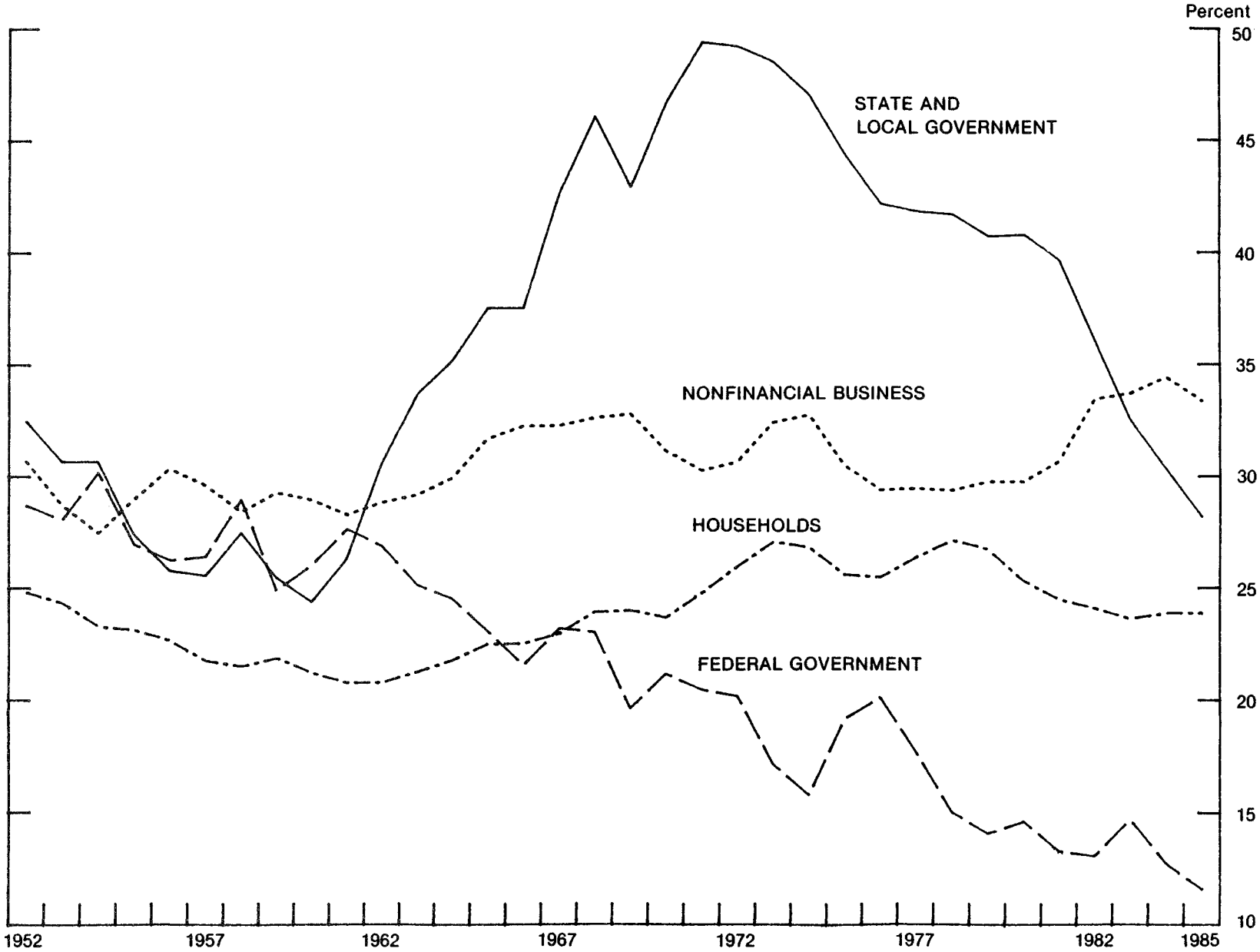
1. Excluding four banks that sustained significant earnings shortfalls in 1983, 1984, or 1985.

2. Excluding two banks that sustained significant earnings shortfalls in 1983, 1984, or 1985.

Source: Report of Condition and Income.

Chart 6

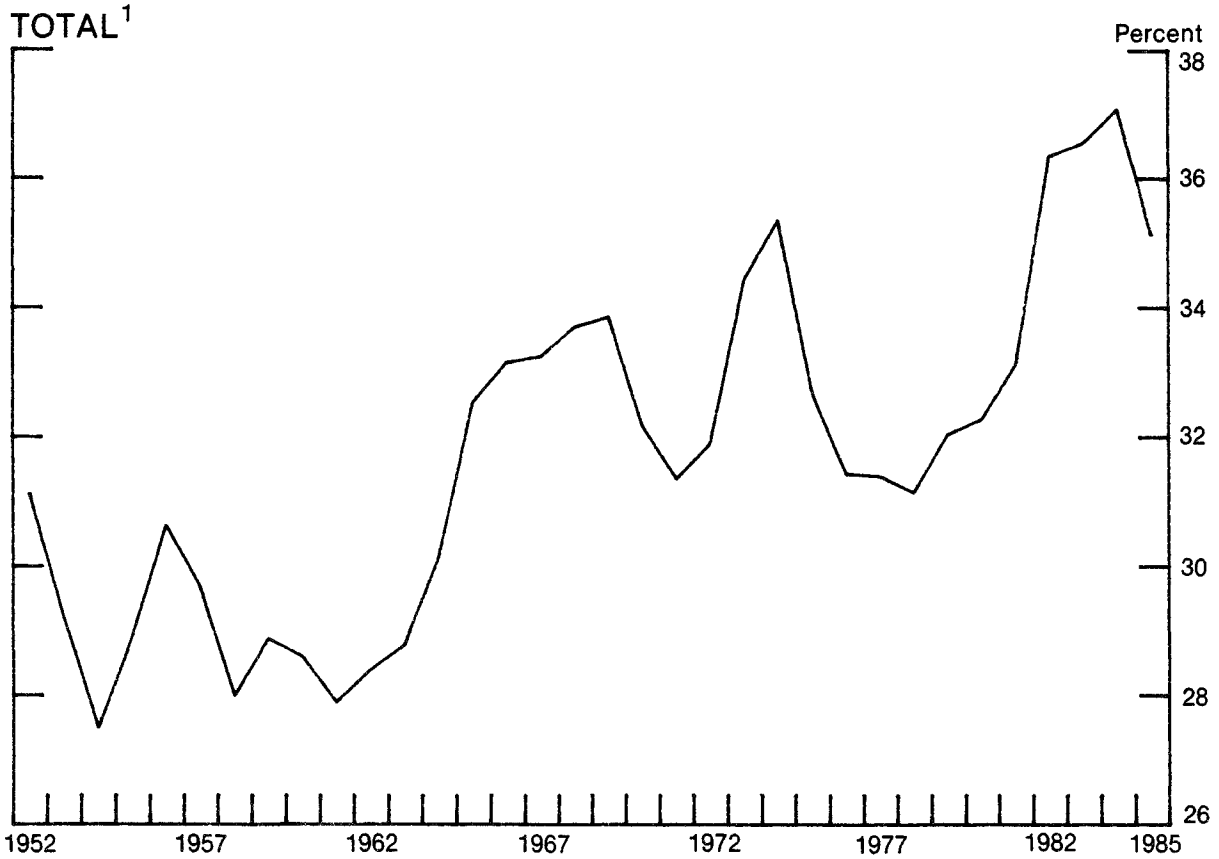
U.S. Banks' Share of Credit Extended to Domestic Nonfinancial Sectors

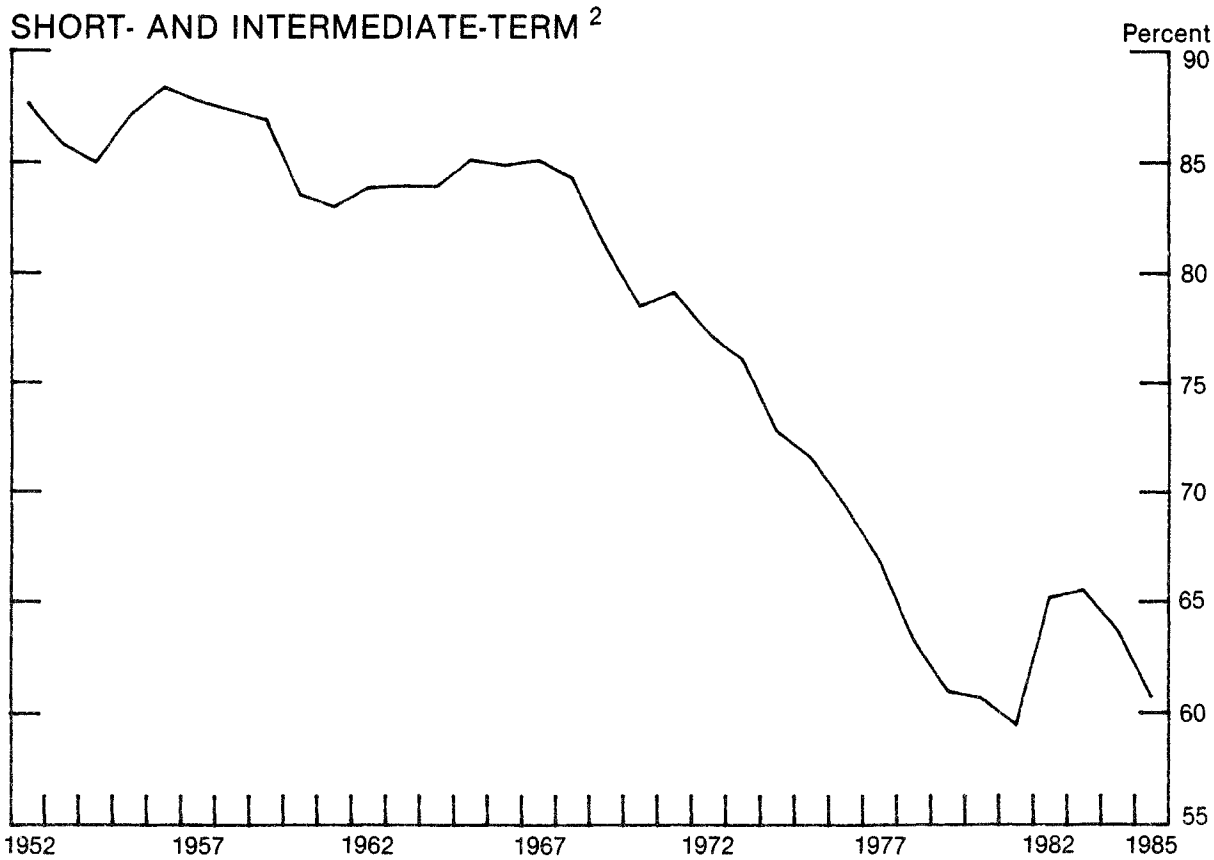


Source: Flow of Funds.

Chart 7

U.S. Banks' Share of Credit Extended to Domestic Nonfinancial Corporations





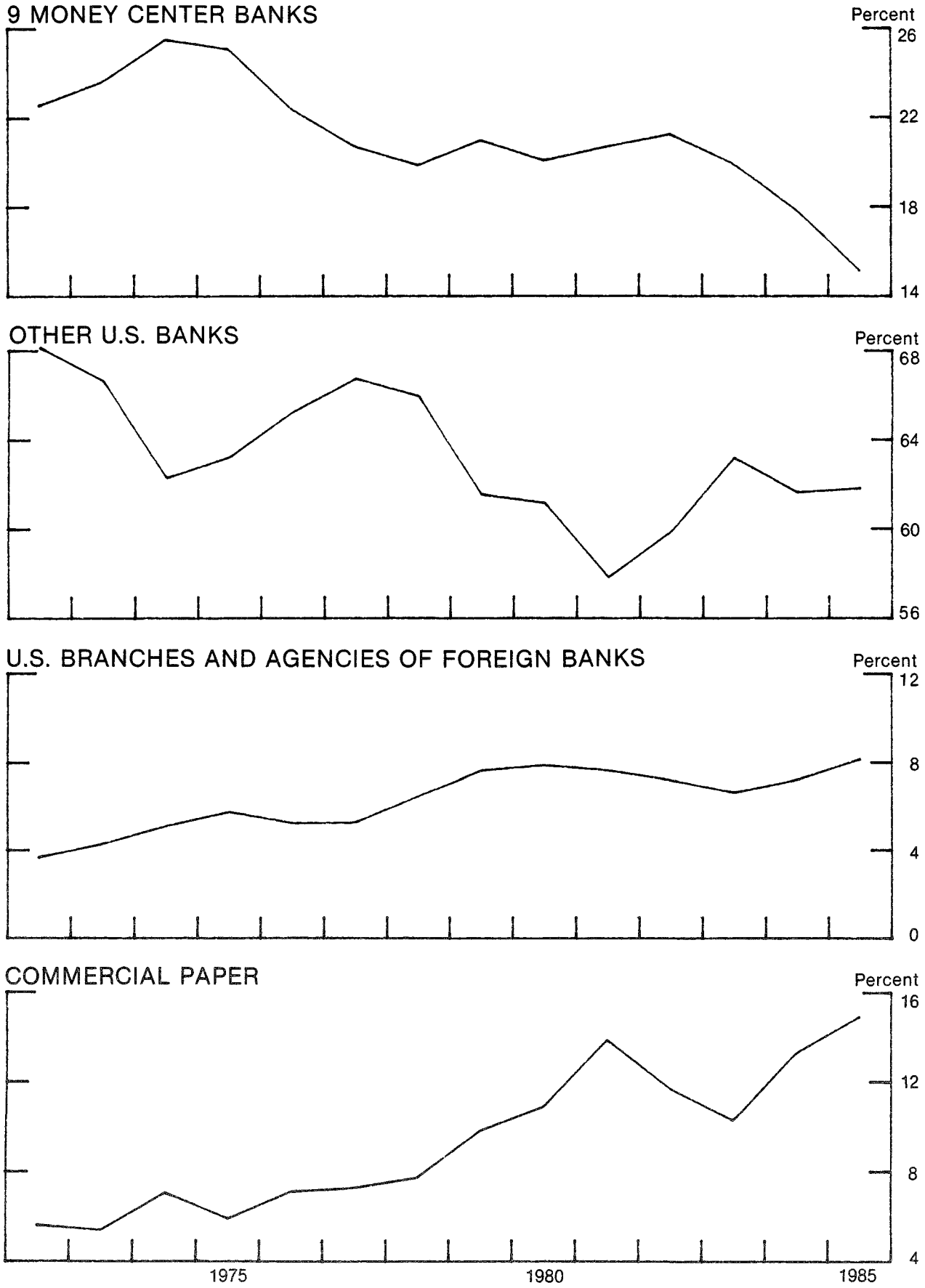
1. U.S. chartered commercial bank holdings of total loans, including those backed by real estate, extended to nonfinancial corporations, plus their holdings of short- and long-term securities issued by those corporations, all as a share of the total credit market debt of the domestic nonfinancial corporate sector.

2. U.S. banks' holdings of nonmortgage loans and short-term paper issued by nonfinancial corporations as a share of nonfinancial corporations' total nonmortgage loans plus short-term paper outstanding.

Source: Flow of Funds.

Chart 8

Shares of Short- and Intermediate-Term Business Credit[1]



1. Commercial and industrial loans and commercial paper issued by nonfinancial businesses.

Source: Report of Condition and Income, and Bank Credit data.

Address

Volcker

Appendices to the Statement by Paul A. Volcker, *Chairman* Board of Governors of the Federal Reserve System

before the

Subcommittee on Commerce, Consumer & Monetary Affairs

of the

Committee on Government Operations

of the

United States House of Representatives

6/11/86

Papers Prepared by Federal Reserve Board Staff

Table of Contents

The Separation of Banking and Commerce In American Banking History

It has been asserted that there is no traditon of separating banking and commerce in the United States. Based on a review of historical treatises, articles, state and federal statutory materials, legislative histories, court decisions, bank charters, and other materials enumerated in the bibliography, this paper concludes that the separation of banking and commerce has been a prevailing principle applied to commercial banks in America since colonial times.

I. 18th Century Banking

Commercial banks developed in colonial times to fill the need for money as a medium of exchange and as a source of liquid capital.[1] Bank activities generally were limited to issuing currency, accepting deposits, and making loans to business and government. Because the money creating function of banks affected the larger economic welfare, banks were regarded as quasi-public institutions and were subject at an early date to an unusual degree of government supervision and regulation.[2]

The early American concept of banking was influenced by the "real bills" doctrine enunciated by Adam Smith in *The Wealth of Nations* published in 1776. Smith wrote that the proper function of a bank was limited to making short-term, self-liquidating loans to finance the conversion of raw materials into goods and move them to market.[3] This doctrine was necessitated by the demand nature of bank funds. A bank could not meet its obligation to pay its liabilities on demand if its assets were tied up in long-term, illiquid assets. Early bank charters typically limited the duration of loans to 30 days, 45 days, or generally no more than three months, with some states restricting loan renewals.[4]

The real bills doctrine had as its primary objective the stabilization of the banking system. In the 18th and 19th Centuries, there was no federal safety net and banks had to remain liquid, solvent, and profitable on their own. The real bills doctrine was accepted as the "best rule of thumb" for banks to follow.[5]

The separation of banking and commerce was a necessary corollary of the real bills doctrine. Under the orthodox view, the assets of a commercial bank had to be capable of ready liquidation. Bank investments in real estate and corporate stock or other enterprises were inconsistent with this view.[6]

Early state and federal bank charters were patterned after the charter granted by Parliament to the Bank of England in 1694. The Bank of England was prohibited from "directly or indirectly dealing or trading or permitting anyone on their behalf to deal or trade, with any of the money, stock or effects of the corporation, in buying or selling any goods, wares or merchandise whatsoever."[7] Treble damages were imposed for violations of this stricture. This charter restriction was deemed necessary to avoid "the hazard of bankruptcy" as well as to allay fears of merchants that the bank's powers would give it an unfair competitive advantage and monopoly control.[8]

The Bank of North America

The first incorporated bank in the United States established the principle of banks as a type of public utility operating in close relation to government needs and the public interest with limited powers that separated them from commerial enterprises. The Bank of North America, chartered by the Continental Congress in 1781 to help finance the Revolutionary War and reincorporated by Pennsylvania in 1786, was limited to issuing demand notes, accepting deposits, making short-term loans, and acting as fiscal agent of the federal government. Echoing the Bank of England's charter, the bank was specifically prohibited from trading in merchandise and from owning real estate except as necessary for its place of business and for loan collateral. These provisions, and a 14-year limit on the bank's charter, were intended to keep the bank "closely within the reach of the state."[9]

First Bank of the United States

Alexander Hamilton's "Treasury Report on a National Bank" in 1790 reflected the concept of banking as limited to providing a means of exchange and making

Melanie L. Fein, Senior Counsel, was primarily responsible for the preparation of this paper. M. Michele Faber, Attorney, assisted in

short-term loans for business purposes and clearly did not contemplate the bank's involvement in commercial enterprises.[10] The 1791 Act establishing the First Bank of the United States on the basis of Hamilton's Report was modeled after the Bank of England and specifically provided that the bank could not "directly or indirectly deal or trade in any thing, except bills of exchange, gold or silver bullion, or in the sale of goods really and truly pledged for money lent and not redeemed in due time; or of goods which shall be the produce of its lands."[11] The bank's powers to invest in real estate were limited to that "as shall be requisite for its immediate accommodation in relation to the convenient transacting of its business, and such as shall have been bona fide mortgaged to it by way of securities, or conveyed to it in satisfaction of debts previously contracted in the course of its dealings."[12]

A description of the First Bank's activities in the Report of the Secretary of the Treasury in 1809 indicated that the bank was not engaged in any activities other than narrowly circumscribed banking activities. The Report depicted the Bank as engaged strictly in the acceptance of deposits, the issuance of bank notes and credits as a circulating medium, the payment of drafts drawn on the bank by individuals, and the payment of dividends to shareholders. The property of the Bank consisted of "1st, outstanding debts, consisting principally of notes payable at sixty days, which have been discounted at the bank; 2dly, specie in the vaults; 3dly, buildings necessary for the institution."[13]

II. 19th Century Banking

By 1800, 29 commercial banks were operating in the United States, mainly on the Hamiltonian model.[14] As the banking system developed in the 19th Century, the concept of banking as limited to issuing currency, accepting deposits, and making loans continued.

Because of the recognized importance of banking to the larger economic welfare and the need to ensure the safety of deposits, regulation of banks came to be one of the essential functions of government.[15] Banking generally was not permitted without express government authorization and had to be conducted in an incorporated entity.[16] Early restraining acts typically prohibited unincorporated entities from issuing notes or otherwise engaging in banking activities. Later laws prohibited corporations from exercising banking powers unless expressly authorized to do so. By 1830, almost all of the states had confined the right to engage in banking to incorporated banks.[17] Nearly all of the states required banks to organize either under special acts or under a general banking law that differed materially from the general business incorpo-

By the end of the first quarter of the 19th Century, the notion that banks should be separated from commercial ventures was well established. Willis and Bogen state that "[t]he primitive condition of the country, the preponderant importance of trade, and the requirements of state laws caused these banks to restrict their activities almost entirely to purely commercial banking transactions."[19]

The charter of the Second Bank of the United States in 1816 included provisions similar to those of the First Bank limiting its involvement in nonbanking activities.[20] State chartering laws also included similar prohibitions. Typical of the state statutes was the Pennsylvania Act of 1814 which chartered 41 banks with identical charters. The banks were prohibited from dealing or trading in any manner in merchandise or stock, except for bank stock, government securities, bills of exchange, and gold or silver bullion.[21] New York banks in 1825 were authorized to "carry on the business of banking by discounting bills, notes, and other evidences of debt; by receiving deposits; by buying gold and silver bullion and foreign coins; by buying and selling bills of exchange, and by issuing bills, notes, and other evidences of debt" and were to have "no other powers whatever."[22]

Internal Improvement Banks

The separation of banking and commerce was not strictly adhered to in the second quarter of the 19th Century. Industrialization and the opening of the south and west generated vast capital needs to support the nation's rapid internal growth. The states began to freely grant bank charters to fill this need. Charters were granted to any group of individuals who had the necessary capital and met other minimum qualifications.

This period, known as the "free" or "wildcat" banking era, saw widespread speculation throughout the country, particularly in the frontier states. Numerous banks sprang up "willing to finance almost any conceivable proposal."[23] It was not uncommon for the "less financially orthodox" states to charter internal improvement companies to build canals, railroads, hotels, and turnpikes with powers to issue notes in order to raise capital or to require banks to invest in the stocks of various public works projects.[24]

The experience of these ventures tended to encourage the view that banking could not be safely commingled with nonbanking activities. The assets of the internal improvement banks were devoid not only of liquidity but frequently of value. When a business venture failed, as many of them did in the Panic of 1837, so much of the bank's assets were lost that the bank could not redeem its notes and function as a bank.[25]

Although the internal improvement banks no doubt helped to finance and construct a number of valuable public works projects, these companies were so insecure as banks that historians have described their operations as "building America through bankruptcy," "disastrous," and a "nightmare."[26] The National Monetary Commission, in assessing the combination of railroads and banking in Mississippi, concluded that

> Mississippi was gridironed with imaginary railroads and beridden with railroad banks. In these enterprises there was more watered stock sold than there were cross-ties laid; reckless speculation brooked nothing as prosaic as the actual construction of railroads, on the successful operations of which it was supposed fabulous dividends would be declared.[27]

In 1836, Pennsylvania rechartered the Second Bank of the United States as a state bank with a directive that the bank invest in public works projects. Symons reports that "[t]here was hardly a commercial enterprise in the United States in which this bank did not either directly or indirectly invest."[28] When the value of the bank's investments declined, the bank failed spectacularly, losing $35 million in capital. The Pennsylvania bank was the last 19th Century bank of its kind as "state governments gradually realized that granting banks the power to invest in a broad range of commercial enterprises simply created an intolerable risk of bank failures."[29]

Development of State Banks

The six years following the Panic of 1837 saw approximately one fourth of the total number of banks fail.[30] This experience encouraged states to limit the involvement of banks in nontraditional activities:

> The experience of the wildcat banks resulted in a general disposition to curtail banking activity, and especially to demarcate commercial and investment banking. In the southern states, for example, where some of the worst examples of unsound banking had occurred, amendments were generally passed severely restricting investments by banks in real estate and securities. There was a general disposition to recognize the essential differences between banking with liquid and illiquid assets, and doubtless the experience of the panic period played an important role in making relatively complete the segregation of commercial and investment banking institutions in this country.[31]

Bank powers again were confined to issuing notes, accepting deposits, and making loans. With the exception of issuing notes, which were taxed into retirement by the National Currency Act of 1863, the powers of state banks remained thus limited throughout the remainder of the 19th Century and into the 20th Century.[32]

It was not uncommon for state banks to be chartered to serve special economic groups. In 1860, there were more than 60 banks for farmers, 50 for mechanics, 45 for merchants, 20 for traders, 15 for manufacturers, and various banks for lumbermen, grocers, importers, miners, wheat growers, reapers, millers, and whalers.[33] The banks financed these businesses through loans or the purchase of bonds, but did not engage in the business of the borrowers.

Private Banks, Savings Banks, and Trust Companies

State institutions that combined banking powers with broader activities developed outside of the commercial banking structure in the post-Civil War period.[34]

Private banks were unincorporated banks that accepted deposits but, unlike commercial banks, were free to pursue any activity because they did not issue notes as a form of currency.[35] Most of the private banks were small institutions that opened in localities that could not support a bank with the minimum capital required by law and confined their activities to normal banking operations. Although they were referred to as banks, many states prohibited them from using the name "bank".[36]

A small but significant number of private banks, particularly in the larger cities, combined banking activities with mercantile, real estate, and securities investment, brokerage, and underwriting operations.[37] These private bankers generally accepted deposits only from their corporate clients, friends, and employees, and rarely from the general public, and dealt in bankers' acceptances, commercial paper, letters of credit, and foreign exchange. Among their ranks were names such as J.P. Morgan & Co., Kuhn, Loeb & Co., Goldman, Sachs, J. & W. Seligman, Lehman Brothers, Kidder, Peabody, and Brown Brothers & Co. These private banks became the investment bankers that dominated the investment banking business in the early 20th Century. Their deposit taking activities were terminated with enactment of the Glass-Steagall Act in 1933.[38]

Savings banks also developed in the 19th Century, primarily as home lenders in the New England states. These banks accepted savings deposits but, unlike commercial banks, generally did not accept demand deposits or make commercial loans. Their activities were less restricted than commercial banks, and some of these banks made significant stock investments in nonbanking companies. A spate of savings bank failures following the panic of 1873 led to more con-

servative practices, however. In addition, the mutual form of many savings banks limited the opportunities for private gain. These banks thus did not significantly depart from the separation of banking and commerce principle.[39]

Trust companies expanded their business beyond fiduciary activities in the latter part of the 19th Century. It was not uncommon for commercial banks to organize as trust companies in order to acquire trust powers otherwise denied to them as well as to take advantage of less restrictive regulation.[40] Trust companies frequently were organized under the general business law rather than the banking law and were free to accept deposits and engage in any business activity, although most confined their activities to the banking and trust business.[41]

By the early 20th Century, a significant number of trust companies were active in the securities business. Many of them became affiliated with large investment houses or, like the large private banks, became investment bankers themselves. Trust company affiliates provided a vehicle for commercial banks and life insurance companies to engage indirectly in securities activities prohibited to them. The securities activities of these companies eventually were prohibited in the Glass-Steagall Act in 1933.[42]

III. The National Banking System

The policy of separating banking and commerce was embodied in the national banking system established in 1864. The National Bank Act of 1864 reflected the limited concept of banking that confined banks to issuing currency, accepting deposits, and making short-term commercial loans. National banks were limited to exercising

> all such incidental powers as shall be necessary to carry on the business of banking by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; by obtaining, issuing, and circulating notes according to the provisions of this act. . . .[43]

This language has remained in the National Bank Act essentially unchanged since its original enactment.

The courts interpreted the National Bank Act strictly to allow national banks to exercise only those powers expressly conferred or those incidental to their express powers.[44] The scope of national bank powers was tested in several early cases involving attempts by national banks to engage in broad commercial activities. Generally, the courts refused to allow national banks to place depositors' funds at risk by engaging in unauthorized nonbanking activities and allowed the banks to raise the defense of *ultra vires* in order to escape liability for their involvement in unauthorized activities.

In *First National Bank v. Converse*, 200 U.S. 425 (1906), a national bank participated with creditors of a failed manufacturing company in organizing a new corporation to assume the business of the failed company. The U.S. Supreme Court ruled that a national bank had no power to engage in or promote a purely speculative business.

In *Gress v. Village of Ft. Loramie*, 125 N.E. 112 (Ohio 1919), the court ruled that it would be *ultra vires* for a bank to operate a railway. In *Cooper v. Hill*, 94 F. 582 (Col. 1899), it was held *ultra vires* for a national bank to carry on an ordinary mining, manufacturing, or trading business, or a speculative venture such as prospecting for ore. Similarly, in *First National Bank v. Stokes*, 203 S.W. 1026 (Ark. 1918), it was held *ultra vires* for a national bank to engage in buying and selling cattle.

Like state banks, national banks were expressly prohibited from owning real estate except for bank premises and real estate acquired through foreclosures and debts previously contracted.[45] Unlike state banks, which could make real estate loans subject to certain restrictions, national banks were barred from making loans secured by real estate.[46] The purpose of the restrictions on national bank real estate powers was stated to be

> threefold: . . . to keep the capital of the banks flowing in the daily channels of commerce; to deter them from embarking in hazardous real estate speculations; and to prevent the accumulation of large masses of such property in their hands, to be held, as it were in mortmain.[47]

National banks were not authorized to engage in securities activities other than investment in federal and state government securities, although they could make call loans repayable on demand with stock as collateral.[48] In this regard, the national banking system followed the traditional English concept:

> In its early history, the American banking system, at least in theory, held to the traditional English view—*i.e.*, that banks which accepted deposits from the public should not engage in investment banking. During the latter half of the 19th Century, the national banking system generally followed, albeit imperfectly, the English practice of separating commercial and investment banking functions.[49]

A divergence from a strict separation began when the courts interpreted the clause "by discounting and

negotiating promissory notes . . . and other evidences of debt" in the National Bank Act to give national banks implied power to invest in state, municipal, and corporate bonds.[50] Once national banks could invest in municipal and corporate securities, it was difficult to distinguish underwriting and the Comptroller allowed the banks to underwrite bonds to the extent they were permitted to invest in them.[51] Courts held it beyond the power of a national bank, however, to purchase or underwrite equity stock of corporations or other national banks,[52] or to engage in securities brokerage activities.[53]

The real bills doctrine continued to be the best "rule of thumb" for banking safety and soundness. Comptroller of the Currency Knox in 1875 stated, "a bank is in good condition just in proportion as its business is conducted upon short credits, with its assets so held as to be available on brief notice." Comptroller Trenholm in his 1888 annual report stated that national banks constituted "a body of bankers exclusively devoted to the collection, the safekeeping and employment in temporary loans of the private capital of the country."[54]

Among the regulations applied to national banks by the National Bank Act was a limit on loans to a single borrower of ten percent of capital.[55] This regulation, which provided a model for similar provisions in state laws, reflected the dangers inherent in the combination of banking and commerce through control of banks by individuals and corporations engaged in nonbanking businesses. The National Monetary Commission remarked on this aspect of the lending limits:

> [I]n many banks a controlling interest is held by a person, firm, or corporation that is actively engaged in other business enterprises. . . . One consequence of the close identification of interests thus brought about between banking and other business enterprises is the probability that loans will be made directly or indirectly to some one borrower to an amount larger than a proper distribution of risks would justify.[56]

IV. Securities Affiliates and the Glass-Steagall Act

A major departure from the separation of commercial banking and investment banking occurred with the development of securities affiliates in the early 20th Century. National banks formed securities affiliates as vehicles to avoid restrictions on their direct securities activities, particularly underwriting. Peach states, "[t]he simple effect of allowing national banks to organize affiliates . . . was to defeat the purpose of the law in limiting their powers."[57] By 1930, commercial banks and their affiliates participated in the distribution of 61 percent of all bond issues and had become "the dominant force in the investment banking field."[58]

Congressional concern over the commingling of commercial banking and investment banking was first aroused in 1912 by the Pujo Committee hearings focusing on the concentration of money and credit in the so-called "money trusts." The Pujo Committee recommended that national banks be prohibited from underwriting corporate securities.[59]

No Congressional action was taken to limit the securities activities of banks or their affiliates until after the collapse of the stock market in 1929 and the wave of subsequent bank failures in the early 1930s. Congressional hearings on the securities practices of banks disclosed that bank affiliates had underwritten and sold unsound and speculative securities, published deliberately misleading prospectuses, manipulated the price of particular securities, misappropriated corporate opportunities to bank officers, engaged in insider lending practices and unsound transactions with affiliates.[60] Evidence also pointed to cases where banks had made unsound loans to assist their affiliates and to protect the securities underwritten by the affiliates. Confusion by the public as to whether they were dealing with a bank or its securities affiliate and loss of confidence in the banking system were also cited as adverse consequences of the securities affiliate system.

These abuses led to the Glass-Steagall Act prohibiting banks from underwriting or purchasing securities for their own account, with exceptions for government securities and certain investment securities, and banning affiliations and interlocks between member banks and companies primarily or principally engaged in securities activities.[61]

V. Bank Holding Companies

Bank holding companies developed as significant institutions in the banking industry only relatively recently in our history. Group banking, as bank holding companies originally were known, was dependent upon the enactment of state laws authorizing corporations to hold stocks of other companies. The Adam Hannah Company, organized in 1900 in Minnesota, was the first company established to hold stock in banks.[62] Except to the extent holding companies were used to establish securities affiliates of national banks, however, group banking did not become significant until the 1920s.[63]

The early regulatory and Congressional concern over bank holding companies seems not to have been so much with respect to their nonbanking activities—

with the obvious exception of securities activities—as with potential abuses of their subsidiary banks and the opportunities for unlimited geographic expansion and concentration of banking resources.

Beginning with its 1927 Annual Report to Congress, the Federal Reserve Board expressed concern about the use of holding companies to evade state branching laws and the lack of supervision or regular examination by state or federal authorities over such companies.[64] In 1930, a staff sudy by the Federal Reserve Committee on Branch, Group, and Chain Banking concluded that "[t]he chief weakness of the holding company device as an instrument for strengthening the banking structure lies in its manipulative possibilities, and the difficulties of adequate supervision."[65] The study did not indicate bank holding company involvement in nonbanking activities to any substantial extent.

Significant combinations of banking and industrial or manufacturing sectors generally did not occur until later in the 20th Century.[66] Concerns over the development of a conglomerate system thus were not voiced until later and—other than with respect to securities activities—the nonbanking activities of bank holding companies were not restricted until the 1956 Bank Holding Company Act and its 1970 Amendments.[67]

Bank holding companies as a percentage of total commercial banking resources was somewhat modest prior to enactment of the Bank Holding Company Act. In 1955, information provided by the Federal Reserve Board to the House Banking and Currency Committee reported the existence of 114 bank holding companies controlling 452 banks, representing 5.87 of total commercial bank deposits.[68] Forty-six of these companies were subject to regulation under the Bank Holding Company Act of 1956;[69] only five were affected by the divestiture requirements.[70]

Despite the relatively modest growth of bank holding companies,[71] the potential of the holding company device to undermine the historic separation of banking and commerce and result in a concentrated banking system was of such concern to the Congress that the restrictions of the Bank Holding Company Act were deemed necessary.

Bank Holding Company Act

The House Banking and Currency Committee Report on the Bank Holding Company Act of 1956[72] reported that "[e]vidence developed during the hearings has convinced your committee that bank holding companies are not in accord with the very precepts upon which our banking system rests."[73] That Congress intended the Bank Holding Company Act to embody the separation doctrine is clearly stated in the Senate Committee report in 1955:

> In general, the philosophy of this bill is that bank holding companies ought to confine their activities to the management and control of banks and that such activities should be conducted in a manner consistent with the public interest. Your committee believes that bank holding companies ought not to manage or control nonbanking assets having no close relationship to banking.[74]

The Committee report recognized as a basis for this philosophy the quasi-public role of banks as the custodians of the bulk of liquid savings:

> The combination under single control of both banking and nonbanking enterprises [permits] departure from the principle that banking institutions should not engage in business wholly unrelated to banking. Such a combination involves the lending of depositors' money, whereas other types of business enterprise, not connected with banking, do not involve this element of trusteeship.[75]

The Act and its 1970 Amendments aimed at four specific adverse effects that the Congress believed were likely to arise when banking and nonbanking interests are combined: undue concentration of resources, conflicts of interest, unfair competition, and exposure of banks to increased risks, and unsafe and unsound banking practices.

Concentration of Resources

Concentration of resources resulting from corporate ownership of banks was a foremost concern expressed in the Senate Committee report in 1955:

> [B]ecause of the importance of the banking system to the national economy, adequate safeguards should be provided against undue concentration of control of banking activities. The dangers accompanying monopoly in this field are particularly undesirable in view of the significant part played by banking in our present national economy. The extensive use of bank checking accounts in modern commerce exerts an influence on the value of money, which the Constitution empowers the Congress to regulate. Moreover, banking activities are carried on to a large extent by the use of depositors' funds rather than by the use of equity capital subscribed by bank shareholders.[76]

The danger of concentration of resources was again articulated by former President Nixon in 1969 when he submitted legislation to Congress to extend the Bank Holding Company Act to one-bank holding companies:

Left unchecked, the trend toward the combining of banking and business could lead to the formation of a relatively small number of power centers dominating the American economy. This must not be permitted to happen; it would be bad for banking, bad for business, and bad for borrowers and consumers.

The strength of our economic system is rooted in diversity and free competition; the strength of our banking system depends largely on its independence. Banking must not dominate commerce or be dominated by it.[77]

Conflicts of Interest

Another goal of the Act was to avoid potential conflicts of interest that undermine the role of banks as impartial granters of credit. The House Committee Report in 1955 expressed concern about preferential treatment of a bank's affiliates:

If banks were permitted to own nonbanking businesses they would be compelled in many instances to extend credit to such businesses to the detriment of other competitive businesses in the community and possibly also to a degree which would be unsound from a banking viewpoint. A bank should always be at arms' length with its borrowers and such a position could not be maintained were banks permitted to own nonbanking businesses and make credit available to them.[78]

Unfair Competition

Congress also sought to guard against unfair competition that results when the recipients of preferential credit treatment compete with companies that do not have access to captive banking resources. The potential for unfair competition to arise from the commingling of banking and commerce was cited by the Senate Committee in its report on the 1970 Amendments:

If a holding company combines a bank with a typical business firm, there is a strong possibility that the bank's credit will be more readily available to the customers of the affiliated business than to customers of other businesses not so affiliated. Since credit has become increasingly essential to merchandising, the business firm that can offer an assured line of credit to finance its sales has a very real competitive advantage over one that cannot. In addition to favoring the business firm's customers, the bank might deny credit to competing firms or grant credit to other borrowers only on condition that they agree to do business with the affiliated firm. This is why . . . if we allow the line between banking and commerce to be eased, we run the risk of cartelizing our economy. . . . Just as we have seen the country's largest banks join the new wave of one-bank try's business firms clustering about banks in holding company systems in the belief that such affiliation would be advantageous, or perhaps even necessary to their survival.[79]

Increased Risks and Unsafe and Unsound Practices

The Bank Holding Company Act also reflects a Congressional concern to avoid exposure of banks to the risks of unregulated activities of their parent companies and affiliates and the potential for unsafe and unsound banking practices.

The House Committee Report in 1955 cited several instances where the condition of subsidiary banks had been adversely affected as a result of the activities or practices of their parents and affiliates. The Committee cited cases in which banks had lent heavily to their officers to finance speculation in the stock of their parent holding companies and to the parent companies to finance speculative dealings, and had been compelled to pay unwarranted dividends in the face of operating losses to enable holding companies to maintain their dividend policies.[80] While acknowledging that the Banking Act of 1933 addressed some of these abuses, notably the section 23A limitations on transactions with affiliates, the Committee nevertheless concluded that Bank Holding Company Act regulation was necessary.

The Senate Banking Committee Report in 1955 referred to "the danger to a bank within a bank holding company controlling nonbanking assets, should the company unduly favor its nonbanking operations by requiring the bank's customers to make use of such nonbanking enterprises as a condition to doing business with the bank."[81] The Committee similarly noted that

While it is true that banks within a bank holding company system are subject to Federal or State supervisory authority (and sometimes both), fear has been expressed that, improperly but within the present law, a bank holding company may take undue advantage of one or more banks in its system. This it might do by discounting commercial paper at the bank with a resulting profit to the bank holding company itself but at an unwarranted risk to the bank and its shareholders.[82]

Conclusion

The separation of banking and commerce has been a prevailing regulatory principle applied to banks since colonial times. Early federal and state bank charters granted only limited banking powers and expressly

in goods and merchandise. This policy was continued throughout the 19th Century and into the 20th Century. The separation policy appears to have been dictated by the demand nature of bank obligations, which required a high degree of liquidity of bank investments, as well as by the limited concept of banks as public utilities whose proper role was confined principally to accepting deposits, providing a system of monetary exchange, and making loans.

There are notable periods in our history when the separation of banking and commerce was not as strictly enforced as during other periods. State governments have not applied the policy as strictly as the federal government. Early instances of commingling of banking and commerce tended to occur outside of the banking structure through trust companies and unregulated private banks owned by individuals—the forerunners of today's investment banks—or public improvement companies such as water, canal, and railroad companies that issued notes to raise capital. The experience with these ventures tended to discourage the notion that banking could be safely combined with other business activities. When banks have diverged significantly into nonbanking areas, Congress and the states have reaffirmed the separation of banking and commerce by imposing specific statutory limitations.

Footnotes

1. Miller, *Banking Theories in the United States Before 1960*, 11-14 (1927); Hammond, *Banks and Politics in America from the Revolution to the Civil War* 69 (1957).

2. Hammond, 594.

3. Smith, *An Inquiry Into The Nature and Causes of The Wealth of Nations* (Cannan ed.) 287 (5th ed. 1930); Luckett, *Money and Banking* (3d ed.) 190-91 (1984).

4. Barnett, *State Banking Before the Civil War*, S. Doc. No. 581, 61st Cong., 2d Sess. 183-84, National Monetary Commission (1911).

5. Luckett, 191; Krooss and Blyn, *A History of Financial Intermediaries* 48-51 (1971).

6. *Id.*

7. Shull, "The Separation of Banking and Commerce: Origin, Development, and Implications for Antitrust," *Antitrust Bulletin* 260 (Spring 1983); Hammond, 128-30.

8. *Id.* 259-62. The Act establishing the Bank of England stated the purpose of the prohibition to be "that their Majesties subjects may not be oppressed by the said corporation by their monopolizing or engrossing any sort of goods, wares or merchandise." *Id.* 260.

9. Hammond, 63; Senate Committee on Banking and Currency, "Proceedings in Congress on Bank of North America," *Federal Banking Laws and Reports 1780-1912*, 1-6 (March 15, 1963); Lewis, *History of the Bank of North America* 73 (1882).

10. Report of Secretary of Treasury (Alexander Hamilton) on a National Bank, Dec. 14, 1790, reprinted in *Federal Banking Laws and Reports* 7.

11. Act of February 25, 1791, §7(X), 1 Statutes at Large 191, 1st Cong., 1st Sess. (1791), reprinted in *Federal Banking Laws and Reports* 66, 70. Treble damages were provided for violations of this stricture. *Id.* §8, 71.

12. *Id.* §7(VIII), 69.

13. Report of the Secretary of the Treasury on the Subject of a National Bank (1809), reprinted in Clarke and Hall, *Legislative and Documentary History of the Bank of the United States* 116-120 (1832).

14. Hammond, 142-144.

15. Hammond states, "Legislators hesitated about the kind of conditions under which banking should be permitted but never about the propriety and need of imposing conditions. . . . The issue was between prohibition and state control, with no thought of free enterprise. . . . The impression was general that the exercise of the banking function without express authorization from the sovereign power was improper, if not impracticable." Hammond, 185-86.

16. In early American history, all corporations were held to be of a public character. Redlich, *The Molding of American Banking*, vol. II 60 (1951).

17. Hammond, 27-28; Barnett, George E., *State Banking Before the Civil War*, 143, 147.

18. Barnett, George E., *State Banks and Trust Companies Since the Passage of the National Bank Act* S. Doc. No. 659, 61st Cong., 2d Sess. 33-34, National Monetary Commission (1911).

19. Willis and Bogen, *Investment Banking* 156 (1929).

20. "An act to incorporate the subscribers of the Bank of the United States" §§11-12, reprinted in Krooss and Samuelson, *Documentary History of Banking and Currency in the United States* 460 (1969).

21. Symons, "The Business of Banking: A Historical Perspective," 51 *Geo. Wash. U. L. Rev.* 688 (1983). An exception to this general proscription on nonbanking activities was made for bank investments in Pennsylvania internal improvement companies. *Id.*

22. Hammond, 593. In a few cases, state legislatures granted banking powers to companies whose stated purpose was other than banking, such as the Manhattan Company, chartered by the New York legislature as a water company, and the Wisconsin Marine and Fire Insurance Company, referred to as an "illegal bank." Hammond, 153-55, 171; Golembe, *State Banks and the Economic Development of the West 1830-44* 29-30 (1978); Reubens, "Burr, Hamilton and the Manhattan Company", 72 *Political Science Quarterly*, 578 (1957).

23. Willis and Bogen, 165.

24. James, *The Growth of Chicago Banks* 13 (1938); Green, *Finance and Economic Development in the Old South 1804-1861* 113-14 (1972); Smith, *Economic Aspects of the Second Bank of the United States* 60 (1953). *State Banking Before the Civil War*, 51-53. For example, New Jersey chartered the Morris Canal and Banking Company in 1824; Connecticut in 1832 chartered the Quinebaug Bank as an adjunct to the Boston, Norwich and New London Railroad. In 1835, Michigan conferred banking powers on four railroad companies. The first railroad in Texas was the Texas Railroad, Navigation and Banking Company. Louisiana chartered the New Orleans Gaslight and Banking Company in 1829, the Atchafalaya Railroad and Banking Company in 1834, and in 1836 granted banking powers to the Pontchartrain Railroad. Between 1835 and 1837, South Carolina, Georgia, Mississippi, and Louisiana chartered sixteen combined banking and railroad companies. Klebaner, *Commercial Banking in the United States: A History* 32 (1974).

25. Smith, 60; James, 117-160; Symons & White, *Banking Law* 9 (1984).

26. Reed, "Boom or Bust: Economic Outlook of the 1830's", *Louisiana History*, vol. IV 49 (1963), cited in Green, 34; James, 143, 160; Carosso, *Investment Banking* 3 (1970).

27. *State Banking Before the Civil War*, 52-53.

28. Symons, 689.

29. *Id.*

30. Klebaner, 48.

31. Willis and Bogen, 166-67. Symons and White give a similar assessment: "It was determined that banks should be provided powers that enabled them to assist in the functioning of the economy and in serving enterprise, but stopped them from becoming so involved in enterprise that they could be destroyed by it." Symons and White, 11.

32. *State Banks and Trust Companies*, 12. See generally, Welldon (ed.), *Digest of State Banking Statutes*, National Monetary Commission (1910).

33. Trescott, *Financing American Enterprise* 36 (1963).

34. In 1889, there were 2,097 state banks, 4,215 private banks, and 63 trust companies. By 1900, there were 4,405 state banks, 5,287 private banks, and 492 trust companies; and by 1909, there were 11,292 state banks, 4,407 private banks, and 1,079 trust companies. *State Banks and Trust Companies*, 248, 250, 260.

35. Banking was synonymous with note issue until the mid-19th Century. Redlich, 60-84, 178. Note issuance was considered the most important banking function because it involved the circulation of money. Symons, 9. Deposits did not become significant as a form of money until after the National Bank Act of 1864. Redlich, 66, 175.

36. Trescott, 34-35; Klebaner, 58; Krooss and Blyn, 33-34; *State Banks and Trust Companies*, 213.

37. According to Carosso, in 1902 there were 675 private bankers engaged in investment banking activities. Carosso, *Investment Banking* (1970).

38. *Id.* 85, 89.

39. Krooss and Blyn, 81, 113, 128; *State Banks and Trust Companies*, 10.

40. National banks were not granted trust powers until the Federal Reserve Act of 1913. In addition, reserve requirements for trust companies were less restrictive than for state and national banks. See generally, *State Banks and Trust Companies*, 12-22, 234-40; *Digest of State Banking Statutes*; Krooss and Blyn, 102-103.

41. Despite their liberal charters, there is no evidence suggesting that trust companies were extensively engaged in nonbanking activities other than securities activities and some real estate development and management. Carosso states that trust companies "accepted deposits; made loans; participated extensively in reorganizing railroads and consolidating industrial corporations; acted as trustees, underwriters, and distributors of new securities; and served as the depositories of stocks, bonds, and titles. Frequently they acted as attorneys for individuals and companies. Corporations regularly appointed them as registrars or fiscal and transfer agents. Very often they also owned and managed real estate." Carosso, 98.

42. Perkins, "The Divorce of Commercial and Investment Banking: A History," 88 *Banking Law J.* 483, 487-89 (1971); Treasury Department, *Public Policy Aspects of Bank Securities Activities*, Appendix 3 (1975).

43. Act of June 3, 1864, 13 Stat. 99, §8, reprinted in *Federal Banking Laws and Reports*, 351.

44. See *Weckler v. First National Bank*, 42 Md. 581 (1875); *Mathews v. Skinker*, 62 Mo. 329 (1876); *Logan County Nat'l Bank v. Townsend*, 139 U.S. 67 (1890); and other cases cited in Peach, 39, n.2.

45. Act of June 3, 1864, §28, reprinted in *Federal Banking Laws and Reports*, 359.

46. National banks were not permitted to make loans on real estate until 1913. One-year mortgages on nonfarm property were permitted in 1916; five-year mortgages in 1927; 25-year mortgages in 1964; and 30-year mortgages in 1970.

47. *National Bank v. Matthews*, 98 U.S. 621 (1878).

48. Peach, *The Securities Affiliates of National Banks*, 43–44 (1941); *Lyons v. Lyons Nat'l Bank*, 19 Blatchford 279 (N.Y. 1881).

49. Department of Treasury, *Public Policy Aspects of Bank Securities Activities*, Appendix 2 (1975).

50. *First National Bank v. Bennington*, 16 Blatchford 53 (N.Y. 1879); *Newport National Bank v. Board of Education of Newport*, 70 S.W. 186 (Ky. 1902). The Comptroller of the Currency concurred in this interpretation. Report of the Comptroller of the Currency 8-9 (1909), cited in *Public Policy Aspects of Bank Securities Activities*, Appendix 4.

51. Redlich, 389.

52. See *First Nat'l Bank of Charlotte v. Nat'l Exchange Bank of Baltimore*, 92 U.S. 122, 128 (1875); *Barron v. McKinnon*, 196 F. 933 (Mass. 1912); *Chapman v. First Nat'l Bank*, 285 S. W. 1118 (Tex. 1926); *Cassat v. First Nat'l Bank*, 156 A. 278 (1933); *First Nat'l Bank v. Hawkins*, 174 U.S. 364 (1899); *Shaw v. Nat'l German-American Bank*, 199 U.S. 603, *aff'g* 132 F. 658 (1905); *Metropolitan Trust Co. of New York v. McKinnon*, 172 F. 486 (1909).

53. *Weckler v. First National Bank*, 42 Md. 581 (1875); *Smith v. Philadelphia Nat'l Bank*, 1. Walk. 318 Pa. (1879); *Farmers' and Merchants' Nat'l Bank v. Smith*, 77 F. 129 (1896); *First Nat'l Bank v. Hock*, 89 Penn. St. 324 (1879); and other cases cited in Peach, 46.

54. Redlich, 175; Klebaner, 75, 79.

55. Act of June 3, 1864, §29, reprinted in *Federal Banking Laws and Reports* 359–60.

56. *State Banks and Trust Companies*, 86.

57. Peach, 52. The first security affiliate was established in 1908. The number of banks having securities affiliates increased to 18 in 1922, 62 in 1926, and 180 in 1930. *Id.* 83. In addition, many banks engaged directly in the securities business through their bond departments.

58. Perkins, 495; Peach, 87–93.

59. *Report of the Committee to Investigate the Concentration of Money and Credit*, 62nd Cong., 3d Sess. 151–52, 170 (1913).

60. *Stock Exchange Practices: Hearings Before a Subcommittee of the Senate Committee on Banking and Currency*, 73rd Cong., 2d Sess. (1933).

61. 12 U.S.C. 24 (Seventh), 78, 377, 378.

62. Cartinhour, *Branch, Group, and Chain Banking* 90 (1931).

63. Savage, "A History of the Bank Holding Company Movement, 1900–78," *The Bank Holding Company Movement to 1978: A Compendium* 25 (1978). The legality of bank holding companies was somewhat in doubt prior to 1933. In 1911, the Solicitor General of the United States issued an opinion declaring bank holding companies unlawful. No action was taken to prevent the formation of bank holding companies, however. Opinion of the Solicitor General, Nov. 6, 1911, reprinted in *Stock Exchange Practices*, 2030; see Peach, 144–48.

64. Board of Governors of the Federal Reserve System, *Annual Report* 32 (1927).

65. Board of Governors of the Federal Reserve System, *Branch, Group, and Chain Banking*, Vol. 1, 54 (1930).

66. By 1968, one bank holding companies were engaged in a wide variety of nonbanking activities, including coal mining, farming, electronics, manufacturing, railroads, telephone communications, motion pictures, hospitals, and window cleaning. "The Growth of Unregulated Bank Holding Companies—Problems and Perspectives," House Committee on Banking and Currency (Staff Report) (1969). Most of these companies were formed after 1965. *Congressional Record* 9778–9803 (Oct. 21, 1969) (data compiled for Cong. Patman).

67. The Banking Act of 1933 required corporate owners of member banks to obtain a voting permit from the Board before voting their bank stock and to submit to supervision and examination by the Federal Reserve Board but did not restrict their nonbanking activities. Banking Act of 1933, ch. 89, §19, 48 Stat. 162.

68. H. Rep. No. 609, 84th Cong., 1st Sess. 8 (1955).

69. S. Rep. No. 1095, 84th Cong., 1st Sess. 2 (1955).

70. Savage, 49.

71. Bank holding companies did not grow significantly during the decade following enactment of the 1956 Act. From 1966 through 1970, however, the number of multibank holding companies doubled. Savage, 54. The number of one bank holding companies rose from 117 in 1956 to 550 in 1965 and to approximately 1400 by 1970. Savage, 56. The rapid growth of one bank holding companies has been attributed to, among other things, the usefulness of holding companies in allowing diversification into activities prohibited to banks. *Id.* 57.

72. 12 U.S.C. 1841 *et seq.*

73. H. Rep. No. 609, 84th Cong., 1st Sess. 1–2 (1955).

74. S. Rep. No. 1095, 84th Cong., 1st Sess. 1 (1955).

75. *Id.* 2 (citing Federal Reserve Chairman Martin). The House Banking Committee also articulated the historical separation doctrine. H. Rep. No. 609, 7.

76. S. Rep. No. 1095, 1.

77. Statement of President Richard Nixon of March 24, 1969, reprinted in H. Rep. No. 1747, 91st Cong., 2d Sess. 11 (1970).

78. H. Rep. No. 609, 7 (1955).

79. S. Rep. No. 1084, 91st Cong., 2d Sess. 3 (1970) (quoting Federal Reserve Chairman Martin).

80. H. Rep. No. 609, 4–5 (1955).

81. S. Rep. No. 1095, 5.

82. *Id.* 4.

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The Federal Reserve Board's Oversight of the Domestic and International Activities of U.S. Banks and Bank Holding Companies

Introduction

In carrying out its regulatory and supervisory responsibilities for bank holding companies, the Federal Reserve has been guided over time by the principal purposes embodied in the Bank Holding Company Act. These were to prevent undue concentration of economic resources, conflicts of interest, and unfair competition and to preserve the soundness of banks by limiting their exposure to undue risks from the unregulated activities of affiliates. In order to carry out these purposes, the Act confined the activities of bank holding companies to those of banking and managing or controlling banks and a limited range of other related activities.

The legislation passed in 1956 defined bank holding companies as companies that owned or controlled two or more banks and established a relatively narrow test for determining the nonbank activities in which holding companies could engage. The 1970 Amendments brought companies that owned just one bank under the definition of bank holding companies and established a more flexible standard for defining permissible nonbank activities. While these amendments gave the Board broader authority to approve nonbank activities, they continued the fundamental principle of the separation of banking and commerce.

The Bank Holding Company Act as amended provides that bank holding companies may only engage in nonbanking activities that are so closely related to banking or managing or controlling banks as to be considered a proper incident to banking. In determining whether a particular activity is a proper incident to banking, the Board must consider whether its performance by a holding company may reasonably be expected to produce benefits to the public, such as greater convenience, increased competition or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. Consequently, consistent with the purposes of the Bank Holding Company Act, a major responsibility of the Federal Reserve has been to define, and then supervise and regulate, the nonbanking activities in which bank holding companies may engage.

More specifically, as the agency charged with administering the Bank Holding Company Act, the Federal Reserve conducts the following activities:

1. Establishes, by regulation or order, the nonbank activities in which bank holding companies may engage;
2. Establishes procedures for bank holding companies to apply for approval to acquire banks and nonbank firms and acts upon such applications;
3. Supervises bank holding companies through on-site inspections, off-premise surveillance, and the issuance, when appropriate, of supervisory enforcement actions; and
4. Promulgates supervisory policies and guidelines designed to limit undue risk-taking, protect the financial health of subsidiary banks, and provide guidance on supervisory concerns to the banking industry.

In carrying out these responsibilities, a major objective of the Federal Reserve is to ensure that bank holding companies serve as a source of financial and managerial strength to their subsidiary banks.

The Federal Reserve's domestic supervisory and regulatory activities should be considered in the context of two significant trends within the holding company movement. First, as illustrated in Attachment I-A, the number of bank holding companies and the percentage of commercial bank assets controlled by such companies have increased significantly since the passage of the 1970 Amendments. By bringing companies that owned just one bank under the statutory definition of bank holding companies, these Amendments increased the number of such companies supervised by the Federal Reserve from 121 in 1970 to 1,567 in 1971. In 1975, there were 1,821 bank holding companies controlling 69 percent of all commercial bank assets. By 1985, the number of companies had increased to 6,453, and such companies controlled over 90 percent of all commercial bank assets. As shown in Attachment I-B, while the overwhelming majority of bank holding companies have consolidated assets of less than $150 million, over 80 percent of aggregate holding company assets are held by large regional and

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multinational companies with consolidated assets in excess of $1 billion.

A second important development is the increase in the variety and volume of nonbank activities in which bank holding companies have been permitted to engage (Attachments I-C and I-D). The process of reviewing and approving new activities for bank holding companies, as discussed below, has been a dynamic one that has responded to changes and developments within the banking system. The volume of permissible nonbank assets of the larger bank holding companies (for this purpose defined as those with consolidated assets over $150 million) has increased from approximately $26 billion in 1976, representing about 3 percent of the consolidated assets of such holding companies, to approximately $132 billion at year end 1984. While the relative size and importance of nonbanking activities varies significantly from company to company, in the aggregate, nonbanking assets of holding companies still represent a modest percentage of aggregate holding company assets. Thus, at year end 1984, nonbank assets constituted approximately 6.4 percent of the aggregate consolidated assets of the larger bank holding companies.

With respect to foreign activities of U.S. banking organizations, the Board administers several different statutes, including provisions of the Federal Reserve Act dealing with establishment of foreign branches and the chartering of Edge corporations, that is, specialized banking vehicles that engage only in foreign financing, investment and related activities. The Bank Holding Company Act also provides for direct investment in foreign companies by U.S. bank holding companies, and governs the U.S. nonbanking activities of foreign banks.

These statutes and the Board's implementing regulations and policies are described in the second part of this study. These laws generally recognize that foreign economic and regulatory structures may differ from that of the United States and give the Board discretion to approve financial and related activities abroad that permit U.S. banks to remain competitive with foreign banks and enable them to serve better the interests of U. S. trade and commerce. The statutes, however, do not permit such activities to be conducted in the United States. Despite the broader range of permissible activities, virtually all overseas activities of U.S. banking organizations are of a banking or financial nature. The second half of this study also gives data on the extent to which U.S. banks operate abroad and includes a description of the statutes and regulations governing foreign bank activities in the United States.

I. Domestic Operations of Bank Holding Companies

Establishment of Permissible Bank Holding Company Activities

Closely Related and Proper Incident Tests

Section 4(c)(8) of the Bank Holding Company Act authorizes bank holding companies to engage directly or through a subsidiary in activities that the Federal Reserve Board determines are closely related to banking or managing or controlling banks. Over time, the Board and the courts have established the following guidelines for determining whether a nonbanking activity is closely related to banking:[1]

1. whether banks have generally provided the service;
2. whether banks generally provide services that are operationally or functionally so similar to the proposed service as to equip them particularly well to provide the proposed service; or
3. whether banks generally provide services that are so integrally related to the proposed service as to require their provision in specialized form.

In addition, the Board may consider other factors in deciding what activities are closely related to banking.[2] Once a positive determination has been made that a proposed activity is "closely related to banking or managing or controlling banks," the Board must also find that the activity is a "proper incident" to banking before the activity is deemed permissible for bank holding companies. As already noted, in making this judgment, the Board must determine that performance of the activity by a bank holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. The guidelines and procedures for approving new activities, as well as the list of permissible activities, are contained in the Board's Regulation Y which establishes the regulatory framework for the Federal Reserve's administration of the Bank Holding Company Act.

Approved Activities

The list of nonbanking activities approved by regulation as generally permissible for bank holding companies has expanded over time and now contains eighteen items. (See Attachment I-D.) Some activities are limited in scope (e.g., management consulting to depository institutions or underwriting certain credit-

related life and disability insurance), while others are more broadly written and hold the potential for a wider scope of operation (e.g., data processing). Eight of the activities were approved as part of the original list in 1971, and three more were added by the mid-1970s. Included in these early activities were such credit-related functions as consumer and commercial finance, mortgage banking and leasing, activities in which banks themselves have traditionally engaged. An important reason for conducting these activities at the holding company level was to avoid some of the geographic and operating restrictions that apply to commercial banks, such as limitations on branching.

In light of the recession in the mid 1970s and the Board's concern over the condition of some banking organizations, the Board did not approve any new activities by regulation in the period 1975 through 1977. This hiatus gave banking organizations time to consolidate the nonbank expansion undertaken in the early 1970s and to address weaknesses resulting from the steep recession and problems in the real estate sector during this period.

Over the past seven years, seven new items have been added to the list of permissible activities by regulation. Most of these have been of a non-credit granting nature, affording banking organizations the latitude to earn additional fee income without involving significant credit risk. The emphasis has been on the role of the bank holding company as a broker of financial services, responding to evolving structural changes and practices in financial markets. For example, arranging commercial real estate equity financing, approved in 1984, was an outgrowth of the increased emphasis by permanent investors on the use of equities to finance real estate projects, rather than long-term debt. Similarly, acting as a futures commission merchant in financial instruments, also approved in 1984, was unheard of fifteen years ago, but has been adopted in response to new developments in the trading markets for these instruments.[3]

Apart from amending the list of permissible activities contained in Regulation Y, the Board has also permitted individual companies to engage in certain nonbanking activities on a case-by-case basis through company-specific Board orders. This procedure has been used when there is only limited interest on the part of bank holding companies to engage in the activity or when the Board is reluctant to designate the activity as generally permissible for all bank holding companies. (Also see Attachment I-D). Two-thirds of this class of activities was approved in the 1980s, reflecting innovation and expansion in the financial services sector. The bulk of these activities has not raised significant policy issues with the obvious exceptions of nonbank and other limited purpose banks and the limited number of thrift acquisition proposals. Most of the approvals via Board order have involved activities of special interest to individual bank holding companies or were designed to permit a company to complete an existing line of products and services.

In approving new activities by regulation or order, the Board has attempted to recognize and be responsive to changes and innovations in financial markets, consistent with the requirements of the Bank Holding Company Act. Thus, the range of activities conducted by bank holding companies has expanded over time as organizations have sought and received approval to offer new products and services.

In approving new activities, the Board has used its rulemaking authority to incorporate within its regulations appropriate limitations and restraints on the conduct of the activities. In doing so, the Board has sought to permit holding companies to engage in new nonbank activities while limiting the possibility of any adverse effects arising from the conduct of the activities. In this regard, the Board has most commonly sought to preclude conflicts of interest and undue risk taking. For example, the Board requires that financial institutions that are clients of bank holding company management consulting subsidiaries must, among other things, be provided with the names of all depository institutions that are affiliates of the consulting subsidiary. Similarly, in arranging commercial real estate equity financing, the bank holding company may not also provide financing to the investor for the same real estate project, nor may the holding company have an interest in managing, developing or syndicating the same project. Another example involves futures commission merchants. Futures commission merchants must have fully adequate capitalization and may not extend credit except in limited circumstances. Further, a futures commission merchant subsidiary may not become a clearing member of any exchange that would require its parent to also become a clearing member unless a waiver has been granted.

In addition to the activities already approved by regulation or order, the following nonbanking activities have been proposed by individual bank holding companies:

- Underwriting and dealing in certain securities
- Acting as issuer's agent in the placement of commercial paper
- Offering of investment advice in connection with securities brokerage activities
- Credit bureau and credit reporting activities

These currently pending proposals, particularly those involving certain securities-related activities, raise a number of important policy questions. In considering these proposals, the Board must take into account restrictions contained in the Glass-Steagall Act as well as the provisions of the Bank Holding Company Act

As discussed above, nonbanking activities of bank holding companies by law must be closely related to banking and must pass a net public benefits test. The only exceptions to this general rule are a limited number of instances, where Congress specifically exempted certain companies from the nonbanking prohibitions of the Bank Holding Company Act. In doing this, Congress stated that it did not believe that companies that acted in good faith under existing law should be subjected to extreme ex post facto consequences. In enacting the grandfather clause, Congress noted that such companies were not exempt from the registration requirements of Regulation Y or supervision by the Federal Reserve.

The 1970 Amendments to the Bank Holding Company Act provided certain bank holding companies with exemptions generally referred to as "permanent grandfather rights." These companies were granted specific exemptions for certain of their nonbanking activities provided that these activities were engaged in on or before June 30, 1968 and continuously conducted since that date. Presently, there are about 128 bank holding companies conducting nonbanking activities under the authority of the grandfather provisions. The aggregate consolidated assets of such companies represent about one percent of aggregate U.S. banking assets. The overwhelming majority of these companies are in fact engaged in financially related activities—for the most part general insurance; only a small number of companies are engaged in activities that would otherwise be prohibited under the Act. Even in these latter situations, the grandfathered activities represent a very small percentage of the holding companies' consolidated assets.

Congress also exempted a small number of closely held family corporations that owned a bank prior to June 30, 1968, as well as nonbanking businesses, and that were formed to facilitate joint family ownership and distribution of income. Thus, section 4(c)(ii) of the Bank Holding Company Act provides that such companies would be exempt from the nonbanking prohibitions so long as the companies remained under family control, which was defined as 85 percent owned by members of the same family or descendants. There are approximately 100 such companies that continue to be exempted from the nonbanking prohibitions of the Act. These companies, most of which control small banks located in the midwest, have total assets amounting to less than one-half of one percent of aggregate U.S. banking assets.

Denied Activities

Activities denied by the Board can be divided into four broad categories, each of which represents about a quarter of the activities denied over time (See Attachment I-E). These activities are insurance (mostly noncredit related), real estate, financial/securities services, and general business activities. The Board is precluded by law from expanding the insurance activities of holding companies, and, in this connection, recently declined to publish for comment the conduct of title insurance activities. Consistent with the Bank Holding Company Act, activities have been denied when they have been found not to be closely related to banking, such as owning a travel agency, or not to meet the proper incident test,such as acquiring a healthy savings and loan association. Regarding the proper incident test, a major concern has been the adverse effects stemming from potential conflicts of interest associated with a holding company's conduct of an activity. This was illustrated in 1985 when the Board refused to allow a large bank holding company to engage in the business of providing credit ratings on bonds and commercial paper. The reason for this decision was that the provision of such ratings by a major lending organization could involve pervasive conflicts of interest.

Procedures for Adding Activities to Permissible "Laundry" List

Federal Reserve procedures provide that proposals to engage in activities listed as permissible by regulation (the so-called "laundry list" activities) are promptly published for public comment in the Federal Register for a period not to exceed 30 days. The publication of other proposed nonbanking activities, including those not previously considered, and those previously considered and denied, requires specific authorization by the Board. Regulation Y requires the Board to make a determination as to whether to publish within ten business days of acceptance of the application by the Reserve Bank, although the Board may extend this period for up to an additional 30 calendar days upon notice to the applicant.

Regulation Y directs the Board to cause notice to be published unless it determines that the applicant has not demonstrated that the activities could be found to be permissible (i.e., closely related to banking and a proper incident thereto). By publishing a proposal for comment, the Board does not reach a decision on the merits of the proposal. Rather, the Board determines that the applicant has made a reasonable showing that the proposal should be considered on its merits and that public comment would be beneficial in this process. The comment period is usually for 30 days, although more complex proposals with broad policy implications may be published for longer periods of time

Once the comment period expires and all timely comments have been received, the Reserve Bank and Board staff summarize the comments and evaluate the merits of the proposal. The actual decision is made by the Board, and every effort is made to conclude the process within the 60 calendar day internal processing period. In many cases, however, the length of the comment period, the number of comments received, and the complexity and public policy implications of the proposal require an extended processing period. In any event, the application is automatically approved if it is not acted on within the statutory 91 day period that commences with the completion of the record. Applicants are notified whenever the processing period is extended.

Review and Processing of Applications

Two of the most fundamental provisions of Regulation Y (and of the Act) are the requirements that a company apply to the Federal Reserve System before acquisition of a bank, and that existing bank holding companies apply for or give notice prior to the acquisition of certain types of nonbanking companies. Through the evaluation of such applications or notifications, the System furthers the objectives of the Act by (1) limiting nonbanking activities to those permitted by the Bank Holding Company Act and Regulation Y, (2) assessing the financial and managerial resources and future prospects of the applicant and target companies, and (3) ensuring that proposed transactions would not be significantly anticompetitive and that the convenience and needs of the community would be served.

When a company applies to conduct a new activity, the Board evaluates the proposal for consistency with the Bank Holding Company Act, Regulation Y and other banking legislation, such as the Glass-Steagall Act, in order to carry out the Congressionally-mandated policy of the separation of banking and commerce. In this regard, the applications process is the primary method by which the Board regulates the nonbank activities of bank holding companies.

In evaluating applications under the Act, the Board is required to take into consideration "the financial and managerial resources and future prospects of the company or companies and the banks concerned." The evaluation of financial and managerial factors involves analysis of 1) pro forma capital and debt ratios, 2) the financial condition and historical performance of the banks and companies involved, and 3) the record and qualifications of the proposed management. From this information, which is gathered from supervisory authorities and reported financial data, the Board makes a judgment as to whether the future prospects for the companies involved are favorable. Trends in the examination ratings of the holding company and its subsidiary banks, and trends in their earnings, capital, and asset quality, combined with analysis of the risk factors surrounding the organization, weigh heavily toward the determination of whether the future prospects of the organization are satisfactory. Such a favorable determination is required for the Board to approve an application.

The Board has established certain standards for sound banking practices, and proposals that do not meet these standards are identified in the applications process. The analysis of a proposal rests, in significant part, on the prospective capital position of the applicant organization. The Board evaluates the capitalization of banks and bank holding companies in relation to its published Capital Adequacy Guidelines and, for organizations with assets of less than $150 million, its Small Bank Holding Company Policy Statement. For organizations in an expansionary posture, or those whose condition suggests some additional risk, the Board generally requires that the minimum capital levels expressed in the guidelines be exceeded on a pro forma basis.

The other major factor considered in evaluating the financial and managerial aspects of a proposal is the record and qualifications of the proposed management. This analysis includes assessment of their experience with the applicant organization or, if new management is proposed, assessment of their record with other financial institutions or companies. It is essential that the proposed management be capable in order for the Board to determine that the future prospects of the organization are satisfactory.

The applications process affords the Board the opportunity to assess the financial and managerial resources of an applicant organization at a time when its level of risk is particularly likely to increase—that is, when it undergoes an expansion. In these situations, the Board assesses the likely effects of the proposed transaction on the organization and disapproves proposed acquisitions that would create an unacceptable degree of risk to the holding company and, ultimately, to the bank affiliates. This process is, of course, complemented by other supervisory functions, such as on-site inspections, which serve to monitor proposals after they are approved. The applications approval process, however, is an important first step in limiting the risk undertaken by bank holding companies.

The scrutiny involved in the applications process provides an important discipline on the behavior of banking organizations. Thus, applicants are often responsive to suggestions from the Federal Reserve for improvements in their condition or for changes to their proposals in order to limit adverse effects and thereby increase the chances for approval. Applicants often

take action to improve their condition even before filing proposals, in recognition of the Federal Reserve's standards for approval. In addition, while only a relatively small percentage of proposals is denied, a significant number are modified after filing. Others are withdrawn, at least until remedial changes can be effected. Through this process, banking organizations are encouraged to constrain their expansion to appropriate levels, to avoid excessive risk-taking and, if necessary, to improve their condition.

Policies carried out in the context of the applications process also assist in protecting the public interest through analysis of the competitive effects of proposed transactions and consideration of the needs of the community to be served by the applicant holding company. In enumerating the statutory criteria for approval, Regulation Y notes that the commencement or expansion of a nonbanking activity *de novo* is presumed to result in benefits to the public through increased competition. The Bank Holding Company Act further states that the Board shall not approve any proposed bank acquisition "whose effect in any section of the country may be substantially to lessen competition . . . unless it finds that the anticompetitive effects of the proposed transactions are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served." The "proper incident" test described above provides comparable assurance for nonbanking acquisitions. The application of these standards helps to ensure that the public will have access to a sufficient number of competitive providers of financial services.

In the evaluation of each application, the Board considers the potential effect on competition in the relevant geographic and product markets through analysis of market shares, concentration ratios and inter-industry overlap of products. The views of the U.S. Department of Justice are also sought. The Board must conclude that the proposal would not result in a significant reduction in competition that is not offset by other public benefits.

In applications to acquire a bank, the Board also considers the record of the applicant organization in meeting the credit needs of the community. This includes evaluation of its compliance with the Community Reinvestment Act and other consumer legislation and regulations. Such an evaluation helps to ensure that bank holding companies, whose subsidiaries are entrusted with deposits of the public, will serve their communities in the public interest.

The volume and breakdown by type of applications processed by the Federal Reserve Board and Reserve Banks since 1971 is shown in Attachment I-F. The number of applications processed annually has increased significantly since the early 1970s and peaked at 2516 in 1983. The ability to handle this volume of applications is due in significant part to the measures, discussed below, to decrease processing time and enhance processing efficiency.

Processing Time

The Bank Holding Company Act provides that an application must be acted on within 91 days from the date of submission to the Board of the "complete record" on the application. The Board recognizes that delays in processing proposals can result in additional expense for the applicant and delays in the delivery of benefits to the public. Accordingly, the Board has attempted over time to process applications as expeditiously as possible, without compromising its responsibilities under the Bank Holding Company Act.

The Board's Regulation Y and internal operating procedures make timeliness a principal objective in the applications process. Although the Act provides that the Board may take up to 91 days after the submission of the complete record, procedures were voluntarily developed in 1971 that established internal processing periods substantially shorter than those required by statute. Since that time, the internal goal of 90 calendar days has been reduced to 60 days and processing efficiencies have continued. In addition, the Board has developed a "notification" process for certain bank holding company proposals that normally do not present any issues. Thus, a bank holding company need only notify the Reserve Bank—rather than receive prior approval—for the acquisition of a *de novo* permissible nonbanking firm, the acquisition of a "small" nonbanking going concern, or the redemption of the bank holding company's shares. After a waiting period of 15-30 days from acceptance, the proposal may be consummated unless objected to by the Reserve Bank. Several hundred such proposals are processed by the System each year.

As indicated above, the Board has, over time, been concerned that applications be processed in as timely a manner as possible, and in the early 1970s established an objective of processing 90 percent of all applications within 90 days. The Board modified this goal in 1983 to process 90 percent of all applications within 60 days. These processing objectives have been met every year since 1977. In 1985, the Federal Reserve processed 96 percent of all applications within the 60-day period.

Delegation to the Reserve Banks

Subsequent to the enactment of the 1970 Amendments to the Bank Holding Company Act, the Board

delegated certain authority to Reserve Banks to process bank holding company applications. This new authority was added in an effort to identify and expedite the processing of problem-free applications. In 1971, rules regarding delegation of authority were formally adopted to cover the formation of one-bank holding companies. In 1972, the Board expanded this authority to include the acquisition of *de novo* banks.

In 1973, the Board again expanded the authority to include the formation of multi-bank holding companies and acquisitions of existing banks. These delegations were designed to reduce the Board's workload, and to improve the timeliness of applications processing. The rules also included restrictive parameters, which if exceeded, would require Board action on the application. In 1972, approximately 40 percent of all applications were processed by Reserve Banks under delegated authority. The rules were amended on several occasions between 1974 and 1979. In 1979, the Federal Reserve's guidelines were substantially revised to permit the delegation of most applications, provided that they met certain policy, competitive, and financial and managerial criteria. In recent years, an average of approximately 85 percent of all applications have been processed by Reserve Banks under delegated authority in about one-half the time necessary for more complex cases acted on by the Board.

The Board has developed procedures under which most applications that are processed under delegated authority are subject to review by Board staff and certain Board members prior to approval. This review promotes consistency of action and maintenance of high analytical standards among the Reserve Banks. The Board has also developed internal procedures which permit the processing of some delegated applications without this review if the characteristics of these applications fall within certain predefined parameters. During 1985, 625 applications were processed under this procedure with an average processing time of only 25 days after acceptance.

Other Steps to Improve Applications Efficiency and Responsiveness

As indicated above, the Board has, over time, revised its internal procedures and Regulation Y to promote the timely processing of applications. In 1983, the Board approved a substantial revision to Regulation Y that, for the first time, imposed strict timing standards on the pre-acceptance review period for applications. These revisions provided that, under normal circumstances, only 10 business days could be used by the Reserve Bank to review initially an application for legal and informational sufficiency, prior to accep-

provided that the processing period for Board action applications would be reduced from 90 to 60 days after acceptance; and that the processing period for delegated action applications would be reduced from 60 to 30 days. In addition, the Board continually reviews and, when necessary, revises its applications forms in order to collect necessary information while minimizing undue burden on applicants.

The Board monitors industry developments in an effort to maintain efficient administrative and analytical methods, and has issued several policy statements to communicate regulatory priorities to the banking industry. The principal objective of these statements is to make banking organizations and the public aware of current regulatory policies and concerns. The Small Bank Holding Company Policy Statement and the Board's Capital Adequacy Guidelines are two such statements. Through the issuance of these statements, bank holding company applicants are better able to plan corporate objectives and prepare applications that are consistent with the Board's regulatory objectives. In addition, orders issued by the Board on significant cases provide the public with additional policy guidance.

The Board has also developed an Information Series Booklet—*Processing an Application Through the Federal Reserve System*. This Booklet explains in layman's terms the steps that need to be taken in preparing and filing an application and the factors the Board must consider in processing an application.

Supervisory Programs

On-Site Inspections

In addition to establishing permissible activities and acting on applications to engage in these activities, the Federal Reserve has, under authority granted in the Bank Holding Company Act, developed programs to supervise the activities of bank holding companies. This is accomplished primarily through the conduct of on-site inspections of parent companies and their nonbank subsidiaries and through analysis of financial and regulatory reports which holding companies are required to submit periodically. Through these means the System is able to evaluate the financial condition of holding companies, to assess their impact on affiliated banks, and to determine their compliance with banking laws and regulations. Generally, the Federal Reserve has limited its on-site inspection activities to the parent company and its nonbank subsidiaries; for information on a bank subsidiary, the Federal Reserve relies on examinations conducted by

The System's inspection program was developed in the 1970s, partly in response to evolving supervisory views of the potential risks to banks stemming from holding company activities, and partly in response to developments within the banking system. Following the passage of the 1970 Amendments to the Bank Holding Company Act, a number of institutions, particularly the larger regional and money center companies, began to expand through their holding companies into various permissible credit-related activities such as mortgage banking, leasing and consumer and commercial finance.

During the recession of the mid 1970s, many holding companies experienced severe asset problems in their mortgage banking and other nonbank subsidiaries which, in a number of instances, created serious problems for affiliated banks.[4] In some cases, holding company banks attempted to assist their troubled affiliates in order to forestall the affiliates' collapse and to preserve the holding companies', and the banks', reputations. In the process, some of these banks became saddled with poor quality assets. In other cases, the close association in the public's eye between the banks and their troubled nonbank affiliates, often reinforced by common name identification and by the realization that both were under common holding company management, raised questions about the financial capacity, funding and strength of the affiliated banks.

Thus, both the experience of the mid 1970s and the nature of the relationship between a bank and its holding company affiliates demonstrated the practical difficulty of completely insulating a bank from the health of its nonbank affiliates and provided a compelling rationale for the Federal Reserve's implementation of an on-site inspection program for bank holding companies. The principal purposes of on-site inspections were to determine the financial condition of the holding company and its subsidiaries, and the potential impact of these entities on the subsidiary banks. These objectives were a natural extension of the Board's concern that holding companies serve as a source of financial and managerial strength to their subsidiary banks.

The Federal Reserve began conducting on-site inspections of bank holding companies on an informal, as needed basis in 1974 and 1975. This process was formalized in 1976 with the adoption of a requirement that most large holding companies be inspected at least once every three years. The inspection program was strengthened considerably in 1977 with the adoption of a uniform report format and more comprehensive inspection procedures throughout the System. Together with these changes, a more strict frequency regimen was also mandated that called for an annual in-

or credit-extending nonbank subsidiaries. Problem institutions were to be inspected at least annually.

Other changes in the inspection program have been made over the years with the goals of bringing more large companies with leverage and nonbank subsidiaries under the annual frequency mandate, of focusing more supervisory attention on problem institutions and of incorporating surveillance and monitoring data into the conduct of on-site inspections in order to improve the efficiency of the inspection process. As a matter of policy, most small "shell" holding companies—that is, companies with assets of less than $150 million that do not own credit-extending nonbank subsidiaries—have been inspected much less frequently than large institutions since such companies normally pose fewer risks to their subsidiary banks. Shell companies with significant weaknesses, however, have been inspected on a more frequent basis than nonproblem companies.

Last year, the Board tightened the general inspection frequency requirement for all non-shell bank holding companies and, in particular, mandated more frequent on-site reviews of large and troubled bank holding companies. The purpose of these changes was to intensify the degree of oversight of institutions posing the greatest potential risks to their banking affiliates and the banking system generally. Thus, the Federal Reserve now conducts one full scope and an additional limited-scope or targeted inspection of the large regional and multinational institutions each year. Problem institutions are generally inspected semiannually.

The development and expansion of the Federal Reserve's inspection program is reflected in the increase over time in the number of on-site inspections. In 1975, the System conducted 228 inspections; by 1980 this number had expanded to 866. Last year, the System performed a total of 1778 inspections of holding companies and their nonbank subsidiaries (Attachment I-G).

Federal Reserve inspection procedures require an assessment of the quality of the assets of the parent company and its nonbank subsidiaries and an evaluation of the parent company's debt, liquidity and cash flow. Experience has suggested that each of these factors can have a significant impact on the health of the holding company and, in turn, on the condition of subsidiary banks. In the course of each inspection, examiners also evaluate and rate the major components of the holding company, *i.e.*, the bank subsidiaries, the nonbank subsidiaries and the parent company, and appraise the earnings and capital of the holding company on a consolidated basis. These steps, together with a review of the transactions between the bank and other holding company entities, including the payment

eral Reserve examiners to make an evaluation of the overall impact of the holding company on the financial condition of the subsidiary banks. In making this evaluation, Federal Reserve examiners pay particularly close attention to the possibility of any non arms-length transactions with bank holding company insiders that could have a potentially harmful effect on the subsidiary bank.

Another important objective of the on-site inspection is to determine a company's compliance with relevant banking laws, including the Bank Holding Company Act and Section 23A of the Federal Reserve Act. Thus, Federal Reserve examiners seek to determine that holding companies have obtained appropriate regulatory clearances for the activities in which they are engaged and to ascertain whether the companies are conducting any impermissible nonbank activities. Examiners also look for any illegal tie-in arrangements in which the provision of one service or product to a customer is tied to or conditioned upon the customer's acceptance of other holding company services. In addition, examiners check for compliance with any commitments made by an organization in connection with the Board's grant of approval to that organization to expand its activities or acquire additional subsidiaries.

As part of its supervisory process, the Federal Reserve has developed a comprehensive manual of supervisory and on-site inspection procedures. This manual cites the laws and regulations pertaining to bank holding companies and provides guidance to examiners for assessing different types of nonbank activities, evaluating key risk factors at the parent and nonbank levels, and determining the overall condition of the bank holding company. The Federal Reserve has also developed an internal rating system that provides for the evaluation of each component of the holding company and requires the assignment of a composite or summary financial rating to the consolidated holding company.

The Federal Reserve has continually reviewed the adequacy and effectiveness of its inspection program and procedures over time. In the late 1970s and early 1980s, the Federal Reserve, together with the other federal banking agencies, implemented a number of programs to better coordinate examinations of holding companies and their lead bank subsidiaries. Within the last year, the System strengthened its methods for communicating inspection findings to boards of directors by requiring the preparation of a special directors summary report to highlight important supervisory issues and concerns. The Federal Reserve has also tightened its procedures for assessing the liquidity and cash flow of the parent holding company in order to reduce the possibility that funding problems at the parent level will undermine the stability of the holding company or its subsidiary banks.

In its efforts to ensure that bank holding companies remain a source of strength to their banks, the Federal Reserve has actively utilized its formal enforcement authority to issue written agreements or cease and desist orders. Such authority has been used to require holding companies to terminate certain imprudent funding or lending practices, to divest of certain assets that were eroding the financial health of the holding company, and to take certain steps to assist the subsidiary bank, such as reducing the level of bank dividends or injecting additional capital into the bank. As the Federal Reserve's inspection program has expanded over time, the use of enforcement actions involving bank holding companies, nonbank affiliates and individuals participating in the affairs of holding companies has increased dramatically, and has played a critical role in the System's overall supervisory effort.

Supervisory Reports and Surveillance

Another important element in the Federal Reserve's supervisory program has been the requirement that bank holding companies file periodic financial and regulatory reports. Such reports have played an important role in supplementing the System's on-site inspection activities and in monitoring an institution's financial condition and compliance with the Bank Holding Company Act.

Bank holding companies are required to file an annual report generally comprising 1) free-form financial statements (income and balance sheets) on the parent company, its nonbank subsidiaries and the consolidated bank holding company; 2) structure information on the ownership of and investments in nonbank entities; 3) information on the directors and principal shareholders of the holding company; and 4) data on nonbank activities that were commenced or terminated during the year. These reports are reviewed to determine if there have been significant changes within the year in an organization's financial profile or in the nature of its operations.

In 1975, the System instituted a series of financial reports on the parent and consolidated companies designed to collect more frequent information on large holding companies in a standardized format. This permitted certain financial data on holding companies to be computerized for the purpose of compiling and evaluating financial developments and trends involving large numbers of institutions. In the mid 70s, the Federal Reserve also established a requirement that holding companies report on their significant intercompany transactions. This report obligated large holding companies to inform the Federal Reserve of significant loans and other transactions between the subsidiary bank(s) and other holding company affili-

ates. The purpose of this report was to alert supervisory authorities of potentially risky transactions between the banks and their holding company affiliates.

Within the last several years, the System has developed a bank holding company performance report, comparable in many respects to the uniform bank performance report used by the three federal bank regulatory agencies. The performance report contains a considerable amount of current and historical financial information, including data on trends in financial ratios and peer group comparisons. These reports are used by examiners and supervisory analysts to evaluate the performance of individual holding companies over time and to pinpoint those financial factors that may require additional supervisory attention. The Federal Reserve has also developed financial screening and surveillance techniques designed to highlight those companies whose performance deviates in an adverse direction from that of their peers. Organizations failing surveillance screens are subject to additional supervisory scrutiny and, if necessary, on-site inspection.

In light of recent developments in the banking system, the Federal Reserve has within the last year expanded the frequency and content of the standardized financial reports it receives from holding companies and has strengthened its surveillance and screening techniques. Large companies are now required to report quarterly (rather than semiannually), and the reports filed by these companies have been broadened to encompass additional information on capital adequacy, nonperforming loans, and off-balance sheet risks. In addition, reporting requirements involving the volume and composition of a holding company's nonbanking assets have been expanded.

Supervisory Policies and Guidelines

The Federal Reserve has issued a number of policy statements and supervisory guidelines over the years whose goal has been to assure the safe and sound operation of bank holding companies and to protect the financial health of affiliated banks. These supervisory policies have served to inform the managers of holding companies of what is considered appropriate and acceptable banking practice, provided guidance to holding company examiners in assessing holding company actions, and established standards or criteria against which the need for formal enforcement action could be determined. A major element of the on-site inspection is to ascertain a bank holding company's compliance with these supervisory policies.

Concern over potential bank exposure arising out of transactions with nonbank affiliates led the Board to distribute a policy letter to the chief executive officers of all bank holding companies in early 1976. This letter reiterated the Board's view that the purchase of poor quality assets by a subsidiary bank from a holding company affiliate in a non arms-length transaction could be a violation of Section 23A of the Federal Reserve Act, which establishes limits and collateral conditions on bank loans to affiliates. The Board also indicated that Federal Reserve personnel would closely scrutinize transactions between subsidiary banks, their affiliates and other related institutions, and would initiate formal enforcement action, including the issuance of cease and desist orders, when necessary to protect the subsidiary banks. Consistent with these concerns, the Board instituted, as already noted, a reporting requirement that holding companies report significant loans and transactions between subsidiary banks and other holding company affiliates. In conjunction with these actions, the Federal Reserve also made a review of transactions between the bank and its holding company affiliates a critical component of the on-site inspection.

The Federal Reserve has also developed supervisory policies addressing the possible diversion of subsidiary bank income and assets to holding company affiliates. In 1978, the Board issued a policy statement pertaining to certain income tax accounting transactions between subsidiary banks and their parent holding companies. This statement expressed the Board's concern over intercorporate tax payment arrangements that 1) transfer assets and income from subsidiary banks to the parent company without offsetting benefits to the banks, and 2) leave banks owned by holding companies filing consolidated returns less well off from a tax standpoint than the banks would be if they filed on a separate entity basis. In 1979, a related policy was adopted that set forth the Federal Reserve's concerns over other practices that had the effect of inappropriately diverting income from subsidiary banks to other holding company affiliates. This statement alerted Federal Reserve supervisory personnel to the potentially harmful effects of the payment by a bank to any affiliate of management and service fees that were not reasonably related to the value of services received by the bank. The policy also addressed other payments or practices that had the effect of benefitting the holding company to the detriment of the subsidiary bank. Taken together, the policy statements on intercorporate tax payments and income diversion practices underscored the Federal Reserve's concern over the possibly adverse effect of certain holding company transactions on bank subsidiaries and have served as a framework for evaluating the broad range of transactions between subsidiary banks and their holding companies.

In 1981, the Board issued capital adequacy guidelines that established minimum levels of capital to total assets for bank holding companies on a consolidated

basis as well as for state member banks. The guidelines applicable to large organizations were raised in 1983, and the regulatory agencies' authority to enforce minimum capital requirements was strengthened by Congress in passing the International Lending Supervision Act of 1983. The establishment of minimum capital guidelines for bank holding companies on a consolidated basis reflected 1) the realization that financial markets tended to view holding companies and their affiliates, both bank and nonbank, as one organization and 2) the supervisory concern, based upon experience, that weaknesses in the consolidated organization's financial profile can have an adverse impact on the stability or funding of the affiliated banks.

The Board's capital guidelines, as revised over time, also address the question of appropriate capital positions for nonbank subsidiaries of bank holding companies. In this regard, the Board has stated that such nonbank subsidiaries generally should maintain capital levels that are consistent with the industry norms or standards applicable to similar companies that are not affiliated with bank holding companies. This approach was motivated by a desire to avoid extending the high leverage characteristic of commercial banks to nonbank subsidiaries with higher or different risk profiles. One objective of assuring adequate capital in nonbank subsidiaries is to reduce the likelihood that serious problems will emerge in these subsidiaries to the potential detriment of the holding company or its affiliated banks. Nonetheless, the Federal Reserve's capital guidelines place primary emphasis on the capital position of the consolidated holding company in recognition of the practical difficulty of insulating the condition of bank subsidiaries from the public's perception of the strength and stability of the consolidated banking organization.

Last year, the Federal Reserve reiterated, in the form of a policy statement, its long-standing position on the payment of cash dividends by state member banks and bank holding companies experiencing financial difficulties. Such organizations were urged to conserve their capital and reduce or eliminate cash dividends on common stock if such dividends were not funded by current earnings or if the organization's prospective rate of capital retention was inadequate in light of its financial health. Bank holding companies, in particular, were encouraged to review the effect of their dividend policies on bank subsidiaries in order to avoid placing undue pressure on bank earnings and capital. This policy's emphasis on the potential adverse impact of holding company dividends on the condition of subsidiary banks is consistent with the fundamental principle that holding companies are to be a source of financial strength to their subsidiaries.

Since the supervisory capital guidelines were implemented in 1981, capital ratios for the largest organizations have increased considerably, although this improvement needs to be viewed in light of the changing risks to which banking organizations are exposed. Early this year, the Board published for comment a proposal to implement a supplemental adjusted capital ratio. This ratio is designed to be more sensitive to the various risks inherent in a banking organization's assets and, for the first time, to take explicit account of certain off-balance sheet activities. Implementation of the proposal should provide better guidance to bank managers and examiners on what constitutes adequate capital, and should encourage banking organizations who seek to expand their risk-bearing activities to support such activities with adequate capital. This supplemental ratio guideline would apply to state member banks and bank holding companies on a consolidated basis.

II. International Banking Activities of U.S. Banking Organizations

Foreign Activities of U.S. Banking Organizations

Statutory Background

The Federal Reserve Board has jurisdiction over most foreign operations of U.S. banking organizations. The Board regulates foreign activities and investments of member banks, Edge and Agreement corporations, and bank holding companies. The Board does not regulate the foreign operations of nonmember insured banks.

The statutes governing the foreign activities of U.S. banking organizations have evolved over a period of time since 1913. As part of the original Federal Reserve Act, national banks were, with the Board's permission, given the power to establish foreign branches. In 1916, Congress amended the Federal Reserve Act to permit national banks to invest in international or foreign banking corporations known as "Agreement" corporations, because such corporations were required to enter into an agreement or understanding with the Board to restrict their operations to international activities. In 1919 the enactment of section 25(a) of the Federal Reserve Act (the "Edge Act") permitted national banks to invest in federally-chartered international or foreign banking corporations (so-called Edge corporations) which may engage in international or foreign banking or other international or foreign financial operations. In 1966, Congress amended section 25 of the Federal Reserve Act to allow national banks to invest directly in the shares of a foreign bank.

The Bank Holding Company Act of 1956 permitted bank holding companies to invest in foreign bank-

ing companies engaged principally in the banking business outside the United States. In 1970, the BHC Act was amended to provide that a bank holding company, with the Board's approval, may acquire a foreign company that does not engage in business in the United States where the investment would not be substantially at variance with purposes of the Act and would be in the public interest.

Therefore, the Board has a broad grant of discretionary power to determine the overseas activities in which U.S. banking organizations may engage through affiliates. In addition, the Edge Act was amended in 1978 to include a Congressional declaration of purpose which stated that the Edge Act is intended

> "to provide for the establishment of international banking and financial corporations operating under federal supervision, with powers sufficiently broad to enable Edge corporations to compete effectively with similar foreign-owned institutions in the United States and abroad." 12 U.S.C. 611a.

Member Banks

FOREIGN BRANCHES. Under section 25 of the Federal Reserve Act, the Board is given the authority to approve the establishment of foreign branches of national banks (12 U.S.C. 601). Under section 9 of the Federal Reserve Act, State member banks, which have the requisite power to establish foreign branches under State law, may establish and operate such foreign branches with the Board's approval and on the same terms and conditions and subject to the same limitations and restrictions as are applicable to the establishment of foreign branches by national banks (12 U.S.C. 321). The Board thus has regulatory authority over the establishment and operation of foreign branches of both national and State member banks. Foreign branches of national banks are, however, examined by the Comptroller of the Currency.

Through foreign branches, member banks have been permitted by the Board to exercise the normal banking powers that they enjoy domestically under the federal or State laws under which they are chartered and as limited by the Federal Reserve Act. They may also exercise certain enumerated additional powers to the extent such powers are usual in connection with the business of banking in the foreign countries where those branches transact their business. 12 U.S.C. 604a.

The Federal Reserve Act, however, provides that a foreign branch cannot engage in the general business of producing, distributing, buying or selling goods, wares or merchandise; nor may a foreign branch engage or participate, directly or indirectly, in the business of underwriting, distributing, or selling securities, except to such limited extent as the Board may deem necessary with respect to securities issued by any "foreign State" as defined in section 25(b) of the Federal Reserve Act (12 U.S.C. 632).

The Board regulations permit foreign branches of member banks to perform certain functions not permitted to national banks in the United States. These include issuing guarantees on occurrence of readily ascertainable events and subject to monetary limits; investing in certain foreign government securities; acting as insurance agent or broker; and entering into certain repurchase agreements on securities and commodities that are the functional equivalents of extensions of credit.

DIRECT INVESTMENTS. A member bank generally may not invest in the stock of companies. Section 25 of the Federal Reserve Act, however, authorizes a national bank to invest in the shares of a foreign bank. The purpose of this provision was to allow member banks to do business in those foreign countries that prohibited entry by means of branches although it is not limited to those circumstances.

The Board has defined "foreign bank" in section 211.2(g) of Regulation K as

> "an organization that is organized under the laws of a foreign country; engages in the business of banking; is recognized as a bank by the bank supervisory or monetary authority of the country of its organization or principal banking operations; receives deposits to a substantial extent in the regular course of its business; and has the power to accept demand deposits."

This definition assures that a member bank's direct investments will be in entities that are engaged in the business of commercial banking.

The Board has recently amended Regulation K to permit a member bank to invest with the Board's approval in the shares of a wholly-owned company located in the country where the bank operates a branch if the company engages only in activities permitted to the member bank itself.

A member bank may also hold directly the shares of Edge and Agreement corporations, discussed below, and may make indirect investments through these vehicles.

INDIRECT INVESTMENTS. A national bank may, with the Board's permission, invest in the stock of either an Edge corporation, organized under section 25(a) of the Federal Reserve Act (12 U.S.C. 611–631), or an Agreement corporation, operating under an agreement with the Board pursuant to section 25 of the Federal Reserve Act (12 U.S.C. 601), so long as the aggregate amount of stock held in all Edge and Agreement cor-

porations does not exceed 10 percent of the bank's capital and surplus (12 U.S.C. 618). State member banks may, with the Board's permission, also acquire and hold shares of these corporations if permissible under State law. State nonmember banks seeking to organize an Edge corporation must also obtain the Board's approval since such corporations are chartered by the Board.

Edge and Agreement Corporations

Edge corporations are chartered with the Board's approval for the purposes of engaging in international or foreign banking or other international or foreign financial operations either directly or through the agency, ownership, or control of local institutions in foreign countries (12 U.S. C. 611). Edge corporations may also, with the Board's consent, acquire and hold stock of any companies that are not engaged in the general business of buying or selling goods or commodities in the United States and that do not transact any business in the United States except as may be incidental to such companies' international or foreign business (12 U.S.C. 615). Thus, through their Edge corporation subsidiaries, U.S. banks may engage indirectly in international or foreign banking or other international or financial operations abroad; in addition, U.S. banks may indirectly acquire stock of foreign companies through their Edge corporation subsidiaries.

Agreement corporations are banks or corporations chartered or incorporated under the laws of the United States or of any State thereof principally engaged in international or foreign banking, or banking in a dependency or insular possession of the U.S., either directly, or through the agency, control, or ownership of local institutions in foreign countries, or in such dependencies or insular possessions (12 U.S.C. 601). In order for a member bank to invest in the shares of an Agreement corporation, the corporation must enter into an agreement with the Board to restrict its operations or conduct its business in such manner or under such limitations as the Board may prescribe for the place or places where it transacts business (12 U.S.C. 603). The Board has by regulation limited the activities and investments of Agreement corporations to those permissible for an Edge corporation. Thus, a member bank through an Agreement corporation subsidiary may conduct the same foreign activities and hold the same foreign investments that it may conduct and hold through an Edge corporation, unless the Agreement corporation is subject to other specific requirements in its agreement with the Board or is otherwise limited by State law. Because the regulatory standards governing these corporations are identical in each case, any reference to activities conducted or investments acquired and held by an Edge corporation includes activities conducted or investments acquired and held by an Agreement corporation.

Pursuant to its authority under the Edge Act, the Board has adopted and promulgated Regulation K, which sets forth regulations governing the organization of Edge corporations, their activities, and their investments. These regulations are discussed below.

Bank Holding Companies

The Board has discretion under section 4(c)(13) of the Bank Holding Company Act ("BHC Act") to permit bank holding companies to acquire and hold stock of companies that do no business in the United States except as an incident to such companies' international or foreign business, if the Board concludes that such an exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest (12 U.S.C. 1843(c)(13)).

Since its enactment, the Board has interpreted section 4(c)(13) as permitting a bank holding company to engage in the same activities and make the same investments as are authorized for Edge corporations.

Regulatory Background

Regulation K sets forth the standards that the Board expects to be followed in the conduct of foreign operations. Section 211.5(a) states

> Activities abroad, whether conducted directly or indirectly, shall be confined to those of a banking or financial nature and those that are necessary to carry on such activities. In doing so, investors shall at all times act in accordance with high standards of banking or financial prudence, having due regard for diversification of risks, suitable liquidity, and adequacy of capital. Subject to these considerations and the other provisions of this section, it is the Board's policy to allow activities abroad to be organized and operated as best meets corporate policies.

Section 211.5 also contains application procedures that are designed to reduce the burden on banking organizations that conduct overseas operations by minimizing the numbers and kinds of routine investment applications that must be acted on by the Board. The regulation requires specific Board consent for investments that, because of their size, novelty or some other aspect such as the financial condition of the banking organization, deserve Board consideration. Other investments may be made under general con-

sent or prior notification procedures. The general consent procedure allows a banking organization to make investments of up to $15 million in subsidiaries and joint ventures as long as they are engaged in certain permissible activities listed in the regulation (12 C.F.R. 211.5(d)). The general consent also allows portfolio investments (*i.e.*, noncontrolling investments in any type of company, regardless of the nature of the proposed activity) up to that same dollar amount. Beyond that, an investor may invest up to 10 percent of its capital in subsidiaries and joint ventures engaged in listed activities, after 45 days' prior notice to the Board. All other investments, including those involving large dollar amounts or unlisted activities, require specific Board approval.

Overseas Activities Permitted To U.S. Banking Organizations

As discussed above, the Board has broad discretion with respect to the types of activities that it may permit U.S. banking organizations to engage in overseas. Before the Board amended Regulation K in 1979, the Board exercised that discretion by permitting individual organizations, on a case-by-case basis, to engage in particular activities overseas. Any proposal by an Edge corporation or a bank holding company to invest more than $500,000 or acquire more than 25 percent of the shares of a foreign company required the Board's approval. The Board's policy has been to authorize activities, which can be conducted through such foreign companies, of a banking or financial nature.

In reviewing activities, the Board sought to permit activities of general importance to international banking that should be capable of being performed by foreign affiliates of U.S. banks anywhere outside the United States in order to make them competitive with foreign banks. The Board thus approved these activities, including the underwriting of stocks and bonds as "international financial operations," referenced in the Edge Act. The Board also approved applications by U.S. banking organizations to engage overseas in activities that the Board had determined to be "closely related to banking" under Regulation Y. In some cases, such as foreign leasing activities, the Board retained the restrictions imposed domestically under Regulation Y on the activity because the restrictions relate to ensuring the financial nature of the activity. Thus, foreign affiliates of U.S. banks may not engage in leasing operations abroad that did not involve full-payout, because the Board had not determined these activities to be financial operations. In the case of the majority of section 4(c)(8) activities, such as trust company activities, the giving of investment and financial advice, providing bookkeeping and data processing services, and acting as insurance agent or broker, the Board did not impose conditions set forth in Regulation Y, which were designed for the domestic market. Generally, foreign affiliates of U.S. banks could engage in such financial activities to the extent permitted competing foreign institutions in the foreign country.

The Board also approved by order other foreign operations that are not considered closely related to banking domestically. For example, foreign affiliates of U.S. banks may engage in management consulting activities abroad, subject to the condition that such services relating to the U.S. market will be confined to the initial entry of foreign companies into the market. They may also manage foreign mutual funds, subject to the condition that shares of any such funds will only be sold to nonresident aliens and that such funds will not directly or indirectly control or participate in the management of any company. The Board also permitted foreign affiliates of U.S. banks to engage in travel agency and warehousing services in certain countries. While none of these activities were permissible domestically under Regulation Y, the Board approved these activities abroad for foreign affiliates of U.S. banks in particular countries in order to keep U.S. banks competitive with their foreign counterparts. Such activities are either generally performed by banks as part of their international financial operations, or are performed by foreign banks in certain countries.

Before 1979, the Board also specifically denied requests to engage abroad in underwriting general insurance, in customs house brokerage and freight forwarding activities, in purchasing and selling of land, real estate development, participating as a joint venture partner in real estate development, hotel ownership and management and other "non-financial" activities. These requests were denied because the Board determined that these activities were not "financial operations" within the meaning of the governing standard, and U.S. banks would not be harmed competitively abroad if they could not engage in such activities.

1979 Revisions to Regulation K. In its June 1979 amendments to Regulation K, the Board, for the first time, included a list of activities it had determined to be permissible for foreign subsidiaries of U.S. banking organizations. This list included activities that had previously been approved by Board order in particular cases for foreign subsidiaries of Edge corporations and bank holding companies.

The activities that the Board has determined are usual in connection with the transaction of banking or other financial operations abroad [illegible]

permissible overseas in section 211.5(d) of Regulation K, are:

1. Commercial and other banking activities.
2. Financing, including commercial financing, consumer financing, mortgage banking, and factoring.
3. Leasing real or personal property, or acting as agent, broker, or advisor in leasing real or personal property, if the lease serves as the functional equivalent of an extension of credit to the lessee of the property.
4. Acting as fiduciary.
5. Underwriting credit life insurance and credit accident and health insurance.
6. Performing services for other direct or indirect operations of a United States banking organization, including representative functions, sale of long-term debt, name saving, holding assets acquired to prevent loss on a debt previously contracted in good faith, and other activities that are permissible domestically for a bank holding company under sections 4(a)(2)(A) and 4(c)(1)(C) of the BHC Act.
7. Holding the premises of a branch of an Edge corporation or member bank or the premises of a direct or indirect subsidiary, or holding or leasing the residence of an officer or employee of a branch or subsidiary.
8. Providing investment, financial, or economic advisory services.
9. General insurance agency and brokerage.
10. Data processing.
11. Managing a mutual fund if the fund's shares are not sold or distributed in the United States or to United States residents and the fund does not exercise managerial control over the firms in which it invests.
12. Performing management consulting services when rendered with respect to the United States market shall be restricted to the initial entry.
13. Underwriting, distributing, and dealing in debt and equity securities outside the United States, provided that no underwriting commitment by a subsidiary of an investor for shares of an issuer may exceed $2 million or represent 20 percent of the capital and surplus or voting shares of an issuer unless the underwriter is covered by bind ing commitments from subunderwriters or other purchasers.
14. Operating a travel agency provided that the travel agency is operated in connection with financial services offered abroad by the investor or others.
15. Engaging in activities at the Board has determined by regulation in 12 CFR 225.25(b) are closely related to banking under section 4(c)(8) of the BHC Act; and
16. With the Board's specific approval, engaging in other activities that the Board determines are usual in connection with the transaction of the business of banking or other financial operations abroad and are consistent with the FRA or the BHC Act.

The activities listed in section 211.5(d) of Regulation K are, in many cases, related to those activities in Regulation Y that have been determined by the Board to be closely related to banking for the purposes of section 4(c)(8) of the Bank Holding Company Act. As discussed above, the restrictions that are applied to the activity if engaged in domestically do not necessarily apply to the activity when engaged in abroad.

Some restrictions on the U.S. operations of banking organizations stem from concerns with the safety and soundness of the U.S. banking organization, as well as with potential conflicts of interest, which are also relevant to the operations of U. S. banks abroad. Accordingly, the Board has balanced its concerns regarding safety and soundness and conflicts of interests with its objective of allowing U.S. banking organizations to compete effectively in other countries with different kinds of banking systems. Thus, the Board permits U.S. banking organizations to engage to a limited extent in underwriting, distribution and dealing in equity securities abroad. Uncovered underwriting commitments are, however, limited to $2 million and to no more than 20 percent of the capital and surplus or voting stock of the issuer. The Board has permitted U.S. banking organizations to participate fully in the underwriting of debt securities overseas, not only for competitive reasons but also to permit U.S. banking organizations to serve the credit and working capital needs of their U.S. corporate customers.

Most of the large internationally-active U.S. banks have merchant or investment banks in London (Attachment II-C-1) that seek underwiting business. According to *Euromoney*, subsidiaries of five major U.S. banks or bank holding companies ranked among the world's 30 largest underwriters of Eurobonds in 1985, with Morgan Guaranty ranking third among lead managers. In addition to Morgan Guaranty, these companies are Bankers Trust, Bank of America, Citicorp and Chase Manhattan. Combined, these five companies underwrote as lead manager or as co-manager issues representing $18.4 billion, or about 10 percent of the amount underwritten by the top 30 total organizations. See Attachments II-C-2 and 3. Similar merchant or investment bank subsidiaries in Hong Kong, Australia, and other countries also actively underwrite corporate debt, although to a much lesser ex-

tent than those located in London where the Eurodollar market is centered.

Several U.S. banking organizations have also made significant investments in British securities firms that are now possible following recent changes in British laws. These changes liberalized the ownership of securities companies and also enabled stock-brokerage firms to act as principals or market makers in securities traded on the London Stock Exchange. Security Pacific, Citicorp, and Chase Manhattan have recently acquired controlling interests in several such firms.

Other Activities

In its revision of Regulation K in 1979, the Board, in addition to listing activities that U.S. banking organizations could engage in overseas without prior Board approval, provided the investment amounts were within the regulatory limits, also stated that it would entertain requests from U.S. banking organizations to engage in appropriate additional activities overseas. To obtain Board approval of such activities, the applicant would have to show (1) that the proposed activity is usual in connection with the transaction of the business of banking or other financial operations abroad, and (2) that the activity is consistent with the Federal Reserve Act (in the case of Edge corporation subsidiaries) or the Bank Holding Company Act (in the case of bank holding company subsidiaries). Evidence that the activity is itself financial in nature or that banking organizations engage in the activity in connection with their banking or financial operations to a material extent in the proposed market in another country is required to meet the first standard. Under the second standard, the Board examines whether the risks of the proposed activity, or the potential conflicts of interest posed by it, are inconsistent with the supervisory or regulatory purposes of the Bank Holding Company Act or the Federal Reserve Act. A list of activities that the Board has approved or denied by specific order is found at Attachment II-A. A comparison of permissible foreign and domestic activities is found at Attachment II-B.

Methods of Overseas Operations Of U.S. Banking Organizations

While the range of activities permissible to U.S. banking organizations is somewhat broader outside the United States than it is in this country, the activities conducted overseas are virtually all of a banking or financial nature. Only relatively small and noncontrolling investments are permitted in foreign nonfinancial businesses. Tables referred to in this section are at Attachment II-D.

As shown in Attachment II-D-1, U.S. banks and bank holding companies can operate, or invest, abroad either by acquiring or investing in foreign companies or by establishing foreign branches. Regarding investments, the *direct* investments of member banks are restricted by statute to foreign banks. However, indirectly through an Edge corporation or a foreign bank subsidiary, a member bank may invest in financial activities and in small noncontrolling interests in nonfinancial activities. A U.S. bank holding company also has the full range of foreign investment powers of Edge corporations. The forms of U.S. banking organizations operations abroad, described below, include:

1. branches;
2. subsidiaries (majority-owned or otherwise controlled);
3. joint ventures (20 to 50% ownership and not otherwise controlled); and
4. "portfolio" investments (investments representing less than 20 percent of a company's voting shares).

Branches

While the powers of branches are more limited than those of separately incorporated foreign companies, branches dominate the foreign activities of U.S. banking organizations in terms of assets, and are generally the preferred form of operation for U.S. banks. In addition to conducting the general banking activities that are permitted to their home offices within the United States, foreign branches of member banks can conduct a limited range of other activities when they are determined to be "usual in connection with the business of banking in the country where it transacts business." The following activities are among those the Board has permitted within this context:

1. guaranteeing customer debts;
2. investing in institutions "necessary" to the effective operation of the branch; and
3. underwriting debt securities of the national and local governments where the branch is located.

Generally, however, foreign branches conduct traditional consumer and commercial banking, much as they do within the United States. Foreign branches cannot, for example, underwrite equity securities, even though that activity can be performed by some foreign banks. Large banks with international networks operate full-service branches. Most other U.S. banks operate only "shell" branches in the Caribbean for the purpose of raising funds in the Eurocurrency market, while incurring very low overhead costs.

Subsidiaries

Ownership of foreign subsidiaries allows U.S. banking organizations to acquire established foreign banks and other financial institutions and to perform a broader range of activities than is permissible through branches. Perhaps the most notable additional power is that of underwriting corporate debt and equity securities, the latter of which is strictly limited. Subsidiaries can commit to underwrite no more than $2 million or 20 percent of the issuer's shares without binding commitments from sub-underwriters or other purchasers. As a result, the foreign subsidiaries of U.S. banking organizations underwrite relatively few equity issues, but have a larger role in underwriting corporate debt.

Foreign subsidiaries also allow U.S. banking organizations to benefit from local tax laws and regulations and, in some cases, also to gain entry into countries that prohibit branches of foreign banks. For all these and other reasons, U.S. banks and bank holding companies own almost 900 foreign subsidiaries (most of them quite small) that have assets currently of about $100 billion. Attachment II-D-2 shows the amount U.S. banking organizations have invested in foreign subsidiaries based upon the principal activity of the subsidiary. Investments in banking activities, including merchant and investment banks, account for approximately 94 percent of all their investments in foreign subsidiaries. Investments in other financially related companies accounts for virtually all the remaining balance.

Joint ventures

Noncontrolling investments that represent 20 to 50 percent of the voting shares of a company are regulated as "joint venture" investments. Because the level of ownership is noncontrolling, and in order to permit banks to compete effectively abroad in making such investments, the Board has applied more liberal standards to the permissible activities of joint venture companies than it has to the activities of branches and subsidiaries.

Joint ventures must remain predominately banking or financial in nature, but they can have up to 10 percent of their assets or revenues attributed to otherwise impermissible activities. Most joint ventures are banks or finance or leasing companies, although some are real estate brokers and securities brokers. At year-end 1984 U.S. banking organizations held over 100 foreign joint venture investments valued at about $680 million. See Attachment II-D-3.

Portfolio investments

The term portfolio investments refers to relatively small investments that represent less than 20 percent of the voting shares of a company. The Board has taken a generally permissive approach toward these investments in order to give U.S. banks flexibility in structuring a financing package, a limited voice in the management of the borrower, and a way to compete in markets where small equity participations are common.

U.S. banking organizations can hold portfolio investments in virtually any foreign company, provided the total amount of such investments in companies that conduct otherwise impermissible activities does not exceed 100 percent of the investor's equity capital. For this purpose the "investor" is the bank holding company (BHC), the bank, or the Edge corporation subsidiary making the investment. No foreign company in which a U.S. banking organization holds more than 5 percent of the shares, however, may conduct any business in the United States that is not incidental to its foreign business.

Attachment II-D-4 shows the amount and types of foreign companies in which U.S. banking organizations have made portfolio investments. Slightly over one-half of the amount invested in these relatively small holdings is in banking and other lending activities, and another 20 percent is invested in activities of the type generally permissible to bank holding companies under section 4(c)(8) of the Bank Holding Company Act. While the remaining 30 percent is invested in nonfinancial businesses, even many of these investments are similar to those that would be allowed for a small business investment company subsidiary of a bank or BHC.

Supervision of Foreign Operations

The foreign operations of U.S. banking organizations are examined by their primary federal regulatory agency: the Federal Reserve in the case of bank holding companies, State member banks and Edge and Agreement corporations, or the Office of the Comptroller of the Currency ("OCC") in the case of national banks and their direct foreign subsidiaries. Relatively few nonmember banks have foreign activities, and those that do typically have only "shell" branches, which do not conduct a full-service deposit and loan operation.

In most cases, the foreign activities of a bank are examined during the examination of the "parent" institution, that is, the regular examination of the U. S. bank. Banks are required, as a condition of approval for their foreign offices, to maintain at their head

offices adequate documentation about their foreign activities so that examiners can review the condition of these foreign offices. In the case of shell branches, whose business is conducted from the head office, full credit files are readily available. (See policy statement at Attachment II-E.)

The Federal Reserve often examines major foreign offices on-site, especially in the United Kingdom, West Germany, France, and Japan. Federal Reserve examiners have also gone to other major European countries, Australia, and Hong Kong, although not routinely. In recent years, a special effort has been made to review the activities of the large London merchant bank subsidiaries of U.S. banks and bank holding companies. The OCC maintains a full-time staff in London to examine the branches and subsidiaries of the major national banks. The Federal Reserve examines the foreign activities of state member banks and those held directly by bank holding companies by periodically sending teams of examiners from the various Reserve Banks.

In addition to examining foreign branches and subsidiaries of state member banks, the Federal Reserve has supervisory authority over Edge and Agreement corporations, including those of national banks. There are two types of Edge or Agreement corporations: banking and nonbanking (sometimes called "investment") Edges. Banking Edges accept deposits and conduct a full range of banking business, provided the transactions are linked to a foreign or international transaction. Nonbanking Edges are essentially holding companies for foreign investments. By law, each Edge corporation is required to be examined annually by the Federal Reserve.

At year-end 1985 there were 89 banking Edges with total assets of $16.7 billion. There were an additional 52 nonbanking Edge corporations with assets of $4.6 billion.

Reporting Requirements

The international activities of all commercial banks are reflected and disclosed separately in their quarterly consolidated reports of condition and income (their "call" reports). In addition, the Federal Reserve and the other regulatory agencies require a number of other supervisory reports that focus on foreign or international banking.

One of the most important international reports is the quarterly Country Exposure Report (FFIEC 009), which identifies the amount and characteristics of the reporting bank's exposure to foreign borrowers. Aggregate figures showing lending for various groups of U.S. banking institutions are published each quarter in the Country Exposure Lending Survey.

The Federal Reserve also collects quarterly reports of condition (and annual income statements) for banking Edge corporations, and annual condition and income reports from all foreign subsidiaries and nonbanking Edges. A short condition report is also submitted annually to either the OCC or the Federal Reserve by all foreign branches of member banks.

Export Trading Companies

The Bank Export Services Act

The Export Trading Company Act of 1982 was enacted on October 8, 1982. Its purpose was to help promote exports by facilitating the formation and operation of export trading companies.

Title II of this legislation is entitled the Bank Export Services Act ("BESA"). It provides for equity investments by bank holding companies and certain other types of banking organizations in export trading companies. As stated in the BESA, the purposes of the legislation were to:

1. provide for the establishment of export trading companies with powers sufficiently broad to enable them to compete with similar foreign-owned institutions in the United States and abroad;
2. afford to United States commerce, industry, and agriculture, especially small and medium-size firms, a means of exporting at all times;
3. foster the participation by regional and smaller banks in the development of export trading companies; and
4. facilitate the formation of joint venture export trading companies between bank holding companies and nonbank firms that provide for the efficient combination of complementary trade and financing services designed to create export trading companies that can handle all of an exporting company's needs. (12 U.S.C. §1843 note).

To facilitate the export of U.S. goods and services, Congress enacted the BESA despite its departure from traditional banking legislation in permitting participation by banking organizations in commercial ventures. At the same time, however, a number of prudential provisions were included to limit potential adverse financial effects on banks affiliated with export trading companies, such as limitations on the banking organization's aggregate loans to and investments in its affiliated export trading companies.

The statute provides that a bank holding company may invest in an export trading company after providing notice to the Federal Reserve Board. The Federal Reserve is required to review the notice in order to de-

termine whether the proposal may result in unsafe or unsound banking practices, undue concentration of resources, decreased or unfair competition, or conflicts of interest, or whether the investment would have a materially adverse effect on the safety and soundness of a subsidiary bank of the bank holding company.

The Board's Regulations

The Board's regulations are brief and were designed to clarify some areas of ambiguity in the statute and set forth procedures for Board review of proposed investments.

DEFINITION OF AN EXPORT TRADING COMPANY. The statute requires that an export trading company engage "exclusively" in activities related to international trade and engage "principally" in exporting U.S. goods or services or facilitating the export of U.S. goods or services produced by others. The Board concluded that Congress, in enacting the BESA, intended to facilitate banking organization investment in companies acting as trade intermediaries to further the foreign marketing and sales of U. S. goods and services produced by others.

Therefore, the Board's regulations provide that an export trading company in which a bank holding company may invest must derive more than one-half of its revenues from exporting or facilitating the export of goods and services produced in the United States by persons other than the export trading company or its subsidiaries. This definition allows export trading companies to engage in a diverse range of activities including the following export trade services, as defined in the BESA:

> consulting, international market research, advertising, marketing, insurance (other than acting as principal, agent or broker in the sale of insuracne on risks resident or located, or activities performed, in the United States, except for insurance covering the transportion of cargo from any point of origin in the United States to a point of final destination outside the United States), product research and design, legal assistance, transportion, including trade documentation and freight forwarding, communication and processing of foreign orders to and for exporters and foreign purchasers, warehousing, foreign exchange, financing, and taking title to goods.

This list is not exhaustive and these types of services may be provided to facilitate exports, imports, or third-party trade.

The statute also requires that the export trading company must be "principally" engaged in exporting. The regulations implement this provision by requiring that "more than one-half" of an export trading company's revenues be derived from exporting or facilitating exports. This revenues test was designed to ensure that the chief efforts of an ETC are directed to exporting U.S. goods and services, as Congress intended, rather than to trading outside the United States. The legislative history of the Act states:

> [W]hile it is understood that ETCs will periodically have to engage in importing, barter, third party trade, and related activities, the managers intend that such activity be conducted only to further the purposes of the Act.

To allow flexibility for an export trading company to develop an international trade business, especially in the formative stages of the company, this threshold test is applied over each consecutive two-year period rather than on an annual basis.

BANK LENDING TO AFFILIATED ETCs. The BESA provides that transactions between a bank and its affiliated ETC are covered by section 23A of the Federal Reserve Act (12 U.S.C. §371c). Section 23A generally provides that a bank may extend credit to an affiliate subject to certain amount and collateral restrictions. A bank may lend to an affiliate only on a fully secured or a more than fully secured basis. The purpose of section 23A is to limit the ability of banks to make unsound loans to related entities. While it cannot by itself fully insulate a bank from the condition of the consolidated organization, section 23A is a linchpin of efforts to prevent self-dealing by banking organizations and lending by banks on other than an arm's length basis.

In adopting final regulations, the Board determined that some additional latitude in application of the section 23A collateral requirements was possible without creating undue risk to the affiliated bank. The regulations incorporate a waiver from the strict collateralization standards of section 23A where an export trading company proposes to take title to goods against a firm order for sale, and where the affiliated bank takes a security interest in the goods or the proceeds from the sale of the goods.

CAPITAL ADEQUACY. The Board does not impose specific capital requirements on bank-affiliated export trading companies. However, the Board recognizes that capital adequacy is a critical determinant of the financial strength of an ETC and of its ability to withstand unexpected adverse developments. This capital cushion is necessary to prevent an ETC's difficulties from affecting the financial resources of the parent holding company or the safety and soundness of affiliated banks.

As a general matter, the Board takes the view that capital levels should be commensurate with the risk of the company's activities.

PROCEDURES. The procedures adopted for review of notices of proposed investments in export trading companies were designed to minimize the burden on the investing bank holding company while allowing adequate Federal Reserve review of the proposals in light of the statutory factors.

In December 1983, after having reviewed 15 notices, the Board revised the regulation to provide that, under certain circumstances, a notice to invest in an export trading company can be reviewed by the appropriate Federal Reserve Bank under delegated authority. The specific criteria are: (1) the proposed export trading company is to be a wholly-owned subsidiary, or ownership is to be shared only with individuals involved in the operation of the export trading company; (2) the bank holding company investor and its lead bank meet the minimum capital adequacy guidelines of the Board and the Comptroller of the Currency or have capital enhancement plans acceptable to the appropriate supervisory authority; (3) the proposed export trading company will take title to goods only against firm orders, except that the company may maintain an inventory of goods of up to $2 million; (4) the proposed activities of the company do not include product research or design, or product modification; (5) the proposed leveraging of the export trading company (assets: capital) does not exceed 10:1; and (6) the proposal raises no significant policy issue on which the Board has not previously expressed a view.

In sum, the Board's regulations and procedures are designed to promote the purposes and objectives of the BESA, including maintaining the safety and soundness of banks affiliated with export trading companies.

A list of bank holding companies that have invested in ETCs is found at Attachment II-F.

U.S. Activities of Foreign Banks

Statutory Background

Prior to enactment of the International Banking Act of 1978 ("IBA"), federal regulation of foreign banks was confined mainly to governing foreign banks that became bank holding companies by acquiring U.S.-chartered commercial bank subsidiaries. Regulation of foreign bank operations through branches or agencies resided primarily with the banking authorities of those states (New York, California and Illinois, principally) that allowed foreign banks to enter through direct offices. As a result, foreign banks enjoyed certain liberties not available to U.S. banks, such as establishing offices in more than one state and engaging through affiliates in a wide range of nonbanking activities. In addition, they operated under some restrictions not imposed on U.S. banks, such as being ineligible to obtain federal deposit insurance and to acquire Edge corporations.

The IBA, the first federal statute to deal specifically with foreign banking organizations having U.S. branches and agencies, extended the dual banking option to foreign banks and explicitly adopted the U. S. policy of "national treatment." National treatment operates on the principle of equality of competitive opportunity and requires, to the extent possible, that foreign and domestic banking organizations be treated equally. In implementing this policy, the IBA established a federal regulatory framework governing foreign bank activities in the United States that would be nondiscriminatory in its effect on domestic and foreign banks.

Any foreign bank that operates a bank, branch, agency or commercial lending company in the United States is subject to the nonbanking provisions of the Bank Holding Company Act ("BHC Act" or "Act"). The Act provides that a company subject to its provisions may not engage in any activities other than those of banking or managing or controlling banks and other subsidiaries authorized by the Act and those activities permitted under section 4(c)(8).

In addition to the activities that may be conducted under section 4(c)(8), foreign banks may engage in other activities under certain exemptive provisions of the Act that are designed to limit the extraterritorial application of the Act. The exemptions are set out in sections 2(h) and 4(c)(9) of the Act.

Section 4(c)(9) authorizes the Board to exempt by regulation or order the investments or activities of a foreign institution the greater part of whose business is conducted outside the United States if the Board determines that the exemption would not be "substantially at variance with the purposes of [the] Act and would be in the public interest."

Section 2(h) of the BHC Act provides the other exemption for foreign institutions. Section 2(h) generally permits a foreign bank to own shares of a foreign nonbanking company that engages in business in the United States as long as the company engages in the same line of business as it conducts overseas. The exception afforded by section 2(h) is available only to foreign institutions that are "principally engaged in the banking business outside the United States." It applies solely to the ownership of shares of foreign companies and not to direct nonbanking activities by the foreign institution itself.

In addition, in order for the parent foreign bank to be able to take advantage of the exemption, the subsidiary nonbanking company must be principally en-

gaged in business outside the United States. The U.S. business of that subsidiary must be "in the same general line of business as the investor company or in a business related to the business of the investor company."

This broad exemption was added by the IBA because many foreign banks that became subject to the nonbanking restrictions of the BHC Act for the first time as a result of the IBA are permitted in their home countries to have commercial and idustrial affiliates. Thus, like section 4(c)(9), section 2(h) limits the extraterritorial application of the nonbanking restrictions.

One purpose of this exception was to avoid precluding desirable investment in the United States by foreign nonbanking firms because of foreign bank ownership of such firms. The example most often cited is that of Daimler Benz, the German automobile manufacturer, which is more than 25 percent owned by Deutsche Bank. Without some exemption from section 4 of the Act, Daimler Benz would be precluded from doing business in the United States so long as Deutsche Bank did a banking business here and vice-versa.

To protect U.S. banks from unfair or inequitable competition in financial activities, the IBA provided that a foreign bank may not use the section 2(h) exemption to engage in financial operations in the United States without the Board's approval.

The IBA also provided specific grandfathering for foreign banks that conducted nonbanking activities prior to July 26, 1978. Those activities may continue to be conducted by the foreign banks unless the Board determines that their continued conduct would result in adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsafe or unsound banking practices. Under the grandfather exemption of the IBA, foreign banks conduct certain activities that are not permitted to U. S. banking organizations in the United States, including securities activities.

Regulatory Background

Under the Board's regulations, the exemptions afforded by these sections are available *only* to a qualifying foreign banking organization ("QFBO")—a foreign banking organization more than half of whose worldwide business is banking and more than half whose banking business is outside the United States. This assures that only organizations whose chief business is banking will conduct banking operations in the United States and that the exemptions will be afforded only to organizations that are not chiefly domestic. The Board's regulations strike a balance between attempting to assure that foreign banks do not derive significant advantages over domestic banks as a result of these exemptions and carrying out the legitimate purpose of not disrupting the foreign bank's affiliations with overseas organizations where the law of the foreign bank's home country permits such affiliation.

Under section 2(h), a QFBO may hold shares of a foreign nonbanking company that engages in the same business in the United States as it conducts abroad, as determined by reference to the 4-digit establishment number of the Standard Industrial Classification ("SIC"). The regulation provides that certain enumerated activities will be considered to be "financial" for purposes of the statute and regulation, including insurance and most real estate and data processing activities, and prior Board approval is required before a QFBO can engage in such activities in the United States.

Under the regulations implementing section 4(c)(9), a qualifying foreign banking organization may engage directly or indirectly in any activity outside the United States; it may hold shares of any company that engages in activities in the United States that are incidental to foreign business; and it may hold a noncontrolling interest in any chiefly foreign company, regardless of the company's U.S. activities (except that the company may not engage in U.S. securities activities beyond what is permitted to a bank holding company).

In addition to these self-executing exemptions, a foreign bank that does not qualify as a QFBO or that wishes to engage in an otherwise impermissible activity may apply to the Board for permission under section 4(c)(9). It is the policy of the Board, however, that a foreign bank will not be permitted to engage in activities under section 4(c)(9) that are not permitted under section 4(c)(8) or otherwise give foreign institutions a competitive advantage over U.S. bank holding companies.

Supervision of Foreign Banks Operating in the United States

The International Banking Act (IBA) established a framework for Federal participation in the supervision of the U.S. operations of foreign banks. The U.S. presence of foreign banks has grown dramatically since passage of the IBA in 1978. As of December 31, 1985, 255 foreign banks from 55 countries operated 420 state-licensed branches and agencies and 82 branches and agencies licensed by the OCC. Of these offices, 51 had FDIC insurance. Foreign banks also directly owned 22 Edge corporations and 10 commercial lending companies. In addition, foreign banks held a majority interest in 71 U.S. commercial banks. These

foreign banks together control approximately 15 percent of U.S. banking assets.

The IBA gave the Federal Reserve broad residual examination and oversight authority for the supervision and regulation of foreign banks that engage in banking in the United States through branches, agencies, commercial lending companies, or subsidiary commercial banks. Although the OCC, the FDIC and the states are the primary regulators of the U.S. branches and agencies of foreign banks, the Federal Reserve is the residual supervisory authority and is authorized to review all banking operations conducted in the United States by foreign banks. It is the federal agency specifically concerned with the consolidated U.S. activities of foreign banking organizations. Review of these operations is carried out through a number of methods. In addition, the Federal Reserve and the other banking agencies have adopted policy statements that set forth the standards under which the U.S. operations of foreign banks will be supervised. See Attachments II-F and II-G.

Examinations

Examination responsibilities for branches and agencies of foreign banks are divided among the three federal agencies in a way similar to that for examining domestic commercial banks. The OCC examines the branches and agencies that it has authorized to operate under federal license; the FDIC examines state licensed offices that have been granted FDIC insurance coverage; and the Federal Reserve has primary federal authority for examining state licensed uninsured branches and agencies. The IBA, however, instructs the Federal Reserve to rely on State authorities, to the maximum extent possible, to conduct these examinations. Accordingly, the Federal Reserve's involvement in the examination process varies widely depending upon the scope of state examination programs and the state's desire for Federal Reserve assistance and support.

In 1985, the Federal Reserve participated in the examination of 101 branches and agencies. Aside from routine examinations, the Federal Reserve has the authority to examine, at its own initiative, specific problem institutions. The branch and agency examination report was revised in 1985 and is currently being used by the three Federal agencies and most states.

Edge corporations are all examined by the Federal Reserve while commercial lending companies are examined by the respective states. U.S banks owned by foreign banks, along with their holding companies, are examined under normal domestic procedures.

Reporting Requirements

Branches and Agencies. Several supervisory reports are now required of the U.S. offices of foreign banks. The Quarterly Report of Assets and Liabilities (FFIEC 002) filed by each branch and agency of a foreign bank was instituted in June 1980 and revised in 1985. This report is similar to the "call" report prepared by all insured domestic banks and provides information needed to monitor the condition of the U.S. operations of individual foreign banks, as well as for monetary policy purposes.

In addition to this branch and agency "call" report, a new report has recently been adopted—the Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (FFIEC 019). This report will require branches and agencies of foreign banks to report quarterly their exposure to their home country and to the five other foreign countries to which they have the greatest exposures.

Parent Foreign Banks. In addition to the banking agencies' supervisory program developed to review the U.S. operations of foreign banks, the Board also monitors the condition of the respective "parent" banks, as the ultimate responsibility for the U.S. operations resides with these institutions. Therefore, the Federal Reserve requires foreign banking organizations to submit financial and managerial information to permit the Federal Reserve to assess the organization's ability to be a continuing source of strength and support to its U.S. banking operations.

To this end, two reports were developed which provide consolidated information on the foreign parent bank. They are the Annual Report for Foreign Banking Organizations (F.R. Y-7) and the Annual Foreign Banking Organization Confidential Report of Operations (F.R. 2068). The F.R. Y-7 contains financial and managerial information on the parent organization as well as information about its activities conducted in the United States.

The F.R. 2068 is filed by all foreign organizations except those with a limited presence in the U.S. money markets. These foreign organizations are required to provide detailed information on their earnings, loan loss experience, gains or losses on the sale of debt and equity securities, and inner reserves not disclosed in the F.R. Y-7. The information submitted in the F.R. 2068 is treated as confidential by the Board under section (b)(8) of the Freedom of Information Act.

In these reports, the foreign organizations are also required to provide an organization chart of their direct and indirect investments in foreign companies and to provide financial data on material foreign subsidiaries.

NONBANKING ACTIVITIES. The Federal Reserve has established procedures to monitor the U.S. nonbanking activities of foreign banks. The F.R. Y-7 report requires information concerning activities conducted in the United States by the foreign banking organization, either directly or indirectly, so that compliance with applicable statutes and regulations can be assured. Foreign banking organizations are also required by section 211.23(h) of Regulation K to report on a quarterly basis any acquisitions of shares of companies engaged, directly or indirectly, in activities in the United States. The foreign banking organization must also report any direct activities in the United States commenced during the quarter by one of its foreign subsidiaries.

AFFILIATE TRANSACTIONS. In addition to monitoring compliance with regard to nonbanking activities, the Federal Reserve also reviews loans to U.S. or foreign affiliates made by the U.S. offices of foreign banks. These transactions are reviewed during the examination process and through several of the regular reports required of these offices. To date, there have been no significant abuses detected.

Footnotes

1. *National Courier Association v. Board of Governors*, 516 F. 2d 1229 (D.C. Cir. 1975).

2. *Alabama Association of Insurance Agents v. Board of Governors*, 533 F. 2d 224 (5th Cir. 1976), *cert. denied*, 435 U.S. 904 (1978).

3. In addition to the activities already incorporated in Regulation Y, the Board has sought public comment on adding the following activities to the so-called "laundry list" (some have already been approved by order for individual holding companies): i) Advisory services related to commodity trading and FCM activities, ii) Check guaranty services, iii) Consumer financial counseling, iv) Tax planning and preparation services, v) Operating a credit bureau and collection services, vi) Armored car services, and vii) Appraisal of personal property. The Board has also proposed to amend Regulation Y to define the types of insurance activities permissible under the Garn-St Germain Depository Institutions Act of 1982, and has requested public comments on whether to initiate rulemaking on real estate development activities.

4. See: Cornyn, Hanweck, Rhoades and Rose, "An Analysis of the Concept of Corporate Separateness in Bank Holding Company Regulation from an Economic Perspective."

Number of Bank Holding Companies and Percent of Commercial Bank Assets Controlled by Bank Holding Companies in Selected Years 1970-1985

Year	No. of BHCs	Percent of Aggregate Commercial Bank Assets Controlled
1970	121*	16
1971	1567	57
1975	1821	69
1980	3056	78
1981	3702	81
1982	4558	85
1983	5410	88
1984	6102	90
1985	6453	92

* Includes only companies owning or controlling two or more banks.

Breakdown of the Assets of Bank Holding Company
Groups By Size Class as of 12/31/85

Consolidated Asset Size Class	No. of BHC Groups In Size Class	Total Assets In Size Class ($ billions)	As Percent of All Bank Holding Company Assets
Under $150 million	5121	$239.3	9.5
$150 million to $500 million	509	131.7	5.2
$500 million to $1 billion	112	80.0	3.2
$1 billion to $10 billion	205	673.2	26.8
Over $10 billion	43	1390.1	55.3
Total	5990	2514.3	

Note: The total number of bank holding company groups in this Table differs slightly from the total number of bank holding companies shown in Table I-A. This is due to the fact that this Table counts a bank holding company only once, that is, as one group, even if the holding company itself owns another bank holding company. Thus, a multi-tiered bank holding company is counted as one holding company group for the purpose of this Table.

Combined Assets in Nonbank Subsidiaries as
Reported by Bank Holding Companies With
Consolidated Assets in Excess of $150 Million
1976-1984
($ Amounts in Millions)

Year	Aggregate Nonbank Assets	As Percent of Aggregate Consolidated Assets of Bank Holding Companies
1976	$26,510	3.1
1977	31,619	3.3
1978	39,968	3.6
1979	42,428	3.4
1980	51,276	3.7
1981	61,458	4.0
1982	71,007	4.1
1983	83,500	4.4
1984	132,313	6.4

NOTE: These totals do not include assets in subsidiaries of holding company banks.

Domestic Nonbank Activities Permitted by Regulation or Specific Board Order and Date of Initial Approval

Nonbanking Activities Approved

Year	By Regulation	By Specific Order
1971	Making and servicing loans	Operating a "pool reserve plan" for the pooling of loss reserves of banks with respect to loans to small businesses.
	Industrial banking	
	Trust company functions	
	Investment or financial advice	
	Leasing personal or real property	
	Community development	
	Data processing (significantly expanded in 1982)	
	Insurance sales	
1972	Underwriting credit life, accident and health insurance	Operating a thrift institution in Rhode Island.
1973	Courier services	Buying and selling gold and silver bullion and silver coin.
1974	Management consulting to depository institutions (expanded to other than commercial banks in 1982)	None
	Leasing real property	
1975	None	Operating a guaranty savings bank in New Hampshire.

Attachment I-D

Attachment I-D
(Continued)

	By Regulation	By Specific Order
1976	None	None
1977	None	Operating an Article XII Investment Company under New York State law.
1978	None	None
1979	Issuance and/or sale of money orders (up to $1,000 face value), savings bonds, and travelers checks (issuance of travelers checks added in 1981)	Retail check authorization and check guaranty services. Providing consumer-oriented financial management courses, counseling, and related financial materials.
1980	Real estate appraising	None
1981	None	None
1982	None	Engaging in commercial banking activities overseas through branches of a nonbank Delaware company. Operating a distressed savings and loan association.
1983	None	Operating a limited-purpose National bank that conducts credit card activities only.
1984	Arranging commercial real estate equity financing	Issuing consumer-type payment instruments having a face value of not more than $10 thousand.
	Securities brokerage	Operating a "nonbank bank" through a limited purpose commercial bank charter.

	By Regulation	By Specific Order
	Underwriting and dealing in government obligations and money market instruments	FCM brokerage of futures contracts on a municipal bond index, and related futures advisory services.
	Foreign exchange advisory and transactional services	Providing financial feasibility studies for private corporations; performing valuations of companies and of large blocks of stock for a variety of purposes; providing expert witness testimony on behalf of utility firms in rate cases.
	Acting as a Futures Commission Merchant ("FCM")	
1985	None	FCM brokerage of certain futures contracts on stock indexes, and options on such contracts.
		Tax preparation services for individuals performed in a nonfiduciary capacity.
		Credit card authorization services and lost/stolen credit card reporting services.
		Employee benefits consulting activities.
		Expanded student loan servicing activities.
		Issuance and sale of official checks with no limitation on the maximum face value, but subject to certain limitations.
1986	None	Underwriting and reinsuring home mortgage redemption insurance.

Domestic Nonbank Activities Denied by the Board and Reason for Denial

Year	Activity Denied	Reason
1971	Insurance premium funding ("equity funding") (combined sale of mutual funds and insurance).	Potential for conflict of interest and unsound banking practices.
1971	Underwriting general life insurance not related to extensions of credit.	No reasonable basis for a finding that activity was closely related to banking.
1972	Real estate brokerage.	Not closely related to banking.
1972	Land investment and development.	Has not been and is not permissible; not closely related to banking.
1972	Real estate syndication	Inconsistent with Glass-Steagall Act. Activities go beyond those of REIT advisor and are not closely related to banking.
1972	General management consulting	Conflicts of interest and combining of banking and commerce.
1972	Property management services generally	No basis found to support permissibility.
1973	Sale of level term credit life insurance.	Not directly related to an extension of credit.
1973	Armored car services.	Deferral of a decision by the Board due to lack of interest and evidence presented by bank holding companies at rulemaking.

Attachment I-

	Activity Denied	Reason
1974	Underwriting mortgage guaranty insurance.	Not appropriate at the time in light of untested activity, and need of BHCs to slow their rate of expansion and strengthen their existing operations.
1974	Operating a savings and loan association (except in Rhode Island, or unless the S&L is distressed).	(Related to specific case only). Public benefits do not outweigh adverse effects because of financial strain placed on applicant by funding requirements. (See 1977 below.)
1975	Computer output microfilm service where it is not an output device for otherwise permissible data processing services.	Not a financially related activity.
1976	Operating a travel agency.	Insufficient historical relationship to general nature of banking to be closely related; not functionally or integrally related to other permissible banking activities.
1977	Operating a savings and loan association (except in Rhode Island, or unless the S&L is distressed).	(Related to specific case only). Elimination of existing competition. (General considerations). Conflict between regulatory frameworks, erosion of institutional rivalry, and deferral to Congress as to proper means of regulating "near bank" thrifts.
1978	Underwriting property and casualty insurance.	Applicant did not meet its burden of proof that activity met National Courier tests.
1980	Real estate advisory activities.	No reasonable basis found for permissibility.

Attachment I-E
(Continued)

Attachment I-E
(Continued)

	Activity Denied	Reason
1980	Underwriting home loan mortgage life insurance (subsequently approved).	Banks have not traditionally engaged in the activity; not integrally related to lending transaction or otherwise functionally or integrally related to banking. More like term life insurance.
1980	Certain contract, key entry, data processing services.	Services were not data processing or a reasonably necessary incident thereto (alteration of form, not substance, of data).
1982	Offering investment notes with transactional features.	Public confusion regarding uninsured status of notes and lack of diversification of investments. Also, circumvention of Regulation Q.
1985	Providing credit ratings on bonds, preferred stock and commercial paper.	Conflict of interest between a major lender and a rating company are pervasive; particularly serious given relatively few rating companies in industry.
1986	Acting as a specialist in foreign currency options on a security exchange.	Financial risk, insufficient skill and experience to manage risk, and potential for conflicts of interest.
1986	Title insurance activities.	Violates Garn-St Germain limits on insurance activities.

Number and Type of Domestic Bank Holding Company Applications Processed by Board and Reserve Banks 1971-1985

	1971	1972	1973	1974	1975	1976	1977
Section 3 (banking activities)							
Formations	67	123	147	154	156	155	186
Acquisitions	158	298	407	330	162	150	152
Total (Section 3)	225	421	554	484	318	305	338
Section 4 (nonbanking activities)							
Approved by Board Regulation							
Credit Granting	50	206	396	392	170	158	315
Service - related	28	115	268	299	212	290	240
	78	321	664	691	382	448	555
Approved by Board Order							
Credit Granting		1		1	1	1	6
Service -related		3	2	2	1		5
		4	2	3	2	1	11
Total (Section 4)	78	325	666	694	384	449	566
Grand Total	303	746	1220	1178	702	754	904

Attachment I-

Number and Type of Domestic Bank Holding Company Applications Processed by Board and Reserve Banks 1971-1985

	1978	1979	1980	1981	1982	1983	1984	1985
Section 3 (banking activities)								
Formations	273	372	690	840	1089	998	963	655
Acquisitions	157	174	198	332	455	499	499	544
Total (Section 3)	430	546	888	1172	1544	1497	1462	1199
Section 4 (nonbanking activities)								
Approved by Board Regulation								
Credit Granting	350	278	298	360	431	481	316	202
Service - related	236	267	369	368	398	515	440	348
	586	545	667	728	829	996	756	550
Approved by Board Order								
Credit Granting		1	1		5	7	11	20
Service - related	1	4	1	3	8	16	5	7
	1	5	2	3	13	23	16	27
Total (Section 4)	587	550	669	731	842	1019	772	577
Grand Total	**1017**	**1096**	**1557**	**1903**	**2386**	**2516**	**2234**	**1776**

Attachment I-F
(Continued)

Number of Federal Reserve On-Site Inspections
of Bank Holding Companies, 1975-1985

Year	No. of Inspections
1985	1778
1984	1568
1983	1398
1982	1273
1981	1119
1980	866
1979	698 approx.
1978	581
1977	473
1976	352
1975	228

Attachment II-A

NONBANKING ACTIVITIES ABROAD
PERMITTED BY SPECIFIC ORDER*/

Date	Activity	Reasons
1975	Insurance underwriting in Australia.	Australian companies within two years to cease underwriting lines of insurance not "financial" in character or engaging in other non-"financial" activities (real estate development, hotel management, etc.).
1977	Underwriting comprehensive motor vehicle insurance and chattel title insurance in Australia.	Underwriting comprehensive motor vehicle insurance found integrally-related to auto financing in Australia; competitive harm to applicant seen if activity not permitted. Conditions include: auto liability insurance barred; and majority of underwriting to be related to credit extension or auto dealer financing by affiliates of underwriter.

*/ The Board's Regulation K contains a list of activities in which a U. S. banking organization may engage. The list, found at section 211.5(d) of Regulation K, is made up of those activities that the Board had found to be usual in connection with foreign banking or financial operations. A banking organization may also engage overseas in activities listed in Regulation Y.

This table describes activities that either are not on the list or were added to the list after 1979. Prior to 1979, each acquisition, regardless of the activity, required specific Board approval.

Date	Activity	Reasons
1981	Underwriting in Australia credit life, health and accident insurance unrelated to extensions of credit by underwriter's affiliates.	Activity is financially-related and does not involve risks different from underwriting insurance that is directly related to credit extensions by bank or its affiliates; applicant experienced in management of such risks.
1982	Brokerage with respect to gold bullion on London Gold Futures Market and with respect to U.K. government bonds and Eurodollars and sterling deposit interest rate futures on London International Financial.*/	Activity found usual in connection with foreign banking or financial operations in the U. K.; relied on fact that applicant was not to trade for its own account, had in place good credit approval procedures, and had demonstrated expertise in proposed activity; also the nature of futures exchanges reduced risk through guarantees supplied by a clearing house.
1983	Provision of travel related services in Argentina in connection with credit card operations.**/	Services are offered by Argentine banking organization in connection with credit card operations, provision of such services does not pose undue risk or threaten diversion of capital or managerial resources from U. S. banking.

*/ Activity subsequently added to list of activities in Regulation Y (12 C.F.R. 225.25(b)(18)).

**/ Activity subsequently added to list of activities in Regulation K (12 C.F.R. 211.5(d)(14)).

Date	Activity	Reasons
1984	Underwriting life insurance in United Kingdom.	Activity is usual for U. K. financial institutions; Board relied on fact that company was small, its projected growth moderate, and restrictions on loans to affiliates would apply; risks are actuarially predictable and life insur- underwriting is regulated in U. K.
1984	Underwriting general life insurance in Germany and Australia.	Activity usual in connection with banking or finance in each country because activity is financially-related and there are affiliations in each country between banks and insurance companies. Risks are actuarially predictable, each subsidiary is small and adequately capitalized, and projected future growth is moderate. Forbidding activity would result in competitive disadvantage for applicant. Underwriting is subject to supervision by regulatory authorities in Germany and Australia.
1984	Underwriting in Belgium and Luxembourg of: credit insurance not directly related to extensions of credit by applicant's organization; savings completion insurance; and home loan life insurance and endowment life insurance related to mortgage lending activities of applicant's organization.	Activities are financially related and, with exception of savings completion insurance, already engaged in by Belgian banks; applicant experienced in managing the risks involved; subsidiaries involved in activity are small, adequately capitalized, with moderate projected growth.

Date	Activity	Reasons
1985	Real estate brokerage in Hong Kong.	Activity found to be usual in connection with banking services in Hong Kong, and engaged in by applicant's competitors. Risk is slight, involving little exposure of capital or financial resources, as brokerage is fee-based and non-leveraged. Applicant is not to deal in real estate for its own account, and will also have no involvement in credit approval procedures for properties it handles.
1985	Pension fund administration and underwriting of related life and disability insurance in Chile in connection with Chilean mandated worker pensions.	Activity found usual in connection with banking or financial services based on nature of activity and fact that Chilean banks have engaged in the activity; acquisition consistent with Chilean law; underwriting is limited to that required by pension fund administration; amounts insured are small, and reinsurance is to be obtained for large claims.

NONBANKING ACTIVITIES ABROAD
DENIED BY SPECIFIC ORDER

Date	Activity	Reasons
1974	General insurance underwriting in Switzerland	Insurance underwriting requires large amount of capital and specialized managerial resources which could be diverted from U. S. banking activities. Approval could also result in blurring of the line between banking and commerce in the U. S. and record does not show that competitors engage in insurance underwriting. Proposal involves joint venture with a large U. S. insurance company wholly owned by one of largest U. S. retailers and, if approved, might result in undue concentration of economic resources in the U. S.
1974	General insurance underwriting in Brazil	General insurance underwriting involves unfamiliar risks and could divert capital and managerial resources from domestic banking activities. Also, the other main investor in the underwriter is a major U. S. insurer, which raised same issues as described above.
1974	Freight forwarding and customs brokerage activities in Brazil and Canada, respectively.	Proposed activities are not "international or foreign financial operations."

Date	Activity	Reasons
1981	Physical commodities futures trading in Australia	Activity is not financial in character and also entails risks not normally associated with banking.
1984 and 1985	Underwriting property and casualty insurance in Australia	Underwriting property and casualty insurance involves risks that are qualitatively different from both banking and life insurance underwriting. In addition, local regulators would require the subsidiary carrying on the activities to be held in chain of ownership of bank, rather than through the bank holding company.

COMPARISON OF DOMESTIC AND FOREIGN NONBANKING ACTIVITIES PERMISSIBLE FOR U.S. BANKING ORGANIZATIONS

Permissible Foreign Activities for U.S. Banking Organizations as Described in Regulation K	How Analogous Domestic Activity for U.S. Banking Organization Differs from Foreign Activity	Reason for Difference, if any
Commercial banking (211.5(d)(1))	[Section 3 activity]	--
Financing, including commercial financing, consumer financing, mortgage banking, and factoring (211.5(d)(2))	No material difference (225.25(b)(1))	--
Leasing real or personal property if the lease serves as the functional equivalent of an extension of credit to the lessee of the property (211.5(d)(3))	No material difference (225.25(b)(5))	--
Acting as fiduciary (211.5(d)(4))	Limitations on loans and investments that may be made, and deposits that may be accepted (225.25(b)(3))	Domestic restrictions on lending and deposit-taking in order that fiduciary would not be able to function as commercial bank
Underwriting credit life insurance and credit accident and health insurance related to extensions of credit (211.5(d)(5))	Limited to underwriting insurance related to extensions of credit by the bank holding company and its affiliates (225.25(b)(9)	Domestic activity restricted because of "closely related to banking" requirement in section 4(c)(8) and for competitive reasons that have no bearing overseas.

Attachment II-B
(continued)

Permissible Foreign Activities for U.S. Banking Organizations as Described in Regulation K	How Analogous Domestic Activity for U.S. Banking Organization Differs from Foreign Activity	Reason for Difference, if any
Performing services for other direct or indirect operations of a United States banking organization, including representative functions, sale of long-term debt, name saving, and holding assets acquired to prevent loss on a debt previously contracted in good faith (221.5(d)(6))	No material difference [4(c)(1)(C) of BHCA]	--
Holding the premises of a branch of an Edge corporation or member bank or the premises of a direct or indirect subsidiary (211.5(d)(7))	No material difference [4(c)(1)(A) of BHCA]	--
Providing investment, financial, or economic advisory services (211.5(d)(8))	No material difference, although domestic activity defined in terms of five specific areas of advice that may be provided (225.25(b)(4)	--
General insurance brokerage (211.5(d)(9))	Restricted to insurance that is related to either extension of credit or provision of other financial services, unless it is provided in community of less than 5,000 persons or bank holding company has assets of less than $50 million (225.25(b)(8))	Domestic activity restricted for competitive reasons that have no bearing overseas
Data processing (211.5(d)(10))	May be provided only to bank holding company and its subsidiaries, or where services are related to financial, banking, or economic data (225.25(b)(7))	Domestic activity restricted to provide services with respect to financial and economic data because of "closely related to banking" requirement in section 4(c)(8); Board has found the activity to be usual in connection with banking or financial activities

Permissible Foreign Activities for U.S. Banking Organizations as Described in Regulation K	How Analogous Domestic Activity for U.S. Banking Organization Differs from Foreign Activity	Reason for Difference, if any
Managing a mutual fund if the fund's shares are not sold or distributed in the United States or to U.S. residents, and the fund does not exercise managerial control over the firms in which it invests (211.5(d)(11))	BHC may organize and control a "closed-end" investment company but not a "mutual fund," which is an "open-end" investment company (225.25(b)(4))	Restrictions on domestic activity because of prohibitions in Glass-Steagall, which does not apply abroad
Performing management consulting services provided that such services, when rendered with respect to the U.S. market, is restricted to the initial entry of a foreign entity into the United States (211.5(d)(12))	Management consulting prohibited, except in limited cases for non-affiliated bank and nonbank depository institutions (225.25(b)(4) n. 2 & 225.25(b)(11))	Board has determined that general management consulting is not closely related to banking for domestic purposes, but is usual in connection with banking or financial activities abroad
Underwriting, distributing, and dealing in debt and equity securities outside the United States provided that no underwriting commitment by a subsidiary of an investor for shares of an issuer may exceed $2 million or represent 20 percent of the surplus or voting stock of an issuer unless the underwriter is covered by binding commitments from subunderwriters or other purchasers (211.5(d)(13))	Activity prohibited in U.S. except with respect to certain government obligations and money market instruments	Glass-Steagall prohibits engaging in activity in United States, but activity is permitted on limited basis abroad because foreign banks traditionally engage in these activities and Glass-Steagall does not apply overseas; limits are applied for prudential reasons

Attachment II-B (cont.)

Permissible Foreign Activities for U.S. Banking Organizations as Described in Regulation K	How Analogous Domestic Activity for U.S. Banking Organization Differs from Foreign Activity	Reason for Difference, if any
The operation of a travel agency provided that the travel agency is operated in connection with financial services offered abroad by the investor or others (211.5(d)(14))	Activity prohibited in U.S.	Board determined that activity is usual overseas for banking organizations and presents little, if any, risk to the banking organization; domestically, Board has determined that operation of a travel agency is not closely related to banking
Engaging in other activities that the Board has determined by regulation are closely related to banking under section 4(c)(8) of the BHCA	--	--

Attachment II-B
(continued)

Table II-C-1

Major merchant or investment banking subsidiaries
of U.S. banking organizations, by location

United Kingdom	Bank of America International Limited
	Bankers Trust International
	Carolina Bank Limited 1/
	Chase Manhattan Limited
	Chemical Bank International Limited
	Citicorp International Bank Limited
	First Chicago Limited
	First Interstate Capital Markets Limited
	Irving Trust International Limited
	Manufacturers Hanover Limited
	Morgan Guaranty Limited
	Wells Fargo Limited
Australia	BT Australia Limited 2/
	Chemical Australia International, Ltd.
	Citicorp Capital Markets Australia Ltd.
	Morgan Guaranty Australia Ltd.
	Security Pacific Australia Limited
Hong Kong	Asia Pacific Capital Corporation Ltd. 3/
	BA (Asia) Limited 4/
	BT Asia, Limited 2/
	Chemical Asia, Limited
	Citicorp International Limited
	Manufacturers Hanover Asia, Limited
Singapore	Citicorp International (Singapore) Ltd.
	Morgan Guaranty Pacific Limited
	Republic National Bank of New York (Singapore) Ltd.
	Security Pacific Bank Asia, Ltd.
Switzerland	Chase Manhattan Bank (Switzerland)
	Chemical Bank (Suisse), S.A.
	Citicorp Bank (Switzerland) A.G.
	Morgan Guaranty (Switzerland) Ltd.

1/ Owned by North Carolina National Bank
2/ Owned by Bankers Trust
3/ Owned by Citicorp
4/ Owned by BankAmerica

Table II-C-2

Underwritings of top 30 Eurobond lead managers, 1985 1/

Rank	U.S. bank affiliate	Institution	Number of issues	Amount (Million $)	Share of total market
1		Credit Suisse First Boston	222	$15,160	11.2%
2		Merrill Lynch	133	8,168	6.0
3	Yes	Morgan Guaranty	155	7,762	5.7
4		Salomon Brothers	160	7,378	5.5
5		Deutsche Bank	138	7,109	5.3
6		Morgan Stanley	135	4,900	3.6
7		SG Warburg	73	4,437	3.3
8		Union Bank of Switzerland	88	3,874	2.9
9		Nomura Securities	119	3,536	2.6
10		Swiss Bank Corporation	97	3,452	2.6
11		Goldman Sachs	74	3,276	2.4
12		Sherson Lehman Bros. Int'l	56	2,884	2.1
13		Banque Paribas	93	2,804	2.1
14		Orion Royal Bank	91	2,680	2.0
15		Lloyds	23	2,553	1.9
16		County Bank	16	2,522	1.9
17		Commerzbank	62	2,201	1.6
18	Yes	Citicorp	49	2,106	1.6
19		Daiwa Securities	90	1,933	1.4
20		Samuel Montagu	11	1,925	1.4
21	Yes	Bank of America	25	1,690	1.2
22		Banque Nationale de Paris	45	1,623	1.2
23	Yes	Bankers Trust	53	1,602	1.2
24		Dresdner Bank	50	1,514	1.1
25		Societe Generale	40	1,341	1.0
26		Industrial Bank of Japan	39	1,224	0.9
27		Credit Commercial de France	34	1,211	0.9
28		Bank of Tokyo	34	1,200	0.9
29	Yes	Chase Manhattan	29	1,110	0.8
30		Barclays Bank Group	9	1,103	0.8
		Total, top 30	2,243	$104,278	77.0%
		Total, U.S. banks	311	$14,270	10.5%

Source: Euromoney, "Annual Financing Report 1986," March, 1986.

1/ U.S. bank affiliates performed a relatively smaller role among co-managers. Only two U.S. banks were among the top 30 co-managers in 1985, and they were responsible for only $4.1 billion of underwritings in this capacity, or 5.6% of the total underwritten by the top 30 co-managers.

Table II-C-3

U.S. banking organizations that were among the top 50 Euronote underwriters during 1985

Rank	Institution	Number of issues	Amount (Million $)	Share of total market
6	Bankers Trust	51	$707	1.0%
9	Bank of America	38	654	0.9
22	First Interstate	23	500	0.7
24	Citicorp	44	484	0.7
29	Chase Manhattan	34	408	0.6
30	First Chicago	28	407	0.6
31	Security Pacific	24	404	0.6
33	Chemical Bank	25	403	0.6
42	Continental Illinois	15	297	0.4
43	Morgan Guaranty	19	287	0.4
49	Manufacturers Hanover	18	243	0.3
	Total	319	$4,794	6.7%

Source: Euromoney, "Annual Financing Report 1986," March, 1986.

Table II-D-1

Foreign offices and investments of U.S. banking organizations, Year-end 1985

Amounts in billions U.S. $

Type of office or investment	Estimated assets 1/ Gross	Estimated assets 1/ Net	Book value of investment
Branches	$458	$280	Not applicable
Subsidiaries	100	77	$9.4
Joint ventures 2/	20	20	0.7
Portfolio investments 3/	N.A.	N.A.	0.3

1/ Assets are gross and net of claims on other offices of the "parent" bank. Branch figures are from Federal Reserve Bulletin. Other figures are estimated based on 1984 data.

2/ Estimated assets assume that investments of U.S. investors account for one-third of a joint venture's equity and that the joint ventures have an average capital ratio of about 10 percent.

3/ These are investments representing less than 20 percent of the foreign company's voting shares.

N.A. means not available.

Source: Federal Reserve data

Table II-D-2

Investments of U.S. banks and bank holding companies in foreign subsidiaries by principal activity, December 31, 1984 1/

Type of activity of subsidiary	Number of investments > $50 thousand	Amount invested: Book value (million $)	Amount invested: Percent of total
Commercial banks	154	$3,920	45.3%
Investment/merchant banks	68	1,240	14.3
Funding vehicles	14	980	11.3
Consumer finance companies	32	900	10.4
Leasing companies	96	580	6.7
Commercial finance companies	58	280	3.2
Mortgage banks	6	60	0.7
Factoring companies	9	40	0.5
Other financial activities	100	150	1.7
Subtotal, lending	537	8,150	94.2
Trust companies	28	110	1.3
Securities brokers & dealers	23	90	1.0
Real estate	23	60	0.7
Insurance underwriters	4	55	0.6
Export/import company	6	15	0.2
Insurance agency/brokerage	9	5	0.1
Mutual fund managers	4	4	0.0
Investment, economic, and management consulting	45	90	1.0
Subtotal, financially related activities	142	429	5.0
Non-financial services 2/	7	25	0.3
Other nonfinancial companies 3/	32	50	0.6
Subtotal, nonfinancial activities	39	75	0.9
Grand total	718	$8,654.0	100.0%

1/ Includes investments made through Edge and Agreement Corporations.
2/ Bank premises companies and companies acquired through loan defaul
3/ Mostly shipping companies acquired through loan defaults.

Source: Federal Reserve data

Table II-D-3

Foreign joint venture investments of U.S. banks and bank holding companies by principal activity, December 31, 1984

Type of activity of joint venture	Number of investments > $50 thousand	Amount invested: Book value (million $)	Amount invested: Percent of total
Commercial banks	33	$413.9	60.9%
Investment/merchant banks	24	151.0	22.2
Leasing companies	13	33.0	4.9
Commercial finance companies	8	20.4	3.0
Other financial activities	7	14.0	2.1
Factoring companies	2	5.0	0.7
Consumer finance companies	2	2.4	0.4
Subtotal, lending	89	639.7	94.1
Holding companies	3	18.0	2.6
Real estate	5 1/	6.1	0.9
Trust companies	2	4.0	0.6
Insurance agency/brokerage	1	2.0	0.3
Mutual fund managers	1	1.0	0.1
Securities brokers & dealers	2	1.0	0.1
Investment, economic, and management consulting	3	1.0	0.1
Subtotal, financially related activities	14	32.1	4.7
Non-financial services	7	5.0	0.7
Manufacturing	3	3.0	0.4
Subtotal, nonfinancial activities	10	8.0	1.2
Grand total	113	$679.8	100.0%

1/ In addition, there are numerous very small investments.

Source: Federal Reserve data

Table II-D-4

Foreign portfolio investments of U.S. banks and bank holding companies by principal activity, December 31, 1984

Type of activity	Number of investments over $50,000	Amount invested: Book value (million $)	Amount invested: Percent o total
Commercial banks	25	$52.9	21.5
Investment/merchant banks	23	50.1	20.3
Leasing companies	7	3.2	1.3
Consumer finance companies	11	2.7	1.1
Industrial banks	8	2.5	1.0
Factoring companies	2	0.8	0.3
Other financial activities	20	14.0	5.7
Sub total, lending	96	126.2	51.2
Insurance underwriters	37	15.6	6.3
Holding companies	1	14.0	5.7
Investment, economic, and management consulting	19	13.0	5.3
Securities brokers and dealers	5	3.0	1.2
Export/import	3	1.9	0.8
Real estate	4 1/	1.9	0.8
Mutual funds managing	4	1.0	0.4
Data processing	1	0.6	0.2
Sub total, financially related activities	74	51.0	20.7
Manufacturing	58	40.8	16.6
Mining and drilling	16	9.0	3.7
Nonfinancial services	3	3.2	1.3
Construction companies	3	2.9	
Retail trading companies	3	1.2	0.5
Transport., commun., electric, gas or sanitary services	7	0.7	0.3
Other nonfinancial activities	15	11.3	4.6
Sub total, nonfinancial activities	105	69.1	28.1
Grand total	275	$246.3	100.0

1/ In addition, there are many very small investments.

Source: Federal Reserve data

SUPERVISION—Policy Statement on Availability of Information Concerning Foreign Operations of Member Banks

For the guidance of member banks having foreign operations, the Board publishes the following statement of policy regarding availability of information pertaining to member banks' foreign branches and subsidiaries to enable proper supervision of those operations:

The Board of Governors of the Federal Reserve System, as a central bank, is properly concerned with the preservation and promotion of a sound banking system in the United States. The Board of Governors and other federal banking supervisory authorities have been given specific statutory responsibilities to assure that banking institutions are operated in a safe and prudent manner affording protection to depositors and providing adequate and efficient banking services to the public on a continuing basis. These responsibilities and concerns are shared by central banks and bank supervisors the world over.

Under sections 25 and 25(a) of the Federal Reserve Act, the Board has particular responsibilities to supervise the international operations of member banks in the public interest. In carrying out these responsibilities, the Board has sought to assure that the international operations of member banks would not only foster the foreign commerce of the United States but that they would also be conducted so as not to encroach on the maintenance of a sound and effective banking structure in the United States. In keeping with the latter consideration, the Board believes it incumbent upon member banks to supervise and administer their foreign branches and subsidiaries in such a manner as to assure that their operations are conducted at all times in accordance with high standards of banking and financial prudence.

Proper administration and supervision of foreign branches and subsidiaries require the use of effective systems of records, controls, and reports that will keep the bank's management informed of the activities and condition of its branches and subsidiaries. At a minimum, such systems should provide the following:

1. Risk assets. To permit assessment of exposure to loss, information furnished or available to head office should be sufficient to permit periodic and systematic appraisal of the quality of loans and other extensions of credit. Coverage should extend to a substantial proportion of risk assets in the branch or subsidiary, and include the status of all large credit lines and of credits to customers also borrowing from other offices of the bank. Information on credit extensions should include (i) a recent financial statement of the borrower and current information on his financial condition; (ii) credit terms, conditions, and collateral; (iii) data on any guarantors; (iv) payment history; and (v) status of corrective measures employed.
2. Liquidity. To enable assessment of local management's ability to meet its obligations from available resources, reports should identify the general sources and character of the deposits, borrowings, etc., employed in the branch or subsidiary with special reference to their terms and volatility. Information should be available on sources of liquidity—cash, balances with banks, marketable securities, and repayment flows—such as will reveal their accessibility in time and any risk elements involved.
3. Contingencies. Data on the volume and nature of contingent items such as loan commitments and guaranties or their equivalents that permit analysis of potential risk exposure and liquidity requirements.
4. Controls. Reports on the internal and external audits of the branch or subsidiary in sufficient detail to permit determination of conformance to auditing guidelines. Such reports should cover (i) verification and identification of entries on financial statements; (ii) income and expense accounts, including descriptions of significant charge-offs and recoveries; (iii) operation of dual-control procedures and other internal controls; (iv) conformance to head office guidelines on loans, deposits, foreign exchange activities, proper accounting procedures, and discretionary authority of local management; (v) compliance with local laws and regulations; and (vi) compliance with applicable U.S. laws and regulations.

1973 *Fed. Res. Bull.* 449; 12 CFR 211.110; ¶ 5635.

LIST OF BANK HOLDING COMPANIES AND AFFILIATED ETCs

NOTIFICATION TO ESTABLISH EXPORT TRADING COMPANIES

Bank Holding Company	Export Trading Company	Date of System Action	Current Status
Security Pacific Corporation, San Francisco, CA	Security Pacific Export Trading Company Los Angeles, CA	5/09/83	Operating
Citicorp, New York, NY	Citicorp International Trading Company, New York, NY	5/31/83	Operating
Walter E. Heller International Corporation, Chicago, IL	Heller Trading Company Chicago, IL	6/13/83	Closed
First Interstate Bancorp, Los Angeles, CA	First Interstate Trading Company, Los Angeles, CA	6/15/83	Operating
First Kentucky National Corporation, Louisville, KY	First Kentucky National Trading Company, Louisville, KY	7/25/83	Inactive
Union Bancorp, Inc., Los Angeles, CA	StanChart Export Services Company, Inc., Los Angeles, CA	7/25/83	Operating
Crocker National Corporation, San Francisco, CA	Crocker Pacific Trade Corporation, San Francisco, CA	8/30/83	Closed
Ramapo Financial Corp., Wayne, NJ; Ultra Bancorporation, Bridgewater, NJ; and New Jersey National Corporation, Trenton, NJ	Bancorps' International Trading Corporation, Somerset, NJ	9/14/83	Operating
State Street Boston Corporation, Boston, MA	State Street Trade Development Corporation, Inc., Boston, MA	9/19/83	Sold
International Bancshares Corporation, Laredo, TX	IBC Trading Company, Laredo, TX	10/03/83	Not Activated
United Midwest Bancshares, Inc., Cincinnati, OH	United Midwest International Corporation, Cincinnati, OH		Closed

Bank Holding Company	Export Trading Company	Date of System Action	Current Status
U.S. Bancorp, Portland, OR	U.S. World Trade Corporation, Portland, OR	11/17/83	Inactive
First Chicago Corporation, Chicago, IL	First Chicago Trading Company, Chicago, IL	11/21/83	Operating
Rainier Bancorporation, Seattle, WA	Rainier International Trading Company, Seattle, WA	12/07/83	Operating
Shawmut Corp., Boston, MA	Shawmut Export Corporation, Boston, MA	12/12/83	Operating
Hongkong and Shanghai Banking Corporation, Hong Kong	Equator Trading Company Limited, Hartford, CT	12/27/83	Operating
BankAmerica Corporation, San Francisco, CA	BankAmerica World Trade Corporation, San Francisco, CA	02/02/84	Inactive
Bankers Trust New York Corporation, New York, NY	Bankers Trust International Trading Corporation New York, NY	02/02/84	Operating
First National State Bancorporation, Newark, NJ	First International Trading Co., Newark, NJ	02/13/84*	Operating
Chase Manhattan Corp., New York, NY	Chase Trade, Inc., New York, NY	02/21/84*	Operating
Society Corporation, Cleveland, OH	Export Partnership for International Trade, Inc., Cleveland, OH	03/04/84	Operating
Fleet Financial Group, Inc. Providence, RI	Fleeting Trading Company, Providence, RI	03/19/84*	Inactive
First National Bancshares, Inc. Houma, LA	First Export Corporation, Houma, LA	04/06/84*	Operating
Manufacturers Hanover Corporation, New York, NY	C.I.T. International Sales Corporation, New York, NY	04/24/84	Operating
First Union Corporation, Charlotte, NC	First Union Export Trading Company, Charlotte, NC	05/07/84*	Operating

*Acted upon by Reserve Banks pursuant to Delegated Authority.

Bank Holding Company	Export Trading Company	Date of System Action	Current Status
Alaska Mutual Bancorporation, Anchorage, AK	Mutual International Corporation, Anchorage, AK	06/06/84*	Operating
Frontier Bancorp, Vista, CA	Interbank Trading Company, San Diego, CA	07/30/84*	Not Activated
Florida Park Banks, Inc. St. Petersburg, FL	Park Services International, Inc., St. Petersburg, FL	09/19/84	Closed
Capital Bancorp, Miami, FL	Capital Trade Services, Inc., Miami, FL	09/20/84*	Operating
CoreStates Financial Lancaster, PA	CoreStates Export Trading Company, Philadelphia, PA	10/13/84*	Operating
North Valley Bancorp, Redding, CA	Casia-Pacific Company, Redding, CA	10/18/84*	Operating
Maryland National Corporation, Baltimore, MD	MN Trade Corporation, Baltimore, MD	12/18/84*	Operating
Marine Corporation, Milwaukee, WI	Marine Financial Services, Inc., Milwaukee, WI	12/31/84*	Operating
Ramapo Financial Corp., Wayne, NJ; Ultra Bancorporation, Bridgewater, NJ; and New Jersey National Corporation, Trenton, NJ	Florida Interbank Trading Company, Inc., Jacksonville, FL	01/07/85	Operating
First Wisconsin Corp., Milwaukee, WI	InterContinental Trading Co., Inc., Rolling Meadows, IL	02/11/85	Operating
Commerce Union Corporation, Nashville, TN	Commerce Trading Corporation, Nashville, TN	03/22/85	Operating
Valley National Corporation, Phoenix, AZ	Valley Internation Trading Company, Phoenix, AZ	04/16/85*	Operating

Acted upon by Reserve Banks pursuant to Delegated Authority.

Bank Holding Company	Export Trading Company	Date of System Action	Current Status
Manufacturers Hanover Corporation, New York, NY	Manufacturers Hanover World Trade Corporation, New York, NY	04/21/85*	Operating
Marine Midland Banks, Inc., Buffalo, NY	Marine Midland Trade, Inc., New York, NY	04/21/85*	Operating
United Bancorp of Arizona, Phoenix, AZ	United Bank Export Trading Company, Phoenix, AZ	07/05/85	Operating
InterFirst Corporation, Dallas, Texas	InterFirst World Trade Corporation, Dallas, Texas	--	Pending

*Acted upon by Reserve Banks pursuant to Delegated Authority.

Attachment II-F
(continued)

OTHER EXPORT TRADING COMPANY NOTIFICATIONS

Bank Holding Company	Export Trading Company	Date of Notice	Date of System Action[1]	Request
Security Pacific Corporation, Los Angeles, CA	Security Pacific Trading Co.	11/21/83	01/18/84	Expand Activities[2]
Society Corporation, Cleveland, OH	Export Partnership for Intercontinental Trade Inc.	01/23/85	03/20/85	Additional Investment
Hongkong and Shanghai Banking Corporation, Hong Kong	Equator Trading Co.	02/06/85	04/05/85	Additional Investment
Citicorp, New York, NY	Citicorp International Trading Co.	03/19/85	04/09/85	Additional Investment
State Street Boston Corp., Boston, MA	State Street Trade Development Co., Inc.	06/07/85	07/29/85	Additional Investment
Citicorp, New York, NY	Citicorp International Trading Co.	09/10/85	11/08/85	Invest in Bonded Collateral Management Vehicle
State Street Boston Corp., Boston, MA	State Street Trade Development Co., Inc.	10/31/85	12/19/85	Additional Investment
Chase Manhattan Corp., New York, NY	Chase Trade, Inc.	11/04/85	02/26/86	Increase Leveraging[3] to 17:1

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[1] In each instance, the Federal Reserve had no objection to the proposal.

[2] In its notification to the Board to establish its ETC, Security Pacific sought to engage in only limited ETC activities. The purpose of this notification was to enable it to engage in the full scope of the activities permitted under the BESA.

[3] Technically, this request was for relief from a commitment, not an ETC notification.

FOREIGN-BASED BANK HOLDING COMPANIES—Policy Statement on Supervision and Regulation of

The Board of Governors has a number of supervisory responsibilities over the operations of foreign banking organizations in the United States under the Bank Holding Company Act and, more recently, under the International Banking Act of 1978. During the past year the Board has undertaken a major review of its supervisory and regulatory policies toward foreign bank holding companies. Major elements underlying that review were the growth in number and total assets of U.S. banks owned by foreign banks and other foreign companies and the experience gained in regulating foreign bank holding companies since the 1970 Amendments to the Bank Holding Company Act. In the course of the review, the International Banking Act of 1978 was passed, thereby broadening the Board's supervisory responsibilities over the U.S. operations of foreign banks and establishing certain legislative policies over their operations in this country. In order to inform the public and the banking industry, the Board is issuing this statement setting forth its policy toward regulating foreign bank holding companies in the United States and describing initiatives that are underway in order to implement this policy more effectively.

Bank supervision in the United States has as a principal objective the promotion of the safety and soundness of banking institutions as going concerns serving depository and credit needs of their communities and the economy as a whole. To this end, a number of standards have been established governing domestic entry into the banking business and ongoing supervision of banking operations of domestic banks and bank holding companies.

In urging legislation to provide for federal regulation of foreign banks in the United States, the Board endorsed the principle of national treatment, or nondiscrimination, as a basis for the rules governing the entry and subsequent operations of foreign banks in this country. The International Banking Act of 1978 generally incorporates that principle in its provisions.

The Board continues to believe that the principle of national treatment should be the guiding rule in administering the Bank Holding Company Act and the International Banking Act of 1978 as they affect foreign banks. Following this rule, the Board believes that in general foreign banks seeking to establish banks or other banking operations in the United States should meet the same general standards of strength, experience and reputation as required for domestic organizers of banks and bank holding companies. The Board also believes that foreign banks should meet on a continuing basis these standards of safety and soundness if they are to be a source of strength to their U.S. banking operations.

At the same time, the Board is cognizant that foreign banks operate outside the United States in accordance with different banking practices and traditions and in different legal and social environments. The Board also recognizes that its supervisory responsibilities are for the safety and soundness of U.S. banking operations. Its supervisory concerns for the operations and activities of foreign banks outside the United States are, therefore, limited to their possible effects on the ability of those banks to support their operations inside the United States. As embodied in both the Bank Holding Company Act and the International Banking Act of 1978, it is the general policy of the Board not to extend U.S. bank supervisory standards extra-territorially to foreign bank holding companies. The Board will give due regard to these factors in applying the principle of national treatment.

The Board has jurisdiction over foreign entry in the case of foreign organizations seeking to acquire U.S. banks. Whenever a foreign bank applies to become a bank holding company, the Board will seek to assure itself of the foreign bank's ability to be a source of financial and managerial strength and support to the U.S. subsidiary bank. In reaching this judgment, the Board will analyze the financial condition of the foreign organization, evaluate the record and integrity of management, assess the role and standing of the bank in its home country, and request the views of the bank regulatory authorities in the home country. In connection with its financial analysis, the Board will require sufficient information to permit an assessment of the financial strength and operating performance of the foreign organization. Information will consist of reports prepared in accordance with local practices together with an explanation and reconciliation of major differences between local accounting standards and U.S. generally accepted accounting procedures including full information on earnings, capital, charge-offs, and reserves. The Board will also continue to work with bank supervisory authorities of other major countries to improve overall cooperation in international bank regulation.

Since the Board believes that foreign bank holding companies should be strong reputable organizations with banking experience, the Board is considering an amendment to tighten the definition by which a foreign company can qualify under section 4(c)(9) of the Bank

Holding Company Act for exemption from the prohibitions on ownership of nonbanking companies. For the purposes of section 4(c)(9), section 225.4(g) of Regulation Y defines a foreign bank holding company as a company chartered abroad "more than half of whose consolidated assets are located, or consolidated revenues derived, outside of the United States." The Board will propose for public comment a change in that regulation which would require the company to be primarily engaged in banking abroad. This would essentially reserve section 4(c)(9) for foreign organizations that were principally banks or banking institutions. As a result, both the foreign and domestic operations of foreign nonbank companies acquiring U.S. banks would either have to be divested or meet the more restrictive tests for exemption under section 4(c)(8) or section 4(c)(13) of the act.

In connection with the Board's overall review of its regulations and the implementation of the International Banking Act, a general revision of the regulation governing section 4(c)(9) will also be proposed later in 1979.

Once a foreign bank holding company has been established, Board supervisory procedures will be primarily directed at promoting the safety and soundness of the subsidiary U.S. banks. Examinations carried out by the relevant federal and/or state supervisory authority will continue to be the primary instrument for this purpose. Special attention will be given to transactions and correspondence between the U.S. subsidiary bank and its foreign parent and to monitoring credits by the U.S. bank to parties that are also customers of the parent. In particular, federal bank supervisors will expect the U.S. bank to maintain sufficient information on all borrowers to permit both the U.S. bank and bank examiners to make an independent appraisal of the bank's credits.

In addition to the examination process, the Board will require foreign bank holding companies to report quarterly on transactions between the U.S. subsidiary bank and its foreign parent. This reporting system is currently under development and will be implemented in the near future. The report will be similar to one currently required from domestic bank holding companies but will be designed to take into account the particular nature of the U.S. operations of foreign banks.

The Board will also require submission of sufficient financial information to enable it to assess the operations and general condition of the parent institution. To this end, the Board is in the process of amending its Annual Report for Foreign Bank Holding Companies (F.R. Y-7) to require more financial information on the foreign parent. In particular, full information on earnings, reserves and capital will be required along with an explanation of major material differences between U.S. and foreign accounting practices. In its use and handling of the information, the Board will take into account the fact that much of the information required may be confidential commercial information that is not generally disclosed.

This statement of policy applies to foreign bank holding companies and their U.S. bank subsidiaries. However, the Board has directed its staff to review supervisory policy with respect to the branches, agencies, and commercial lending companies of foreign banks in the United States in light of the Board's expanded supervisory responsibilities under the International Banking Act of 1978. At the conclusion of this review, the Board will issue a statement addressing the supervision of these offices. STATEMENT of Feb. 23, 1979.

FOREIGN BANKS—Policy Statement on Supervision of U.S. Branches and Agencies of

The recently enacted International Banking Act of 1978 (IBA) gives the three federal bank regulatory agencies expanded supervisory authority and responsibility with respect to the operations of foreign banks' U.S. branches, agencies, and commercial lending companies.* It provides for the establishment of federal branches and agencies by the Office of the Comptroller of the Currency and permits U.S. branches to apply for insurance coverage by the Federal Deposit Insurance Corporation (FDIC). It also subjects these U.S. offices to many provisions of the Federal Reserve and Bank Holding Company Acts.

In order to insure adequate supervision of these offices within the present federal-state regulatory framework, the IBA provides that the Comptroller, the FDIC, and the various state authorities will have primary examining authority over the offices within their jurisdictions. Additionally, the act gives the Federal Reserve Board residual examining authority over all U.S. banking operations of foreign banks, similar to its existing authority over U.S. subsidiary banks of bank holding companies. This distribution of responsibilities calls for close coordination of the efforts of the relevant authorities. Accordingly, the Comptroller, the FDIC, and the Board, in coordination with the Federal Financial Institutions Examination Council (FFIEC), are issuing this joint statement to inform the public and the banking industry of their supervisory policy toward these U.S. offices.

The agencies' supervisory interests in the operations of U.S. branches and agencies of foreign banks are directed to the safety and soundness of those operations in serving the needs of borrowers and depositors and other creditors in the United States. For this reason, the regulatory agencies will place primary emphasis on assessing the financial well-being of the U.S. offices. They will also be concerned with adherence to U.S. law and regulation by these offices.

At the same time, the agencies recognize that, even more than in the case of U.S. bank subsidiaries of foreign banks, the strength of these branches and agencies devolves from their head offices and organizations outside the United States and that ultimate responsibility for branch and agency activities resides in head offices overseas. Consequently, the agencies will seek to assure themselves that the parent institutions are financially sound. To this end, they plan to collect information on the consolidated operations of the foreign banks, as described below, and to expand their contacts with senior managements of the banks. Additionally, United States authorities are now working and will continue to work with bank supervisory authorities of other nations to improve both the coordinated exchange of banking information and the compatibility of international banking regulation.

The IBA mandated that the federal regulatory agencies cooperate closely with state banking authorities in examining U.S. offices of foreign banks. In furtherance of this mandate, a uniform approach to examining these offices is being developed through the FFIEC in order to minimize dual examinations and to facilitate joint federal-state examinations, when desirable. In exercising their responsibilities, the agencies will ensure that each U.S. office of a foreign bank is examined regularly by either state or federal authorities.

The federal regulatory agencies through the FFIEC, in consultation with the relevant state authorities, are also developing joint financial reporting requirements for these U.S. offices. The information required will be similar to that required of U.S. banks while taking into account their different organizational structure.

To gain information on the consolidated bank, the agencies will also develop new reporting requirements for the foreign parent institutions. These information requirements will be similar to those for foreign bank holding companies, including specific information on earnings, reserves, and capital, and an explanation for material differences between U.S. and foreign accounting practices. In the use and handling of this information, the agencies will take into account the fact that some of the information required may be confidential commercial information that is not generally disclosed. These new reporting requirements for both the U.S. offices and the foreign banks are planned to be implemented early in 1980, with some possibly in effect for the reporting period ending December 31, 1979. Detailed requirements and instructions will be issued prior to implementation.

Jointly prepared by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation and adopted by the Federal Financial Institutions Examination Council, July 20, 1979.

* The term "commercial lending companies" is intended to refer to investment companies organized under article XII of the New York State Banking Law, and any similar corporations that may be organized under the laws of other states.

An Analysis of the Concept of Corporate Separateness in BHC Regulation from an Economic Perspective

I. Introduction

This paper proceeds from the basic assumption that certain banking functions are essential so that bank safety and soundness is critical to the smooth functioning of the economic system.[1] The issue analyzed in this study is whether bank holding company (BHC) banks are presently effectively insulated from financial problems of BHC nonbank affiliates and the parent BHC. The analysis applies to nonbank-bank holding companies (HCs) as well as traditional BHCs. The nation's largest BHCs, which operate the nation's largest banking enterprises, engage most extensively in nonbank activities. Furthermore, market forces and public policy are moving toward expanded product lines for BHCs, and nonbank-banks with very large commercial affiliates or parents have been established. Consequently, this is an important policy with implications for the future safety and financial soundness of the banking system.

In the context of BHC regulation, the legal doctrine of corporate separateness is proposed by some as a workable means of insulating bank subsidiaries from the operations of nonbank affiliates and the parent holding company.[2] The chief proponents of this view contend that the legal principle of corporate limited liability—along with supporting statutes and regulations that limit transactions between banks and their affiliates and parents—generally can be relied on to achieve corporate separateness and protect banks and their depositors from risks occurring within the corporate family but outside of bank affiliates. Those of an opposing view contend that banks cannot be effectively insulated because the investing public, large depositors, and BHC management consider all units of the BHC to be interdependent.[3] Consequently, public confidence in bank affiliates of a BHC is linked to confidence in their nonbank affiliates. In this view, the legal doctrine of corporate separateness may not offer a practical means of insulating banks from the actions of their nonbank affiliates and parent companies.

This study examines economic theory and evidence on the question of corporate separateness as it relates to BHCs. The theory is equally relevant to nonbank-bank HCs though the phenomenon is so new that there is no direct evidence on these organizations. The second, third, and fourth sections examine the way in which BHC management, the public, and the regulators, respectively, view the BHC corporate form of organization. The fifth and final section provides a summary of the issues and evidence, and states the conclusion of the study.

II. The Bank Holding Company as Viewed by Management

The perception of market participants (*i.e.*, BHC managers, and the investing and depositing public) and regulators regarding the separability of the various components of a BHC is a critical determinant of the extent to which the bank subsidiaries are insulated from the financial problems in other parts of a BHC, regardless of the effectiveness of the legal doctrine of corporate separateness. This section and the two following sections focus on how the BHC is viewed by market participants and regulators, and the economic rationale for these views. The evidence examined in these sections is generally consistent. It suggests that both market participants and regulators tend to look upon the BHC as a single corporate entity rather than as a conglomeration of separate corporate units. This section explores the views of management by focusing on management's motivations, behavior, and operating policies.

Management Motivation and Behavior

Theory and evidence outlined below suggest that whether BHC or nonbank-bank HC management is motivated by profit maximization or other objectives, there will generally be an incentive to integrate operations. This is important because while profit maximization is commonly assumed, there is good reason to question this assumption.

This paper was prepared by Anthony Cornyn, Gerald Hanweck, Stephen Rhoades, and John Rose. Rose is at Baylor University now but made his contribution to the project while employed by the Board. The views expressed herein are those of the authors and do not necessarily reflect the views of the Board or its staff.

Management Behavior Assuming the Profit Motive

It is usually taken for granted that geographic and product-line diversification increase the value of the BHC firm to shareholders—that is, that such strategies on the part of BHC management are undertaken so as to maximize BHC profits. If management believes there are economies of scale or scope, profit maximization would dictate centralized control over operations. Similarly, if BHC management believes that the overall image of the company is dependent on the financial soundness of its various parts, management may be motivated to exercise control of subsidiaries' activities and operations, and to support ailing subsidiaries. This would also reflect rational profit maximizing behavior.

Management Behavior Assuming Nonprofit Motives

Although rational profit maximizing behavior could well lead to management treating the BHC as an interdependent organization, there is reason to question the assumption of pure profit maximization. If this assumption is questioned, it is necessary to examine the likely effect of alternative management motivation on the degree of BHC integration. The economics literature has long recognized the separateness of ownership and management in large corporations and the potential for differences in the objectives of corporate managers and shareholders.[4] The history of banking since the 1930s suggests a considerable movement away from the owner-managed bank that once characterized even the largest banking firms. Today, hired managers rather than owners operate large banking organizations, and due to the dispersion of ownership through stock, owners have limited control of management. Furthermore, evidence suggests that managers have objectives other than profit maximization.[5] In particular there is some indication that managers will maximize size and diversification subject to maintaining an acceptable level of profits.

The level of management compensation is more closely tied to size than to profitability though profitability is important in determining bonuses and stock options.[6] The evidence suggests that management's compensation will increase if the firm grows and is profitable. However, management's employment, reputation, and future benefits may be adversely effected if the firm does poorly. Thus, managers have a long-run incentive to diversify the operations of their firm in order to increase firm size and to reduce employment risk[7] that may result from fluctuating earnings performance.[8] Such diversification is often accomplished by mergers.[9]

As noted, evidence suggests that BHC management may be motivated to achieve large size and some degree of BHC diversification rather than pure profit maximization. Recent BHC behavior appears consistent with the size and diversification motives. This is reflected by BHCs' active pursuit of growth and geographic diversification through domestic nonbank companies, foreign banking, nonbank subsidiaries, and interstate expansion. Furthermore, within the last five years, BHCs have been particularly active in lobbying to expand into securities activities prohibited by the Glass-Steagall Act and to conduct insurance underwriting. More recently, some large banks are expanding by opening nonbank banks and acquiring failing savings and loan associations.[10]

Like profit maximization, other objectives pursued by BHC management will have implications for the extent to which BHC operations are centralized and integrated. It seems likely that managers of large or diversified firms will seek to centralize important operations to ensure that basic management objectives are being met. The types of operations that are particularly suited to integration include funds management, advertising, data processing, EFT, legal, corporate planning, purchasing, personnel management, and accounting. Within most BHCs, the largest unit and the one with the most diverse management skills and administrative apparatus is the bank subsidiary. Thus, it appears that the organizational structure of the BHC makes the lead bank a key element in the overall operation of the BHC.

The key point that emerges from this discussion of BHC management's motivation and behavior is that whether BHC management seeks to maximize profits or other objectives, such as size and diversification, it appears that there will be an incentive to integrate operations. To the extent that such integration occurs, the lead bank, being the dominant element in the organization, will play a major role.

Management Operating Policies

As has been argued above, there appear to be incentives for BHC management to adopt policies that centralize control. In this section, a number of studies that have examined the operating policies of bank holding companies are reviewed. These studies provide evidence on the degree to which holding company managers operate their organizations as integrated units.

Studies pertaining to holding company operating policies may be conveniently divided into three groups. The first group consists of studies that are

based on survey evidence of bank holding company operating practices and focuses on the degree of parent company (or lead bank) control over bank and nonbank subsidiaries. The second group of studies explores the effect of organizational centralization on the performance of multibank holding company systems. Finally, the results of several recent papers that examine the funds movement practices of bank holding companies are reviewed with regard to their implications for holding company integration.

Degree of Operating Control

Six early studies of bank holding company operating policies were reviewed in a 1978 compendium on the bank holding company movement.[11] One of the studies reviewed examined bank holding company operating policies with respect to nonbank subsidiaries while the other five focused on multibank holding company systems. Though the evidence is limited, the reviewer concluded that it suggests that bank holding companies tend to operate their organizations more like single, integrated entities than like collections of commonly owned but autonomous companies. This tendency is demonstrated by attempts bank holding companies typically make to exercise control over the management philosophy and broad operating policies of their subsidiaries. In addition, bank holding companies usually exert some direct control over specific operational areas (e.g., securities and federal funds management, budget policies, and capital management), though this practice generally seems to be less prevalent with bank subsidiaries than with nonbank subsidiaries.[12] Full integration of the holding company units appears to be partly constrained by section 23A of the Federal Reserve Act, which restricts financial transactions between a bank and its bank and nonbank affiliates.[13]

Two more recent studies of the operating policies of multibank holding companies shed further light on the integration issue. The first study, by Murray, is based on discussions with seven bank holding companies and survey responses from 16 holding companies.[14] The second study relies on survey evidence from 65 multibank holding companies located in 12 states.[15] Evidence presented in the two studies is generally consistent with that reported in the earlier works and suggests that, while the degree of centralization varies considerably across organizations, holding companies exert at least some effort to centralize and integrate the operations of their subsidiaries. Moreover, the evidence from both studies indicates that the extent of centralization within bank holding companies generally increased during the 1970s.[16] Murray offers three reasons for this trend.

> First, the recession [of the mid-1970s] caused operating problems at a number of banking institutions, so many holding companies increased internal operating and financial controls and developed standardized procedures where practical. Second, the rate of acquisition expansion slowed, so resources became available for improving the internal operating policies of holding companies. [Finally], the dramatic growth of government regulation of bank holding companies provided an added thrust toward more centralized policies, which were believed necessary in order to deal effectively with legal compliance requirements.[17]

Overall, studies of the degree of BHC centralization of operating policies are generally consistent and find that BHC management tends to centralize at least some operations. While the degree of centralization varies, it tended to increase during the 1970s.

Centralization Policy and Multibank Holding Company Performance

A number of studies have explored the relationship between multibank holding company centralization policy and holding company performance. These studies are relevant because if they indicate that BHC performance is enhanced by centralization, it would appear that there is an incentive to centralize operations. The first study, by Mayne, examined the association between the performance of individual bank subsidiaries and a holding company centralization index using a sample of 656 banks divided equally between subsidiaries of multibank holding companies and independent banks.[18] Several areas of bank performance were observed over the period 1969–72 and related to various independent variables, including holding company centralization, using multiple regression analysis. Data for the centralization index were obtained from Lawrence, who had constructed the index from the results of a 1969 survey of bank holding company operating policies.[19] Contrary to expectations, Mayne found generally no relationship between the degree of holding company centralization and subsidiary bank performance. A possible explanation, she suggested, was that "regardless of the formal internal organizational structure, identification with the group may result in informal but effectively unifying operating policies."[20] Another possible explanation is that the effects of holding company centralization on subsidiary bank performance may be observed only with a time lag. Thus, the effects may not have been evident in the 1969–72 period covered by the study when the multibank holding company movement was still in its infancy. It is also possible that the effects of centralization may be less observable at the subsidiary level than for the holding company as a whole, due to various

intraorganizational effects, such as interaffiliate financial transactions.[21] Finally, it is possible that the effects of centralization at the subsidiary level may vary with the size of the bank; Mayne did not test for any interactive effect between centralization and subsidiary bank size.[22]

In recognition of the potential problems with Mayne's level of observation, Whalen regressed consolidated holding company profit performance against several indexes of centralization policy and other independent variables, using a sample of 62 multibank holding companies.[23] The centralization indexes were constructed from the results of his 1979 survey work.[24] Holding company profitability was measured alternatively by the valuation ratio and the aggregate rate of return on subsidiary bank equity, for different time periods between 1979 and 1980.[25] Regression results indicated a positive, significant relationship between holding company profitability and internal structural centralization, for all profit measures and centralization indexes. These results suggest that multibank holding company efforts to manage their subsidiary banks as a single enterprise have yielded benefits for the consolidated holding company even if performance effects of centralization are not observable at the subsidiary bank level.

More recently, Whalen has examined the effect of holding company centralization policy on the profitability of individual bank subsidiaries.[26] His analysis is based on a sample of 1,210 banks, divided equally between holding company affiliates and independent banks. Using regression analysis, he estimated a bank profit function with 1979 data. The degree of holding company centralization is captured by dummy variables and is based on the results of his survey work. In contrast to Mayne's findings, the results of this study indicate that subsidiary bank performance is affected by holding company centralization policy. Specifically, the results suggest that subsidiary banks of relatively centralized holding companies tend to record higher profits than both independent banks and subsidiaries of decentralized organizations.

Overall, findings of studies of the effects of the degree of BHC centralization on financial performance are mixed but probably suggest that centralization yields higher profits. This suggests there may be a profit incentive to centralize.

Funds Transfers Within Bank Holding Companies

A third set of studies dealing with bank holding company operating policies examines the movement of funds between different units within the holding company system. In the first study, Mayne explored interbank differences in funds transferred from subsidiary banks to the parent holding company, using a sample of 874 banks from 140 bank holding companies, and data for 1975-76.[27] Upstreamed funds included cash dividends, interest, and management and service fees paid to the parent. Using regression analysis, Mayne found the combined payment of dividends, interest, and fees by the banks to their parents to be positively influenced by both the degree of financial leverage of the parent company and the extent of diversification by the holding company into highly leveraged nonbank activities (e.g., mortgage banking, commercial and consumer finance, factoring, and leasing). She concludes that "the evidence is consistent with the premise that BHC's operate as integrated entities and that this interdependence among component firms may affect the safety and soundness of affiliated banks."[28]

The second study, also by Mayne, takes a broader look at interaffiliate cash flows by examining both upstream and downstream funds transfers between the parent company and its bank and nonbank subsidiaries.[29] Cash flows include interest and dividends from subsidiaries, management and service fees paid to the parent, and loans and advances between the parent and its subsidiaries. Mayne also examines parent company borrowing from subsidiaries. Regression analysis is used to examine the effect of various holding company characteristics on each of the different types of internal funds transfers. The sample consists of 160 bank holding companies and uses data for 1976. Mayne reports several findings consistent with a single-entity view of bank holding companies. For example, she finds that management fees from bank subsidiaries are usually higher in multibank holding companies than in one-bank holding companies, suggesting that more services for bank subsidiaries tend to be centralized in the parent in the case of multibank organizations. She also reports that long-term borrowing by the parent tends to be heaviest (1) for multibank holding companies whose smaller banks have limited access to capital markets and (2) for bank holding companies with a relatively large amount of assets in highly leveraged nonbank subsidiaries. Finally, she finds that a significant factor in determining the amount of bank lending to a parent, as well as in the amount of parent lending to nonbank subsidiaries, is the amount of holding company diversification into highly leveraged nonbank firms.

The last study to be reviewed examines financial transactons between holding company banks and their nonbank affiliates (defined to include the parent company and nonbank subsidiaries of the parent).[30] The study is broader in scope than Mayne's in that it incorporates flows of funds between holding company banks and affiliated nonbank firms. At the same time,

the focus is on financial transactions only, which is narrower than that of Mayne's work. In order to determine the flow of funds associated with financial transactions between holding company banks and their nonbank affiliates, Rose and Talley compiled annual data on two major types of financial transactions—extensions of credit and transfers of assets—for 224 bank holding companies over the period 1975-80. They found a net flow of funds from the nonbank sector to the bank sector of a holding company through both types of transactions each year, with a consistently larger net flow through extensions of credit. Moreover, of the total nonbank-to-bank credit extensions, most came from the parent company, while the bulk of the bank-to-nonbank credit extensions went to nonbank subsidiaries of the parent. The authors attribute the stronger nonbank-to-bank net flow of funds associated with credit extensions to the collateral requirements imposed by section 23A of the Federal Reserve Act on bank lending to affiliated companies.[31] In any event, all three studies of intercompany transactions lead to the conclusion that BHCs are operated as integrated entities.

In summary, this discussion of management motivation and operating policies generally suggests that management will operate a BHC or nonbank-bank HC as an integrated entity. Specifically, with respect to motivation, it appears that whether managers seek profit maximization or size and diversification they have an incentive to integrate operations. Regarding operating policies, research into the existence of centralized policies has found that centralization is common, but studies of the effect of centralization on financial performance yield mixed results. Studies of the intercompany transactions of BHCs suggest that BHCs tend to be operated as interdependent units. The results of this literature are generally consistent with the argument that, in spite of the uncertain benefits for financial performance, most bank holding companies integrate the operations of their various units to some degree, within the confines of regulatory restrictions.

III. The Bank Holding Company as Viewed by Market Participants and the Public

This section discusses the approach used by financial analysts in evaluating BHCs and evidence on the perceptions of market participants and the public regarding the components of BHCs. This discussion suggests that market participants—large depositors, equity and credit analysts, and the public in general—tend to view bank holding companies as single entities. In part, this perception may be attributed to the operating policies of the holding companies themselves. Specifically, bank holding company units often have similar names, and, as noted earlier, many holding companies manage their subsidiaries as integrated entities. This perception may also reflect the fact that BHCs typically report financial data for only the consolidated entity.[32]

The Consolidated Entity as the Focus of Financial Analysis

While there is widespread agreement among financial analysts that a thorough analysis of a bank holding company should include an analysis of the major segments or units of the enterprise, this is not always possible given the available data. As a result, analysts typically limit their attention to the financial statements of the consolidated organization.[33]

This emphasis is not entirely the result of data limitations. It also reflects the widely held view, within the accounting profession, that the consolidated accounting statements of a bank holding company are more meaningful than those of the parent company or its subsidiaries. In fact, in 1959, the American Institute of Certified Public Accountants (AICPA) concluded that consolidated financial statements can be presumed to provide analysts with a clearer picture of the overall condition and operating results of a multicorporate organization than can be obtained from the financial statements of individual units of the organization.[34]

The position of the AICPA is to caution financial analysts to be wary of separate financial statements of the individual corporations in a multicorporate enterprise because of the arbitrary way in which common costs can be allocated and transfer prices can be set. Common costs are costs such as advertising and overhead that are jointly shared by two or more business units of the same enterprise, and transfer prices are prices charged for goods and services that are transferred from one unit of an enterprise to another. By manipulating the allocation of common costs and varying transfer prices, a holding company can distort the "true" financial condition and performance of a subsidiary.

The focus on consolidated statements also reflects the financial disclosure requirements of the Securities and Exchange Commission (SEC). Under the Securities Exchange Act of 1934, bank holding companies meeting certain requirements must file periodic financial reports with the SEC and adhere to extensive disclosure requirements. The requirements governing the form and content of financial statements filed with the Commission are set forth in Regulation S-X. The SEC requires bank holding companies to file consolidated financial statements. Separate financial statements for bank and nonbank subsidiaries are not required, nor are separate financial statements mandated for the parent company.[35]

The emphasis on the consolidated entity is further reflected in the financial statements that bank holding companies provide to shareholders in their annual reports. A survey of bank holding company reporting practices conducted by Peat Marwick and Mitchell & Co., a major public accounting firm, revealed that most bank holding companies do not provide separate financial statements on bank or nonbank subsidiaries in annual reports to stockholders.[36] Specifically, Peat Marwick reviewed the 1982 annual reports for the 100 largest banking organizations in the United States. The findings showed that only 5 of the 100 organizations presented any financial statements for nonbank subsidiaries. Moreover, of the 100 organizations, only 38 included balance sheets of subsidiary banks in their annual reports and only 10 included bank income statements. As these findings suggest, the reporting practices of bank holding companies make it difficult, if not impossible, for market participants to analyze the separate corporate entities that comprise a bank holding company organization.

Although only a very small number of bank holding companies disclose financial information about the bank and nonbank components of their organization in shareholders reports, individual financial statements of subsidiary banks and parent company financial statements of bank holding companies are available to the public from bank regulatory agencies. While bank holding companies provide the bank regulators with financial statements of their nonbank subsidiaries, such statements are provided on a confidential basis and are not made available to the public. The reluctance of bank holding companies to make bank and nonbank subsidiary information directly available to the public through reports to shareholders tends to preclude anything other than a single entity approach to bank holding company analysis.

Evidence on the Perceptions of Market Participants and the Public

Even though a great deal of data are available to the public on the consolidated holding company and banking subsidiaries, the evidence suggests that most attention is placed on the performance of the consolidated BHC. A study by Jacobs, Beighley, and Boyd supports the hypothesis that the investing public focuses on the consolidated bank holding company entity rather than on the individual components of the holding company.[37] In that study, the authors applied a cross-section regression model to 100 BHCs over a four year period, 1970 through 1973. From their empirical results, the authors concluded that "... investors are paying increasing attention to the consolidated financial structure of holding companies" and "... the unconsolidated leverage structure of the holding company does not appear to systematically influence share price." In addition, "... of the three major holding company components—banking affiliates, nonbanking subsidiaries and the parent company—only the financial structure of banking affiliates was found to influence investors."[38]

A study by Beighley analyzed the risk perceptions of those who hold debt in lead banks and BHCs.[39] A sample of 56 issues of 42 different banking firms from 1972 to 1974 was used; 35 issues were parent-firm obligations, while the other 21 were obligations of the lead bank. Beighley concluded that "... there is some evidence in support of the hypothesis that creditors are concerned about the financial structure of the lead (largest) banking firm in the BHC." He added that "... debtholders appear to be indifferent with regard to the location of debt in the BHC (parent firm or lead bank)."[40] This last conclusion provides support for the contention that the market is mainly concerned with the consolidated BHC, as the debtholders look to the strongest component of the holding company for ultimate protection.

The two studies discussed above suggest that holders of long-term debt and equity issues focus on BHCs or the lead bank. However, experience suggests that bank liability holders may now pay closer attention to the financial condition of nonbank subsidiaries. In the mid-1970s, Hamilton National Bank of Chattanooga was forced by the parent holding company to buy a large amount of low quality mortgages from a severely distressed mortgage banking affiliate of the holding company. These purchases far exceeded the amount permitted by law and resulted in the subsequent failure of the bank. This experience would seem to provide several reasons for holders of bank and BHC debt and equity to look beyond the condition of the BHC and the lead bank. First, these investors know that essentially the same group manages the major units of most holding companies. Consequently, it is reasonable to assume that if a nonbank unit of the holding company is so mismanaged that it fails, the affiliated bank may also be mismanaged and could be in unsatisfactory condition. Second, even if the bank's liability holders suspect that the bank is in satisfactory condition, they may not want to be subject to possible criticism by continuing to do business with an organization whose reputation has been tarnished. Third, bank liability holders may be concerned that the bank may be used in an attempt to aid troubled affiliates. Even though current statutes are designed to protect banks from abuse, bank liability holders might still be concerned because the holding company might violate these statutes in a time of crisis.

In addition to the evidence suggesting that the investing public may regard the units of a BHC as inter-

dependent, there is both direct and indirect evidence that depositors may assume such interdependence. The most vivid direct evidence arises from the Beverly Hills Bancorp episode in 1973. Beverly Hills Bancorp, the parent of Beverly Hills National Bank, had loans to a real estate developer that were funded with sales of commercial paper. When the developer could not repay the loans, the holding company was unable to pay off its maturing commercial paper obligations. The adverse publicity that accompanied this default resulted in large-scale runs on the Beverly Hills National Bank. These runs prompted the bank supervisors to merge this previously sound bank into another California bank. The strong name identification of the bank with the holding company and the fact that the parent company had sold its commercial paper to customers of the bank undoubtedly contributed to the bank's downfall.[41]

The actions of BHC management in response to financial problems of the parent or nonbank affiliates appear to provide the market with ample reason for being concerned about the ultimate effect on the bank. In such situations, the holding company management typically tries to save the troubled affiliate by transferring sufficient resources to the affiliate to meet its obligations. There may be a variety of reasons for these managerial decisions, but the major reason appears to be avoidance of serious reputation damage to the holding company organization and its bank. There have been several instances in recent years where banking organizations have gone to great lengths to preserve their reputation in the marketplace. Perhaps the best known case involved United California Bank in 1970. In that situation, the bank voluntarily assumed responsibility for the debts of its Swiss bank subsidiary, which failed after incurring losses of nearly $40 million from unauthorized speculation in cocoa futures. Legally, the bank could have walked away from this failure, but it did not apparently out of concern over possible damage to its reputation in the marketplace.

Other examples of banking organizations taking significant steps to preserve the public's perception of their reputation and financial strength are situations involving BHC-sponsored real estate investments trusts (REITs) in the mid-1970's. In 1971, the Board ruled that bank holding companies could serve as advisors to REITs. While all REITs performed poorly during this period, unpublished evidence compiled by Board staff (based on a sample of 80 REITs) shows that, during 1974–77, bank-sponsored REITs had a higher percentage of nonearning assets than nonbank-sponsored REITs in each of those years. Most notably though, in a number of cases, the bank sponsors provided financial support to their REITs on a non-arms length basis to avoid the adverse publicity which a related REIT bankruptcy would bring. As a result, the real estate investment problems were transferred to the sponsoring bank. This support was provided even though the banks were under no legal obligation to do so.[42]

A common method by which bank sponsors provided support to their advised REIT was to acquire assets from the REIT through asset swaps or straight asset purchases. Examples of this activity involved purchases of assets from advised REITs by Wisconsin Corporation and by Chase Manhattan Bank.[43] First Wisconsin Corp. purchased assets from its advised REIT that it would not otherwise have bought, if not for its role as an advisor. First Wisconsin and the REIT entered into an agreement on June 27, 1974, whereby the Trust agreed to defer litigation against First Wisconsin Mortgage Co. (its advisor), First Wisconsin Corp., and First Wisconsin National Bank. In return, First Wisconsin Corp. agreed to purchase certain loans and to provide $5.5 million of future support involving certain losses that the Trust might realize. Chase Manhattan Bank, in 1976, agreed to purchase $160.6 million of its advised REIT's assets in order to save the REIT from bankruptcy. The funds from this purchase were used by the Trust to pay creditors. Finally, it is notable that the bank regulators may have encouraged the market's perception of BHCs as integrated entities by supporting efforts to save some REITs.

The financial assistance provided by First National Bank of Chicago to Institutional Liquid Assets (ILA) is indicative of the apparent incentive of BHC management to assist financially troubled firms that they advise even though there are no ownership ties. Specifically, in October 1980, the First National Bank of Chicago and Salomon Brothers provided financial assistance to ILA, a Chicago-based institution-only money market fund that was experiencing liquidity problems due to an unusually long asset maturity structure combined with a rise in interest rates.[44] It should be *emphasized* that ILA was not a subsidiary of either First National Bank of Chicago or Salomon Brothers. First Chicago was ILA's investment advisor, and Salomon Brothers the fund's administrator and seller. Nevertheless, both First Chicago and Salomon acted to assist ILA. The reported ILA rescue package included the purchase by Salomon from ILA of $228.5 million of securities at a price about $700,000 above market value and the return to ILA by First Chicago of $1 million of previously paid advisory fees. In addition, First Chicago and Salomon agreed to waive their usual fees for an indefinite period and Salomon Brothers agreed to purchase additional securities, at a loss, if necessary.[45]

More recent evidence regarding the perceptions of market participants and BHC management is provided by the Drysdale experience in 1982. In that case,

Chase Manhattan Bank and Manufacturers Hanover, acting simply as intermediaries between Drysdale Government Securities, Inc. and a number of participants in the government securities market, agreed to make the interest payments that Drysdale was unable to make. Specifically, on May 17, 1982, Chase Manhattan informed the Federal Reserve that Drysdale did not forward $160 million in interest payments to Chase Manhattan. These payments were due to other firms that had loaned government securities to Drysdale, using Chase Manhattan as an intermediary, under repurchase agreements. The following day, Manufacturers Hanover announced that it had not received nearly $30 million in interest payments from Drysdale under the same circumstances. Market pressures built for both banks to make good on the interest payments. For a complex variety of reasons, including both considerations of legal liability and the market pressures, within days, both firms made the interest payments.

Even more recently, the First Chicago Corporation took losses on a Brazilian subsidiary that far exceeded its investment in the subsidiary. In 1985, First Chicago held a 44.5 percent ownership interest in Banco Denasa de Investiment S.A., a Brazilian investment bank which had assets of about $180 million. Banco Denasa had a sizable exposure to the financial and real estate sectors of the Brazilian economy which, according to First Chicago, had come under pressure as a result of the efforts of the Brazilian government to deal with the long-term structural problems of the economy. The downturn in those sectors led First Chicago in the first quarter of 1985 to write down virtually all of its investment in Denasa, which amounted to approximately $15 million.[46]

Denasa's condition continued to worsen into the second quarter. The majority shareholder was unable to provide additional capital support to Denasa. Consequently, to prevent a run, First Chicago decided to take over the management and control of the bank and provide the needed financial support. Although First Chicago was obligated under a special agreement to recapitalize the bank by an amount equal to its 44.5 percent interest in the bank, it decided to provide support over and above that amount. As reported in the *Wall Street Journal*, Barry F. Sullivan, the Chairman of First Chicago Corporation, said, "We believe it was important for us, as a major international bank, to stand behind Banco Denasa and that we must bear the financial consequences of such support."[47] The financial consequences were a $131.1 million loss on the $15 million investment in Banco Denasa.[48]

Another recent experience suggests that it is not possible to ensure insulation through corporate separateness because of the perceptions of BHC managers and the public. This involves the case of Republic Bancorporation and Sunbelt Bank and Trust, both of Tulsa, Oklahoma. The case involved a "run" on a bank that was triggered by the collapse of a group of nonbank companies that were formerly affiliated with the bank. On March 1, 1984, Republic Bancorporation changed its name to Sunbelt Bancorporation and its bank subsidiary, the Republic Bank and Trust Company, changed its name to Sunbelt Bank and Trust. Shortly thereafter Sunbelt Bancorporation decided to divest itself of its "nonbank" subsidiaries, Republic Financial Corporation and Republic Trust and Savings. The divestiture occurred on June 29, 1984.[49] Republic Financial and Republic Trust and Savings were sold to Republic Bancorporation, Inc., and the three entities became known as the "Republic group." All legal ties between the so-called "Republic group" and Sunbelt were severed. On September 24, 1984, Republic Bancorporation, Inc. and its two subsidiaries, Republic Trust and Savings Company and Republic Financial Corporation, filed for reorganization under chapter 11 of the Federal Bankruptcy Code. Oklahoma state banking and securities officials attributed a major cause of the reorganization to a last-ditch transfer of more than $8 million of deposits and loans from Republic Financial Corporation, a nonbank finance company, to its affiliate, Republic Trust and Savings Company. Many of the loans that were transferred were considered to be problem loans by the state bank commissioner.[50] A key point is that despite the earlier divestiture, the collapse of the Republic group triggered a "run" on the Sunbelt Bank and Trust Company even though the two companies were no longer affiliated. On October 1, only a week after the Republic bankruptcy filing, the president of Sunbelt Bank and Trust held a press conference and announced that there had been a run on the bank, which had resulted in the withdrawal of about $10 million of deposits. By mid-October the Bank's president had reported that withdrawals had grown to about $15 million, lowering the bank's deposit base to $95 million.[51] By the end of November, Sunbelt Bank and Trust Company was acquired after approval by the Federal Reserve Board.

To summarize, this section has focused on the way in which BHCs are perceived by market participants and the public. The evidence and studies show that professional financial analysts and investors concentrate on the consolidated BHC, partly due to data limitations. Past experience suggests that investors and depositors have concerns about the affiliate banks when financial problems are encountered elsewhere in the BHC. Furthermore, experience suggests that BHC management will draw on the financial resources of the bank to assist a troubled nonbank subsidiary. Taken together, this evidence and experience suggests that the BHC organization is generally perceived as

an integrated entity. In this regard, it is notable that Walter Wriston has observed:

> If the National Bank Act was amended to say that everything a bank holding company can do, the national bank can do, I'd be extremely happy. It would simplify administration and would make it perfectly clear to the customers that our $7 billion of capital is behind everything that we do.

Furthermore, Wriston notes:

> For example, it is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way.[52]

IV. The Bank Holding Company as Viewed by Regulators

This section examines how federal regulators, particularly the Federal Reserve Board, treat bank holding companies, *i.e.*, whether regulators treat holding companies as single entities or as collections of commonly owned but autonomous companies. The section reviews the historical evidence in three areas: (1) the manner in which regulators treat affiliated units for purposes of competitive analysis of holding company acquisitions, (2) regulatory treatment of banks and their parent holding companies for purposes of monetary policy, and (3) the development of the regulatory and supervisory apparatus for ensuring the soundness of holding company banks. The evidence indicates that, consistent with the perceptions of holding company management and the public, federal authorities generally view bank holding companies as single, integrated entities.

Bank Holding Companies and Merger Policy

As a policy matter, the Board has long considered all of a holding company's bank affiliates operating within the same local market as a single banking entity for purposes of competitive analysis.[53] The Board has taken this position even though it generally has maintained that multibank holding companies are not legally branch banks.[54] In addition, in considering bank holding company applications to acquire nonbank firms engaged in permissible activities such as mortgage banking, the Board has traditionally based its competitive analysis on the total business of the consolidated holding company in that activity in the relevant geographic market.

Other regulatory agencies and the courts have adopted a position in this matter that is similar to the Board's. For example, in commenting on proposed bank holding company acquisitions, the U.S. Department of Justice has consistently considered the holding company organization as a single entity, given a product and geographic market. The courts have regularly followed this approach as well. In addition, in reviewing mergers among affiliated banks in the same holding company, both the Comptroller of the Currency and the FDIC, along with the Federal Reserve Board, have indicated that they view such mergers as essentially corporate reorganizations having no effect on competition.[55]

Bank Holding Companies, Reserve Requirements, and Deposit Rate Ceilings

While federal law and regulation generally treat sister bank subsidiaries within a multibank holding company system as separate units for purposes of reserve requirements,[56] the Federal Reserve Board has traditionally viewed the bank and nonbank sectors of a holding company organization as a single entity for such purposes. The Board first employed the single-entity view of bank holding companies in a regulatory matter relating to monetary policy in 1970. Prior to that time, the proceeds from bank holding company commercial paper issues could be downstreamed to either bank or nonbank subsidiaries without being subject to reserve requirements. Beginning in 1970, however, the Board made any such proceeds obtained by member banks fully subject to Regulation D, pursuant to authority granted to the Board the previous year.[57] The objective of this policy was to preclude banks from using the holding company structure as a vehicle for raising nonreservable funds. By imposing Regulation D on such funds, the Board made clear that it intended ". . . to maintain the effectiveness of the reserve requirement" and ". . . to put instruments of this kind [*i.e.*, bank-related commercial paper] on a more equal footing with negotiable CD's issued by banks."[58] The effect of the Board's action was subsequently determined to have reduced bank use of bank holding company downstreamed commercial paper funds by 39 percent during the first two months following the policy change.[59] Over a longer period (1970–77), the proportion of bank holding company commercial paper proceeds downstreamed to bank subsidiaries dropped from 99 percent to less than 5 percent.[60]

In the early 1970s, several large holding companies began to issue small-denomination, floating-rate thrift notes in order to circumvent Regulation Q restrictions. The Congress, in 1974, authorized the regulators to limit interest rates on holding company debt obliga-

tions (other than commercial paper) that could serve as substitutes for consumer deposits issued by depository institutions, regardless of the intended use of the proceeds of the debt.[61]

In 1977, the Board recognized another avenue by which BHCs could be used to evade reserve requirements. That situation involved an application by a bank holding company to issue, through a nonbank subsidiary, variably denominated payments instruments (essentially, traveler's checks).[62] (Variably denominated payments instruments are fully reservable if issued by a commercial bank but are reserve-free if issued by a nonbank institution.) The Board, however, was concerned that such instruments, if nonreservable, could potentially have an adverse effect on the reserve base due to the erosion of the reservable deposits of the banking system. The Board approved the application on competitive grounds. However, to minimize the potentially adverse effect on the reserve base, it imposed a $1,000 maximum face value on such instruments.[63] Recently, in response to another bank holding company application, the Board increased the maximum face value on such instruments to $10,000. In so doing, however, the Board made clear that it would closely monitor the effects of the proposal and might later impose reserve requirements if it appeared that the proposal was reducing significantly the reserve base or otherwise adversely affecting the conduct of monetary policy.[64]

Bank Holding Companies and Bank Supervisory Policy

Historically, the bank regulatory and supervisory apparatus has focused on the financial soundness of individual *banks* in order to protect the stability of the banking system and to safeguard bank depositors. While this continues to be the primary focus of public policy, the scope of regulatory and supervisory concern has expanded over time to give greater attention to the soundness of the entire holding company organization. The history of this apparatus can be roughly divided into three periods: 1933-1972, 1973-1979, and 1980-present.[65]

1933-1972

Concern with affiliation between banks and nonbank affiliates was expressed initially in 1933 when the Congress enacted section 23A of the Federal Reserve Act. Section 23A was designed to shield bank resources from abuse by placing quantitative limitations on bank transactions with affiliates and by requiring that bank loans and extensions of credit to affiliates be fully secured.[66] As stated by a Senate committee,

> The loan relationship as it exists between the bank and its affiliate differs from that prevailing with the general run of the bank's customers in an essential respect. When dealing with its affiliate, the bank is really dealing with itself, in view of the identity of ownership and management that is established. As a result there tends to be a breakdown of those limitations on the extension of credit which the bank sets up in other cases to guard against the making of excessive or poorly-secured loans.[67]

When Congress enacted the Bank Holding Company Act of 1956, it specifically addressed the issue of bank transactions with holding company units. Its decision, codified in section 6 of the Act, was to *prohibit* intrasystem investments and extensions of credit by banks in holding company systems. The only exemption to this prohibition pertained to certain noninterest-bearing deposit transactions between sister bank subsidiaries. As indicated by Congressional committee reports, the purpose of section 6 was to prevent "unsound banking practices" and to preclude the parent company from taking "undue advantage of the resources of its subsidiary banks."[68]

However, the 1966 amendments to the Bank Holding Company Act repealed the section 6 prohibition and substituted for it a provision whereby a holding company bank became subject to section 23A's limitations on transactions with its parent company and other subsidiaries of the parent. In addition, the purchase of loans on a nonrecourse basis from an affiliated bank (along with certain noninterest-bearing deposit transactions) was exempted from the restrictions of section 23A. This exemption was recommended by the Board on the grounds that both banks in any transaction would be under the supervision and examination of the bank supervisory authorities and that such transactions would allow bank portfolio adjustments in response to changes in deposits and loan demand, in effect permitting more integrated operations of multibank holding company systems without a substantial increase in risk to the banks involved.[69]

Further evidence of Congressional concern with the integrated nature of the bank holding company organization is seen in section 3(c) of the Bank Holding Company Act of 1956. That section directed the Federal Reserve Board, in judging bank acquisitions by holding companies, to consider, among other things, "(1) the financial history and condition of the company or companies and the banks involved, (2) their prospects, [and] (3) the character of their management." The 1966 Amendments to the Act changed the language of this section but maintained the intent by directing the Board to consider in every bank acquisition case

". . . the financial and managerial resources and future prospects of the company or companies and the banks concerned."

Beginning in 1972, the Federal Reserve Board required each bank holding company to submit financial statements for the consolidated organization, the parent holding company, and all nonbank subsidiaries of the parent.[70] At the same time, the Board began to articulate a policy that holding companies should be a "source of financial and managerial strength" to their subsidiary banks. As it noted in August 1972, "The Board believes it is essential that bank holding companies and their nonbank subsidiaries be soundly financed so that they will, if anything, be in a position to add to the strength of their affiliated banks and in no way dilute or 'trade on' that banking strength."[71] Finally, in the same year, the Board recommended that section 23A be extended to cover some additional types of transactions, including "some purchases of assets by banks from affiliates, sales by banks to affiliates, or fees or other charges paid to affiliates," in order to prevent misuse of bank resources.[72] These actions by the Board in the early 1970s reflected an emerging belief that the financial soundness of holding company subsidiary banks is closely linked to the financial condition of the rest of the holding company system, thereby necessitating at least some regulatory oversight of the entire holding company organization.

1973–1979

Prudential regulation of bank holding companies increased substantially during the period 1973–79.[73] This development may be attributed to the general financial strains of the mid-1970s coupled with a growing concern among regulators that financial problems in the nonbank sector of a bank holding company can adversely affect subsidiary banks through either adverse transactions or reputation damage.

In 1976, section 23A came under formal review by the banking committees of the Congress and the federal bank supervisory authorities. This review was prompted by the discovery that several relatively large banks had been adversely affected by transactions with their affiliates.[74] In response, the Federal Reserve Board proposed amendments to section 23A designed, in part, to close a number of loopholes in the statute and to expand the coverage of the law to include transactions between a bank and a company that is sponsored and advised by the bank or its affiliate.[75] This latter recommendation was made in view of the experience of the mid-1970s when, in a number of cases, a financially troubled real estate investment trust received significant financial assistance from its advisory banking organization, presumably to prevent damage to the organization's reputation or to forestall lawsuits alleging that the trust received "bad" or, perhaps, even self-serving advice from the organization. The Board's proposal ultimately served as the basis for the Banking Affiliates Act of 1982, which made important, substantive changes to section 23A to limit the potential for bank abuse by affiliates.[76]

In addition to amending the law to tighten section 23A at several places, the Banking Affiliates Act liberalized the statute to facilitate greater interaffiliate financial transactions (and thus potentially increased integration of the holding company organization) where policymakers believed that such transactions would not increase significantly the risk to subsidiary bank soundness. Most notably, the amended statute (1) exempts most transactions between sister *bank* subsidiaries of a multibank holding company from the major restrictions of the law and (2) provides an expanded list of eligible collateral. The first amendment is designed to treat a multibank holding company much like a branch banking system with respect to intraorganizational funds transfers among bank affiliates; the second is intended to allow holding company banks to lend to all their major nonbank affiliates.

Federal regulators took a number of steps in 1978 and 1979, analogous to the restrictions imposed by section 23A, to protect subsidiary banks from abuse by holding company affiliates. First, in 1978, the Comptroller of the Currency criticized the practice of some national banks of paying management and other fees to holding company affiliates (and other insiders) in excess of the value of goods and services received.[77] Also, at about the same time, the Federal Reserve Board criticized intraholding company income and tax accounting transfers "that have the effect of transferring assets and income from the subsidiary banks to the parent company without offsetting benefits to the bank."[78] Finally, in 1979, the Board enumerated a number of "diversion of bank income practices" which it considered "inappropriate and, potentially unsafe and unsound."[79] The Board indicated that such practices would be subject to examiner criticism or, in cases where they are likely to have an adverse impact on the bank's condition, would be met with "formal supervisory actions (*i.e.*, written agreements and cease and desist orders) . . . to terminate the practices and require restitution or affirmative remedial action."[80]

In 1979, the Board introduced a uniform system of rating bank holding companies. This rating system, known as BOPEC, is designed to evaluate the financial condition of each of the major holding company units—*B*ank subsidiaries, *O*ther (nonbank) subsidiaries, and *P*arent company—as well as the *E*arnings and *C*apital adequacy of the consolidated organization.[81] Thus, by the end of the 1970s, the federal bank

authorities clearly had in place a regulatory and supervisory apparatus that treats the bank holding company organization as an integrated unit and focuses on the financial condition of all the units of that organization, even while seeking primarily to protect subsidiary banks. This regulatory apparatus reflects the view that the actions and financial soundness of the various units of a BHC are interdependent.

1980–Present

Recent steps taken by federal regulators to coordinate their actions reflect a perception that the BHC is operated as an integrated entity.[82] In December 1979, the federal banking agencies agreed to coordinate the inspection of a bank holding company and its lead bank in all cases for holding companies with consolidated assets in excess of $10 billion and those in need of special supervisory attention and in other cases, whenever possible.[83] This agreement was expanded, in 1982, by the Federal Reserve Board and the Comptroller of the Currency to include annual, concurrent examinations of all bank holding companies with consolidated assets in excess of $1 billion and lead bank subsidiaries which were national banks.[84]

Similar coordination between the Federal Reserve and the Comptroller of the Currency is seen in the bank capital-adequacy guidelines issued jointly by the two agencies in late 1981 for national banks, state member banks, and bank holding companies that are in satisfactory financial condition.[85] The Federal Reserve made clear that, in the case of bank holding companies, the guidelines are to be applied both to individual banks in the holding company as well as to bank holding companies on a consolidated basis. The justification for this policy is that ". . . the public usually views the bank and the holding company as a single entity and links their fates."[86] The announcement of these guidelines not only demonstrated the cooperation of the two agencies in supervising bank holding companies, but also showed further their commitment to regulating bank holding companies as consolidated units.

Overall, evidence from a number of areas—competitive analysis of bank holding company acquisitions, monetary policy, and the regulatory and supervisory apparatus for ensuring the soundness of holding company banks—indicates that federal bank regulators generally view bank holding companies as single, integrated entities. With respect to competitive analysis and monetary policy, the single-entity approach has long been employed by the regulators, at least to some degree. By contrast, adoption of the single-entity view for supervisory purposes has occurred largely through an evolutionary process as regulators have observed the linkages between the financial condition of subsidiary banks and that of the rest of the holding company organization. In recognition of the existence of those linkages, the Federal Reserve Board has sought to use the vehicle of the holding company to isolate the bank as much as possible from the nonbanking activities of its holding company affiliates. This has been done in part by insisting, in considering applications to engage in nonbanking activities, that the activity be capitalized at least as well as other firms in the same industry that are unaffiliated with bank holding companies.

V. Summary and Conclusion

The legal doctrine of corporate separateness has been proposed as a means of insulating banks and their depositors from problems of nonbank BHC affiliates (including the parent company). However, a number of economists contend that the legal doctrine of corporate separateness is only one factor in determining the insulation of banks from their affiliates. They argue that the investing public, large depositors, and BHC management view the BHC as an interdependent entity. Thus, regardless of legal corporate separateness, severe problems in nonbank affiliate earnings or financial condition may be perceived by these groups as having an adverse effect on bank affiliates. This perception would arise from a belief that if an affiliate is in trouble, the bank may also have problems because they have common management and because the bank's resources may be used to bolster the troubled nonbanking operations in an effort to maintain the reputation of the BHC. For these and other reasons, it is maintained that bank insulation cannot be effectively achieved simply by enforcing the legal doctrine of corporate separateness. Accordingly, proponents of this view recommend that BHCs be regulated as integrated entities.

Theory, evidence, and regulatory policy appear to be consistent with the inseparability view of the BHC. An analysis of BHC management motives and available evidence indicates that funds do flow among BHC affiliates and that BHC management is generally inclined to support ailing nonbank affiliates by using available resources—including those of bank affiliates. In many cases, the justification for supporting ailing affiliates is to maintain the credibility and reputation of the BHC and banking affiliates. BHC management perception may be correct because additional evidence suggests that large depositors, bank and BHC bondholders and stockholders, and securities rating firms and analysts tolerate problems in one part of the company for a time but, if unresolved, they act as if they believe the entire organization could be in difficulty. It is also notable that the bank regulators have, on

occasion, assisted banks that have experienced problems with their REITs and other affiliates. Such action may have encouraged the view that the BHC is an integrated entity. Finally, BHC regulatory policy has been consistent with the perceptions of BHC management and market participants. For example, limitations have been imposed on bank affiliate exposure to nonbank affiliates via section 23A of the Federal Reserve Act to insulate banking affiliates from problems in the parent and nonbank affiliates. It is notable that this analysis applies with equal force to traditional BHCs as well as nonbank-bank HCs (which own depository institutions with commercial bank charters and FDIC insurance).

In sum, it appears that BHC management, market participants, and regulators view the fortunes of a BHC subsidiary bank as linked with the BHC and nonbank subsidiaries of the BHC. The conclusion which emerges from this study is that the legal doctrine of corporate separateness is not the only factor involved in insulating BHC banks from the financial problems that may be en countered by its nonbank affiliates or the parent BHC. *Regardless* of the effectiveness of the legal concept of corporate separateness as an insulator, evidence suggests that today BHC management, regulators, and market participants (*i.e.*, the investing and depositing public) perceive the entire BHC organization as a financially interdependent entity. Consequently, it seems likely that the financial problems of a parent BHC and/or its nonbank affiliates would affect the financial position of affiliated banks. This conclusion and the fact that market forces and public policy are moving in the direction of expanded product lines for BHCs has implications for the direction that should be taken in regulating bank holding companies including the extent of product line expansion that should be allowed. It is emphasized that this conclusion is not based on an evaluation of the potential for designing legislation and regulation so as to make corporate separateness an effective vehicle for insulating banks. Rather it is an evaluation of the effectiveness of corporate separateness as it works today.

The policy issue of bank separateness has been muted by the fact that most nonbank assets of BHCs have been in activities very closely related to banking and, for most BHCs, nonbank assets have accounted for less than 5 per cent of the total. If, however, BHCs were permitted to enter the activities now being debated by public policymakers, they would be moving farther away from traditional banking activities and the percentage of BHC assets in nonbanking would be likely to increase. Similarly, the problem would be exacerbated to the extent that nonbank-banks (with commercial bank charters and deposit insurance) are allowed, because they may be owned by commercial enterprises in which case the commercial activity is likely to account for a large percentage of the entire organization. Because of the very uncertain implications for bank risk, this prospect makes bank separateness a fundamental issue in considering the direction of BHC regulation in the future—perhaps the near future.

Footnotes

1. This view has been elaborated at length by E. Gerald Corrigan, "Are Banks Special?" *Annual Report, 1982* (Federal Reserve Bank of Minneapolis), pp. 1-18 and Paul A. Volcker, Statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 13, 1983. A similar but more general view is presented by a former member of the Securities and Exchange Commission, Bevis Longstreth, "In Search of A Safety Net for the Financial Services Industry," *Bankers Magazine* (July/August 1983), pp. 27-34. An opposing view is presented by James L. Pierce, "An Essay on the Expansion of Banking Powers," Ch. 2 in Ingo Walter, ed., *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market* (New York: John Wiley and Sons, 1985), and Anthony Saunders, "An Economic Perspective on Bank Uniqueness and Corporate Securities Activities," mimeo (New York University, May 1984), though Saunder's questioning of the uniqueness of banks is considerably more cautious and less sweeping than Pierce's.

2. Samuel Chase and Donn L. Waage, "Corporate Separateness As A Tool of Bank Regulation," Samuel Chase & Company, for the American Bankers Association, October 1983; and Golembe Associates, Inc., "Product Expansion by Bank Holding Companies," prepared for the Association of Bank Holding Companies, January 1982, p. 27.

3. Statement by Robert A. Eisenbeis, Hearings Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, 97th Cong., 2nd Sess. (GPO, 1982), pp. 70-84; and George A. Kaufman, Edward J. Kane, and Paul M. Horvitz, Statements Before the Committee on Banking, Housing and Urban Affairs, 98th Cong., lst Sess. (GPO, 1983), Part II, pp. 893-954.

4. Adolf Berle and Gardner Means, *The Modern Corporation and Private Property* (New York: MacMillan, 1932); Herbert Simon, "Theories of Decisionmaking in Economics and Behavioral Science," *American Economic Review*, 49 (June 1959), pp. 253-83; R. M. Cyert and J. G. March, *A Behavioral Theory of the Firm* (Englewood Cliffs, NJ: Prentice Hall, 1963); and M. C. Jenson and W. H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Cost, and Ownership Structure," *Journal of Financial Economics* (October 1976), pp. 305-60.

5. There is some evidence in banking of this difference in objectives. See C. Glassman and S. A. Rhoades, "Owner vs. Manager Control Effects on Bank Performance," *Review of Economics and Statistics* (May 1980), pp. 263-70.

6. For interesting insights and a large number of references to this literature, see F. M. Scherer, *Industrial Market Structure and Economic Performance* (Chicago: Rand McNally Publishing Company, 1980), pp. 34-41.

7. J. L. Treynor and F. Black, "Corporate Investment Decisions," in S. C. Meyers, ed., *Modern Development in Financial Management* (New York: Praeger Publishers, 1976), and Y. Amihud and B. Lev, "Risk Reduction as a Managerial Motive for Conglomerate Mergers," *Bell Journal of Economics*, vol. 12, No. 2, (Autumn 1981), pp. 605-17.

8. For example, Jensen and Meckling view management's desire to reduce their risk through the firm in terms of agency cost. They note that "If under bankruptcy the shareholders have the right to fire the management, the management will have some incentives to avoid taking actions which increase the probability of this event (even if it is in the best interest of the equity holders) if they (the management) are earning rents or if they have human capital specialized to the firm or if they face larger adjustment costs in finding new employment." Jensen and Meckling, *op. cit.*, p. 352.

9. A number of studies has concluded that mergers in banking as well as in other industries do not generally result in as great a firm value as would be expected from the union and some found that the stockholders of the acquired firms gain from the acquisition while stockholders of the acquiring firm lose. For example, see G. J. Benston, "Conglomerate Mergers: Causes, Consequences and Remedies," Working Paper No. 7914 (Graduate School of Management, University of Rochester, September 1979); M. Firth, "Takeovers, Shareholder Returns and the Theory of the Firm," *Quarterly Journal of Economics* (March 1980), pp. 235-60; T. R. Piper, "The Economics of Bank Acquisitions by Registered Bank Holding Companies," Research Report No. 48 (Federal Reserve Bank of Boston, March 1971), pp. 254-63; and D. C. Mueller, *et. al.*, *The Determinants and Effects of Mergers: An International Comparison* (Cambridge, Massachusetts: Oelgeschlager, Gunn & Hain, Publishers, Inc., 1980), pp. 308, 312-314.

10. See the statement by C. T. Conover, Comptroller of Currency, on establishing a moratorium on nonbank banks, Office of the Comptroller of the Currency, May 9, 1984. Presently, there are applications before the bank regulators for 334 nonbank charters.

11. John T. Rose, "Bank Holding Companies as Operational Single Entities," *The Bank Holding Company Movement to 1978: A Compendium* (Federal Reserve Board, 1978), pp. 69-93.

12. The issue of centralized control in one operational area—funds management—is examined in some detail in Jarratt Robert Devereux, "Central Management of Funds in a Regional Multibank Holding Company," unpublished thesis, Stonier Graduate School of Banking, June 1978. Devereux argues that "centralized management of funds in a regional bank holding company can free assets for more profitable use; secure the greatest benefit from the assets involved; and obtain funds at the lowest cost; thus, improving overall earnings of the holding company" (p. 108).

13. Section 23A limits a bank's financial transactions (including loans, extensions of credit, and purchases of assets) with any single affiliate to no more than 10 percent of the bank's capital and surplus, and with all affiliates combined to no more than 20 percent. In addition, the statute requires that all bank loans and extensions of credit to affiliates be fully secured. Section 23A was substantially amended in 1982, in part to facilitate greater transactions between banks and affiliated units within a holding company. See also John T. Rose and Samuel H. Talley, "The Banking Affiliates Act of 1982: Amendments to Section 23A," *Federal Reserve Bulletin*, vol. 68 (Federal Reserve Board, November 1982), pp. 693-99.

14. William J. Murray, *Bank Holding Company Centralization Policies*. Prepared for the Association of Bank Holding Companies by Golembe Associates, Inc., February 1979.

15. Gary Whalen, "Operational Policies of Multibank Holding Companies," *Economic Review* (Federal Reserve Bank of Cleveland, Winter 1981-82), pp. 20-31.

16. Also, within the last few years several multistate, multibank holding companies appear to have increased the integration of their bank subsidiaries by adopting common names and logos for all their bank units. Examples include the transition of Western Bancorporation to First Interstate Bancorp; Financial General Bankshares, Inc. to First American Bankshares, Inc.; and Northwest Bancorporation to Norwest Corporation.

Despite the trend toward greater centralization within multibank holding companies, integration of subsidiary banks is still less extensive than that of branch offices of a branch banking system. The evidence on pricing behavior of Florida multioffice banking firms indicates a movement toward more centralized pricing following the consolidation of multibank holding companies into limited branch banking systems in the years since Florida liberalized its branching law in 1976. See David D. Whitehead, III, "Home Office Pricing: The Evidence from Florida," Working Paper Series (Federal Reserve Bank of Atlanta, August 1980).

17. Murray, *op. cit.*, p. 4. A recent study of scale economies in compliance costs for consumer credit regulations at commercial banks reports economies of scale at levels of output up to 375,000 consumer credit accounts, beyond which there are small diseconomies of scale. (Among the sample banks, those that have 350,000 to 400,000 accounts have total assets between $1.9 billion and $8.0 billion.) See Gregory Elliehausen and Robert Kurtz, "Economies of Scale in the Cost of Complying With the Truth in Lending and Equal Credit Opportunity Laws," mimeo (Federal Reserve Board, February 1984).

18. Lucille S. Mayne, "Management Policies of Bank Holding Companies and Bank Performance," *Journal of Bank Research*, vol. 7 (Spring 1976), pp. 37-48. Other studies have reported performance differences across holding company-affiliated banks that are unique to the particular holding company organization. However, these studies have not attempted to relate such differences to individual holding company characteristics such as the degree of holding company centralization. See, for example, Arthur G. Fraas, *The Performance of Individual Bank Holding Companies*, Staff Eco-

nomic Studies, 84 (Federal Reserve Board, 1975), and Peter S. Rose and William L. Scott, "Heterogeneity in Performance Within Bank Holding Company Sector: Evidence and Implications," *Journal of Economics and Business*, 36 (February 1984), pp. 1-14.

19. Robert J. Lawrence, *Operating Policies of Bank Holding Companies: Part I*, Staff Economic Studies, 59 (Federal Reserve Board, 1971).

20. Mayne, *op. cit.*, p. 48.

21. For recent discussions of the different intraorganizatonal effects that may serve to increase the profitability of the consolidated holding company, but which may not be observed at the subsidiary level, see Larry A. Frieder and Vincent P. Apilado, "Bank Holding Company Expansion: A Refocus on its Financial Rationale," *Journal of Financial Research*, vol. 6 (Spring 1983), pp. 67-81, and John T. Rose and Samuel H. Talley, *Financial Transactions Within Bank Holding Companies*, Staff Studies, 123 (Federal Reserve Board, 1983).

22. In a 1978 review of the literature dealing with bank holding company affiliation and cost efficiency, Burke concluded that "banks that affiliate with holding companies incur some expense due to costs of centralization. Small unit banks may not achieve levels of output sufficient to offset these expenses. However, as affiliated banks become larger (over $30 million to $40 million in deposit size), economies of affiliation enable them to achieve lower average costs than independent banks of similar size." Jim Burke, "Bank Holding Company Affiliation and Cost Efficiency," in *The Bank Holding Company Movement to 1978: A Compendium* (Federal Reserve Board, 1978), p. 128.

23. Gary Whalen, "Multibank Holding Company Organizational Structure and Performance," Working Paper 8201 (Federal Reserve Bank of Cleveland, March 1982).

24. Whalen, "Operational Policies of Multibank Holding Companies," *op. cit.* In this same study, Whalen also examined various factors that might account for interholding company differences in centralization. Using regression analysis, he found the degree of centralization to be a function of a number of characteristics of the holding company and its subsidiary banks. By contrast, Lawrence (*op. cit.*) earlier found no relationship between the extent of centralization and various organizational or economic characteristics of the holding company.

25. The valuation ratio is defined as the ratio of the market value of the holding company's stock to its book value.

26. Gary Whalen, "Holding Company Organizational Form and Efficiency," Working Paper 8302 (Federal Reserve Bank of Cleveland, July 1983).

27. Lucille S. Mayne, "Bank Holding Company Characteristics and the Upstreaming of Bank Funds," *Journal of Money, Credit and Banking*, vol. 12 (May 1980), pp. 209-14.

28. *Ibid.*, p. 214.

29. Lucille S. Mayne, "Funds Transfer Between Bank Holding Companies and Their Affiliates," *Journal of Bank Research*, vol. 11 (Spring 1980), pp. 20-27.

30. Rose and Talley, *Financial Transactions Within Bank Holding Companies, op. cit.*

31. Amendments to section 23A enacted subsequent to the period covered in the Rose and Talley study substantially expanded the list of collateral that banks can accept when lending to affiliates. To the extent that this facilitates greater lending by holding company banks to their nonbank affiliates within the holding company organization, the flows of funds within bank holding companies in the future may be significantly different from the general patterns observed by Rose and Talley.

32. In a typical annual report to shareholders, the identity of individual bank and nonbank subsidiaries is almost impossible to find. Bank holding companies generally do not provide any financial data on individual subsidiaries.

33. See James H. Wooden and Thaddeus W. Paluszek, "Disclosure Needs of Financial Analysts: Large Bank Holding Companies," *Economic Review* (Federal Reserve Bank of Atlanta, November 1983), p. 77.

34. According to the American Institute of Certified Public Accountants, "There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling interest in other companies." See Accounting Research Bulletin No. 51, "Consolidated Financial Statements" (New York: American Institute of Certified Public Accountants, August 1959).

35. In 1981, the SEC eliminated the requirement for separate, complete financial statements for the parent company and now requires that only condensed financial information about the parent company be presented in the footnotes to a bank holding company's consolidated financial statements.

36. Peat Marwick and Mitchell & Co., *Principles and Presentation: Banking, A Review of 1982 Annual Reports* (July 1983) p. 24.

37. D. P. Jacobs, H. P. Beighley and J. H. Boyd, "The Financial Structure of Bank Holding Companies," Association of Reserve City Bankers, 1975.

38. Jacobs, Beighley, and Boyd, *op. cit.*, pp. 47-48.

39. Beighley, H. P., "The Risk Perceptions of Bank Holding Company Debtholders," *The Journal of Bank Research* (Summer 1977), pp. 85-93.

40. Beighley, *op. cit.*, p. 93.

41. Samuel B. Chase, Jr., "The Bank Holding Company—A Superior Device for Expanding Activities?," in *Policies for a More Competitive Banking System* (Federal Reserve Bank of Boston, 1972), p. 77.

42. Even though the REIT problems have passed, Standard & Poor's considers the strength of the link between the REIT and its sponsor an important rating consideration. They argue that ". . . if the REIT bears the sponsor's name there is a definite economic incentive for the sponsor to keep the REIT solvent and avoid any negative publicity." S&P, *Credit Overview* (August 1983), p. 59.

43. These examples are taken from "Bank and Bank Holding Company Involvement with Real Estate Investment Trusts," David C. Hamilton, mimeo (Federal Reserve Board, May 19, 1978).

44. There were also some other "technical" problems, primarily the accounting method ILA used to value its assets.

45. *Wall Street Journal* (October 8, 1980), p. 3.

46. See press releases from First Chicago Corporation dated April 12, 1985 and July 12, 1985.

47. *Wall Street Journal* (June 18, 1985), p. 8.

48. First Chicago Corporation, Annual Report to Shareholders (1985), pp. 2-3.

49. Tulsa World (October 21, 1984).

50. Tulsa World (October 6, 1984).

51. Tulsa World (October 21, 1984).

52. Walter Wriston, then Chairman of Citicorp, Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, Part II, 97th Congress, U.S. Government Printing Office (October 29, 1981), pp. 589-90.

53. A survey of the earliest Board decisions pursuant to section 3 of the Bank Holding Company Act of 1956 reveals that the Board has always used this approach in its competitive analysis. See, for example, Board orders denying the applications by Northwest Bancorporation, Minneapolis, and Wisconsin Bankshares Corporation, Milwaukee, to organize *de novo* bank subsidiaries. *Federal Reserve Bulletin*, vol. 44 (Federal Reserve Board, January 1958), pp. 11-12, 15-16.

54. See, for example, Board order approving the application by United Missouri Bancshares, Inc., Kansas City, to acquire a bank. *Federal Reserve Bulletin*, vol. 64 (Federal Reserve Board, March 1974), pp. 224-226.

55. See Comptroller of the Currency, *Annual Report*, 1977, 55ff; FDIC, *Annual Report*, 1977, p. 15; and Letter from the Federal Reserve Board's Division of Banking Supervision and Regulation to the Officers in Charge of Examinations, Legal and Research Departments at all Federal Reserve Banks, October 7, 1977 (BHC-127).

56. For example, Federal Reserve reserve requirements are applied to each bank subsidiary individually. In a regime of graduated reserve requirements, this means that the total amount of reserves required of a multibank holding company is less than if all the sister bank subsidiaries were aggregated to a single banking entity.

57. In December 1969, the Congress specifically authorized the Federal Reserve Board to apply both reserve requirements and interest rate controls to funds received by member banks from the

issuance of commercial paper by the bank's holding company (*U.S. Code Congressional and Administrative News*, 91st. Cong., 1st Sess. (1969), vol. 1, pp. 392-400, 1472-1473, 1521). See also *Federal Reserve Bulletin*, vol. 56 (Federal Reserve Board, January 1970), pp. 35-37, 105-106.

58. Board of Governors of the Federal Reserve System, *Annual Report*, vol. 57 (1970), pp. 75-76. See also *Federal Reserve Bulletin*, vol. 56 (Federal Reserve Board, August 1970), p. 657.

59. David B. Humphrey and Donald T. Savage, "Bank Use of Downstreamed Commercial Paper and the Impact of Reserve Requirements in Controlling Liability Usage," *Journal of Economics and Business*, vol. 33 (Winter 1981), pp. 109-114.

60. *Ibid.*

61. *U.S. Code Congressional Administrative News*, 93rd Cong., 2nd Sess. (1966), Part I, pp. 1793-1794, and Part II, pp. 6249-6252, 6264-6265.

62. Variably denominated payments instruments include money orders and similar payments instruments, such as cashier's checks and certified checks.

63. See Board Order approving the application by Citicorp., New York, to engage in the activity of issuing and offering on a consignment basis general purpose, variably denominated payments instruments. *Federal Reserve Bulletin*, vol. 63 (Federal Reserve Board, April 1977), pp. 416-419.

64. See Board Order approving the application by BankAmerica Corporation, San Francisco, to engage *de novo* in the issuance and sale of payments instruments and related activities. *Federal Reserve Bulletin*, vol. 70 (Federal Reserve Board, April 1984), p. 364.

65. The discussion in this section focuses on *domestic* bank holding companies. Regulation of foreign bank holding companies is much narrower in scope and generally concentrates on the domestic subsidiaries of those holding companies.

66. Initially, section 23A applied only to banks that were members of the Federal Reserve System. However, in 1966, the Congress amended the Federal Deposit Insurance Act to extend coverage to insured nonmember banks.

67. Digest of Hearings Before a Subcommittee of the Senate Committee on Banking and Currency pursuant to S. Res, 71st Cong., 3d Sess. (1931); Operation of the National and Federal Reserve Banking Systems, p. 1066.

68. See *Bank Holding Company Act of 1955*, Report No. 609, House Committee on Banking and Currency, 84th Cong., 1st Sess. (May 20, 1955), pp. 17-18; and *Control of Bank Holding Companies*, Report No. 1095, Senate Committee on Banking and Currency, 84th Cong., 1st Sess. (July 25, 1955), p. 15.

69. "Report under Bank Holding Company Act," *op. cit.*, p. 793.

70. Section 5(c) of the Bank Holding Company Act authorizes the Federal Reserve Board to acquire reports from bank holding companies as well as to examine each holding company and each subsidiary thereof. Financial statements for each bank subsidiary are filed with the bank's primary federal supervisor.

71. Board Order approving the application of NCNB Corporation, Charlotte, N.C., to acquire a mortgage banking company. *Federal Reserve Bulletin*, vol. 48 (Federal Reserve Board, September 1972), p. 844. To demonstrate its commitment to the principle that holding companies should be a source of strength to their subsidiary banks, the Board has denied applications that it felt were inconsistent with this objective, pursuant to section 3(c) of the Bank Holding Company Act, as amended. See, for example, Board Orders denying the applications by Seilon, Inc., Toledo, Ohio, to acquire a bank holding company, *Federal Reserve Bulletin*, vol. 48 (Federal Reserve Board, August 1972), pp. 729-730 and First Lincolnwood Corp., Lincolnwood, Illinois, to form a bank holding company, *Federal Reserve Bulletin*, vol. 62 (Federal Reserve Board, February 1976), pp. 153-154. The First Lincolnwood Corp. decision was challenged in court but was eventually upheld by the U.S. Supreme Court. (*Board of Governors of the Federal Reserve System* v. *First Lincolnwood Corp.*, Supreme Court of the United States, No. 77-832, December 11, 1978.)

72. See Board of Governors of the Federal Reserve System, *Annual Report*, vol. 59 (1972), p. 200. The same recommendation also appeared in the Board's *Annual Report* for 1973 (p. 237). The Board made no further recommendations regarding section 23A until it proposed a complete redrafting of the statute in 1977, as discussed later in this section.

73. For a discussion of the heightened interest of the Federal Reserve in holding company supervisory policy during this period, see Carter H. Golembe, "The Supervision and Regulation of Bank Holding Companies: An Assessment of Objectives and Implementation," prepared for the Association of Bank Holding Companies by Golembe Associates, Inc., November 13, 1978, pp. 53-56. See also Lucille S. Mayne, "New Directions in Bank Holding Company Supervision," *Banking Law Journal*, vol. 95 (September 1978), pp. 729-742.

74. Probably the best known case involved Hamilton National Bank of Chattanooga, which failed after having purchased a large amount of low-quality mortgages from a mortgage banking subsidiary of the bank's parent holding company. Recall the discussion of these problems in the previous section of this study.

75. See Board of Governors of the Federal Reserve System, *Annual Report*, vol. 64 (1977), pp. 372-373.

76. Recent amendments to section 23A are discussed in John T. Rose and Samuel H. Talley, "The Banking Affiliates Act of 1982: Amendments to Section 23A," *Federal Reserve Bulletin*, vol. 68 (Federal Reserve Board, November 1982), pp. 693-699.

77. See Phil Battey, "CofC Tells Banks Not to Enrich Insiders with Exorbitant Fees," *American Banker* (September 11, 1978), p. 1.

78. Board of Governors of the Federal Reserve System, "Policy Statement Regarding Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State-Chartered Banks That are Members of the Federal Reserve System," Press Release (September 25, 1978).

79. Among the possible diversion of income practices listed by the Board are "(1) management or service fees, or other payments assessed by the parent company or any affiliated entity and paid by the bank, that bear no reasonable relationship to the fair market value, cost, volume, or quality of services rendered by the affiliate to the subsidiary bank; (2) balances maintained by the subsidiary bank primarily in support of parent borrowings without appropriate compensation to the bank; (3) prepayment of fees to the parent or other nonbank affiliates for services that have not yet been rendered; and (4) non reimbursed expenses incurred by the bank that primarily support a nonbank activity." See letter from the Board's Division of Banking Supervision and Regulation to the Officer in Charge of Examinations at each Federal Reserve Bank, March 19, 1979 (SR-533).

80. *Ibid.*

81. See Board of Governors of the Federal Reserve System, *Annual Report*, vol. 66 (1979), p. 276.

82. Two reports issued by the General Accounting Office in 1980 and 1981 emphasized the integrated nature of the bank holding company organization and suggested that bank supervisors treat holding company systems as single entities. The GAO offered a number of recommendations, including better coordination of supervisory efforts among the three federal bank regulatory agencies. See Comptroller General of the United States, *Federal Supervision of Bank Holding Companies Needs Better, More Formalized Coordination*, GGD-80-20, February 12, 1980; and *Federal Reserve Could Improve The Efficiency of Bank Holding Company Inspection*, GGD-81-79 (August 18, 1981).

83. Federal Reserve Board, *Annual Report* (1979), p. 277. See also *Federal Reserve Bulletin*, vol. 66 (Federal Reserve Board, January 1980), p. 35.

84. See letter from the Board's Division of Banking Supervision and Regulation to the Officer in Charge of Examinations at each Federal Reserve Bank, February 1, 1982 (SR 82-6 (FIS)).

85. See *Federal Reserve Bulletin*, vol. 68 (Federal Reserve Board, January 1982), pp. 33-34. See also *Federal Reserve Bulletin*, vol. 69 (Federal Reserve Board, July 1983 and December 1983), pp. 539-540 and 898.

86. Samuel H. Talley, *Bank Capital Trends and Financing*, Staff Studies 122 (Federal Reserve Board, 1983), p. 16. An exception to the consolidation rule is that in the case of relatively small holding companies (consolidated assets under $150 million) the guidelines apply to the bank only, provided that the company does not engage in any nonbank activity involving significant leverage and that no significant debt of the parent holding company is held by the general public.

Bank Earnings and Market Shares 1970 to 1985

This appendix first discusses recent trends in market shares of U.S.-chartered commercial banks, following that with an analysis of banking industry profits over the past several years.

Commercial Banking Market Shares

As shown in chart 1, U.S. banks' shares of overall credit extended to the household and nonfinancial business sectors have been well maintained in recent years.[1] Indeed, the share of U.S. commercial banks in total credit extended to domestic nonfinancial businesses has trended up over the past 10 years. By disaggregating a bit further and excluding the debt incurred by farms and nonincorporated businesses from the nonfinancial business sector referred to above, we find that the share of U.S. commercial banks in total debt of domestic nonfinancial *corporations*, shown at the top of chart 2, has risen erratically over a longer horizon extending back several decades. Despite all the attention paid recently to the phenomenon of securitization, the share of credit obtained by such corporations through distribution of debt in open markets—including bank loans sold to nonbanks—actually has declined since the late 1970s. A reduction in long-term obligations has been responsible for this drop, as high interest rates probably discouraged bond issuance.

However, at the same time that banks' share of total credit extended to domestic nonfinancial corporations generally has strengthened, their share of short- and intermediate-term credit (also shown in chart 2) has declined, reflecting increased competition from the commercial paper market and from foreign banks. This decline has been most evident at the top nine money center banks. Their share of a measure of short- and intermediate-term business credit, shown at the top of chart 3, has been on a downtrend since the mid-1970s. These largest banks have been losing market share while the commercial paper market and U.S. agencies and branches of foreign banks, displayed at the bottom of chart 3, have increased in importance. Although U.S. chartered banks other than the nine largest, shown in the second panel of the chart, had also lost market share, during recent years they have regained a portion of those losses.[2]

Measures of market share in the short-term business credit market have become less meaningful as U.S. banks increasingly originate assets for distribution rather than holding the assets in their own portfolios until maturity. A number of money center and regional banks have greatly expanded their sales of participations in domestic business loans recently, a large portion of which has been to foreign banks. Consequently, if market share were measured in terms of originations of short-term credit rather than asset holdings, the share of U.S. banks would be somewhat higher.

Since the late 1970s there has been a mild erosion in banks' share of household sector debt, but over a longer period their share of this sector's total debt has displayed little trend. One type of household lending in which the banks' share had displayed a strong long-term uptrend is consumer credit (see top panel of chart 4). More recently, however, commercial banks have lost some market share in both consumer credit and residential mortgage lending, areas in which thrift institutions have made important inroads. For example, savings and loan associations have greatly boosted their consumer lending since the Garn-St Germain Act expanded their powers in this area.

Commercial banks' relative importance in total mortgage lending to *all* borrowers has continued to grow since the early 1960's. Flow-of-Funds data, shown in the bottom panel of chart 4, illustrate the ongoing increase in banks' share of real estate backed loans. Moreover, the actual market share may be understated since these figures exclude bank holdings of securities backed by mortgage pools, such as those issued by GNMA and FNMA.

Banks' shares of the credit market debt of the two government sectors depicted in chart 1 have registered significant declines in recent years. Their loss of market share in state and local government obligations dates from the early 1970s; instead households and mutual funds have acquired an increasing proportion of those obligations. U.S. banks' share of total credit market claims on the federal government has been on the decline for several decades. In recent years, the most rapid growth in holdings of Treasury securities has occurred in the portfolios of other private financial institutions and state and local governments; in dollar terms, both groups' holdings have risen more than five-fold since the end of the 1970s.

The decline in banks' share of borrowings by all levels of government accounts for the entire reduction

[1] This paper was prepared by Board staff.

in banks' share of total credit extended to all domestic nonfinancial sectors that has occurred since the mid-1970s. As noted earlier, over longer periods of time commercial banks have maintained or increased their share of credit extended to nongovernmental borrowers.

In the market for retail deposits, U.S. commercial banks have regained the share that they had lost during the high interest rate era of the 1970s and early 1980s. As shown in chart 5, since the introduction of of money market deposit accounts in December 1982, banks' proportion of retail nontransaction accounts has risen sharply to exceed its 1970 peak as the inroads that have been made by money market mutual funds have ultimately come entirely at the expense of thrift institutions.

Commercial Bank Profitability

The profitability of insured commercial banks turned higher last year, offsetting a portion of the persistent decline during the early 1980s that had dragged profitability down from near post-war peaks. As shown in chart 6, over the five years to 1984, the industry's return on assets fell by one fifth and its average return on equity dropped by a quarter—both to their lowest levels since at least 1970, the first year for which precisely comparable data are available. This downturn was, however, exaggerated by the earnings shortfalls suffered by a handful of large banks, which continued to depress the industry's results somewhat in 1985. Earnings excluding these selected banks are also plotted in chart 6—by the lines punctuated with circles—and show the rest of the industry experiencing a milder initial decline in returns and a more sustained rebound recently.

Last year's improvement in banking industry profitability stemmed entirely from a substantial rise in profits at one size class of banks. As shown in the third panel of chart 7, large banks, excluding the top nine money center banks, scored such a sizable increase in profitability last year that their average return on assets ended up well above its 1979 level. This group of banks registered an especially large increase in interest margins last year, benefiting from lower market interest rates, which also prompted the recognition of gains on securities from investment portfolios. Deleting selected banks that have experienced earnings difficulties does not appreciably change the 1985 figure for average return on assets of these large banks, but, as shown in the third panel of chart 7, it does eliminate much of the earlier decline.

Making a similar adjustment to the figures for the nine money center banks, shown in the bottom panel of that chart, not only eliminates the earlier decline—which in any case was milder than that of the other large banks—but it also lifts their 1985 return on assets significantly. The bottom panel of chart 7 also includes the unadjusted figures for the nine money center banks. Their average return on assets, which earlier had displayed only a mild down trend, dropped by an eighth last year. A modest improvement in their net interest margin and strong growth in noninterest income in recent years have been insufficient to offset the need to raise loan-loss provisions.

These divergent moves in profitability at the top money center banks and at other large banks are also apparent in the results of the parent bank holding companies. Chart 8 displays the average return on assets at the ten largest bank holding companies and at the next forty, with last year's downturn at the money center banks and upturn at other large banks mirrored there.

The upturn in overall banking industry profitability in 1985 occurred despite continued rapid growth in loan-loss provisions. These provisions represent current revenues that commercial banks have diverted from profits in order to raise or replenish their reserves for loan losses. The loan-loss reserve, in turn, is a balance-sheet item that must be maintained at a level adequate to absorb anticipated losses, and it may not be allowed to dip below zero when bad loans are charged off against it. Recent experience with loan-loss provisions has shown them to be closely related to same-year charge-offs of loans. And charge-offs, which had generally been related to the cyclical position of the economy, have risen steadily so far in the 1980s.

Burgeoning loan losses more than accounted for the decline in commercial bank profitability between 1980 and 1984; the aggregate return on assets dropped by 0.16 percentage point and loan-loss provisions rose by about double that amount over those five years. And in 1985, loan losses continued to grow unabated even as profitability turned higher. At this stage of the business cycle, the continued increase in charge-offs—and consequently in additions to loan-loss reserves—is very unusual. Loan quality tends to improve with a considerable lag after a cyclical downturn, but the lag this time appears to have been compounded by the effect on borrowers of a number of factors, such as the severity of the last recession, large changes in the dollar's foreign exchange value, the uneven nature of the recovery, and the declines in inflation rates of the last several years. Certainly, declining commodity prices have been a significant factor in losses on credits extended to the agriculture, energy, and other primary goods industries. In addition, the deregulation of several important U.S. industries caused some painful restructurings during this period, as firms adapted with greater or lesser success to the changed environment.

Loan-loss provisions by size of bank are shown in chart 9.[3] The inverse relationship in recent years between these additions to reserves and the profitability measures in chart 7 are quite clear. The sustained upward trend in loan-loss provisions at the smallest banks and the corresponding slide in their return on assets in the 1980s (shown in the top panels of charts 9 and 7, respectively) represent probably the most obvious example, since larger banks were able to offset the impact of loan losses to various extents by widening their interest margins and boosting noninterest income more than noninterest expenses. Thus, shown in chart 7, the small banks suffered a far sharper profitability downturn in the first half of this decade than did other banks. But this outsized decline simply brought them into line with other groups, since small banks had traditionally recorded the highest return on assets.

While even nonagricultural small banks posted a decline in profitability well in excess of that for the whole industry, part of the recent problems at small banks is no doubt due to their heavier concentration in agricultural lending. Taking just those small banks which have relatively large amounts of agricultural loans on their books, we find that their return on assets dropped from a very profitable 1.28 percent in 1979 to 0.74 in 1984 and 0.57 percent in 1985. Agricultural banks are also appearing more often on the lists of banks that have failed. Bank failures in general have soared recently, to 50-year highs, but of the 118 insured commercial bank failures last year, 68—or more than one-half—were agricultural banks.

Unlike the small banks, medium-sized banks, with total assets between $100 million and $1 billion, did not experience an uninterrupted deterioration in profitability in the 1980s. As shown in chart 7, the average return on assets at these banks dipped in 1981 and 1982, but then stabilized. Their continued increase in loan losses thereafter was balanced by a successful effort to hold down other noninterest expenses and, in 1985, significant gains on securities sold from investment portfolios.

For the banking industry as a whole, the increase in loan-loss provisions so far in the 1980s has been offset to an extent by a widening of the margin between interest income and interest expense. This growing net interest margin, displayed in the top panel of chart 10, suggests that the removal of regulatory ceilings on deposit interest rates did not have a direct negative effect on aggregate profitability, or that any negative effect was offset fortuitously by other factors. Deposit rate deregulation raised the cost of many retail deposits, but it also allowed the banking industry to regain its share of the retail deposit-type market and allowed a number of commercial banks to reduce their reliance on more expensive, wholesale money.

Also shown in chart 10, the industry's negative noninterest margin (excluding loan-loss provisons) changed little on balance over the early 1980s. Around 1979, both noninterest income and noninterest expense, shown separately in chart 11, began to accelerate, but at approximately equal rates, leaving the margin unchanged. The recent rapid growth of noninterest income can be traced in large part to increased fee income. As bankers have "unbundled" financial services, a process probably hastened by deregulation, they have increasingly charged explicitly for services. Service charges on deposit accounts have risen, becoming an important source of income, especially at smaller banks. In addition, banks have expanded their menu of financial products, earning more from such off-balance-sheet items as loan participations, interest rate swaps, and credit enhancement (primarily through the issuance of standby letters of credit). Profits from trading account activities and foreign exchange transactions have also contributed to the growth of noninterest income.

Noninterest expenses were likely boosted by these efforts to capture fee income, as specialized personnel and equipment were necessary to handle new financial products. Wage and salary expenditures were responsible for a good portion of the overall increase in expenses. The undifferentiated "other noninterest expense" on the banking Report of Income also rose significantly, and although no direct data are available, it is likely that this reflects increased promotion of new consumer accounts over the period, as well as stepped-up marketing, automation, and new product development in general.

As shown in chart 12, the Standard and Poor stock index for ten large banks outside New York, which is heavily weighted with banks experiencing earnings shortfalls in recent years, has not fully recovered from its early-1984 decline. But other bank stock indexes have performed as well as, or better than, broader stock market indicators thus far this decade. The Standard and Poor index for six large New York City banks, although dipping in response to international credit problems, has exceeded the Standard and Poor 500 since the end of 1985. The even more dramatic rise shown for the NASDAQ index of 100 regional bank stocks over the last three years no doubt reflects their underlying earnings strength. In general, financial markets appear to have been very receptive to U.S. commercial banks' efforts to bolster their capital positions in recent years.

Footnotes

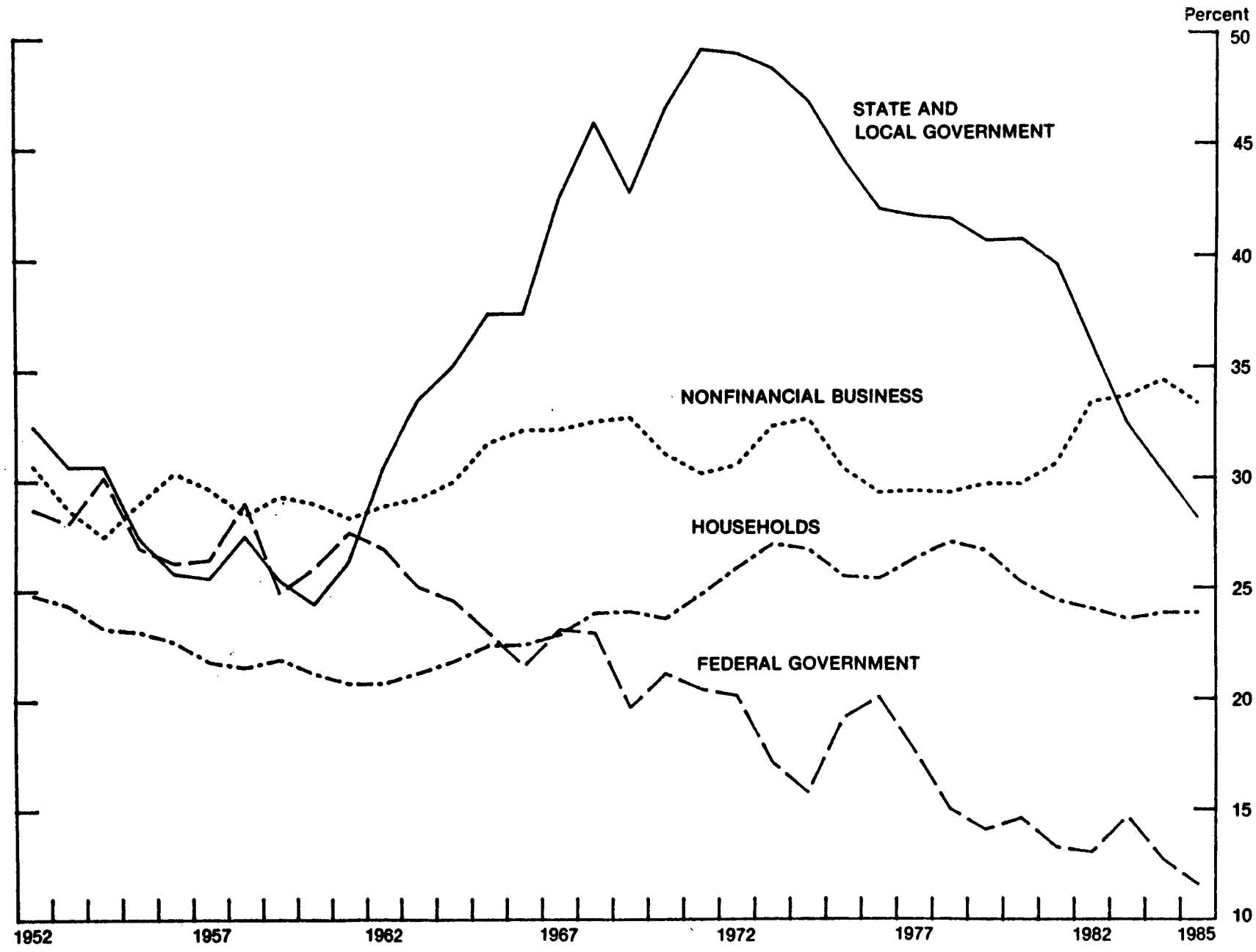
1. Data are from Flow of Funds and, hence, market shares are for commercial banks and the commercial banking activities of bank holding companies; Flow-of-Funds data for nonbank subsidiaries are allocated to other financial sectors.

2. Among this group of other U.S. banks, large banks (excluding the top nine) have registered a sustained increase in their share of short- and intermediate-term business credit over the past decade and a half.

3. The steep upturn in loan-loss provisions in the early 1980s was spread across all size classes of banks. Unlike the 1973 to 1975 period, in which loan-loss increases were more prevalent at larger banks, after the latest recession the smallest banks (those with under $100 million in assets) saw as large a rise in loan-loss provisions as did the nine money center banks. Indeed, the sharp increase at the money center banks during the recent period was not much out of line with the hike in provisions during the earlier episode; loan-loss provisions at those banks in 1985 were on average just above their 1975 level (see chart 9). It is the experience of the other groups of banks that sets the recent period apart.

Chart 1

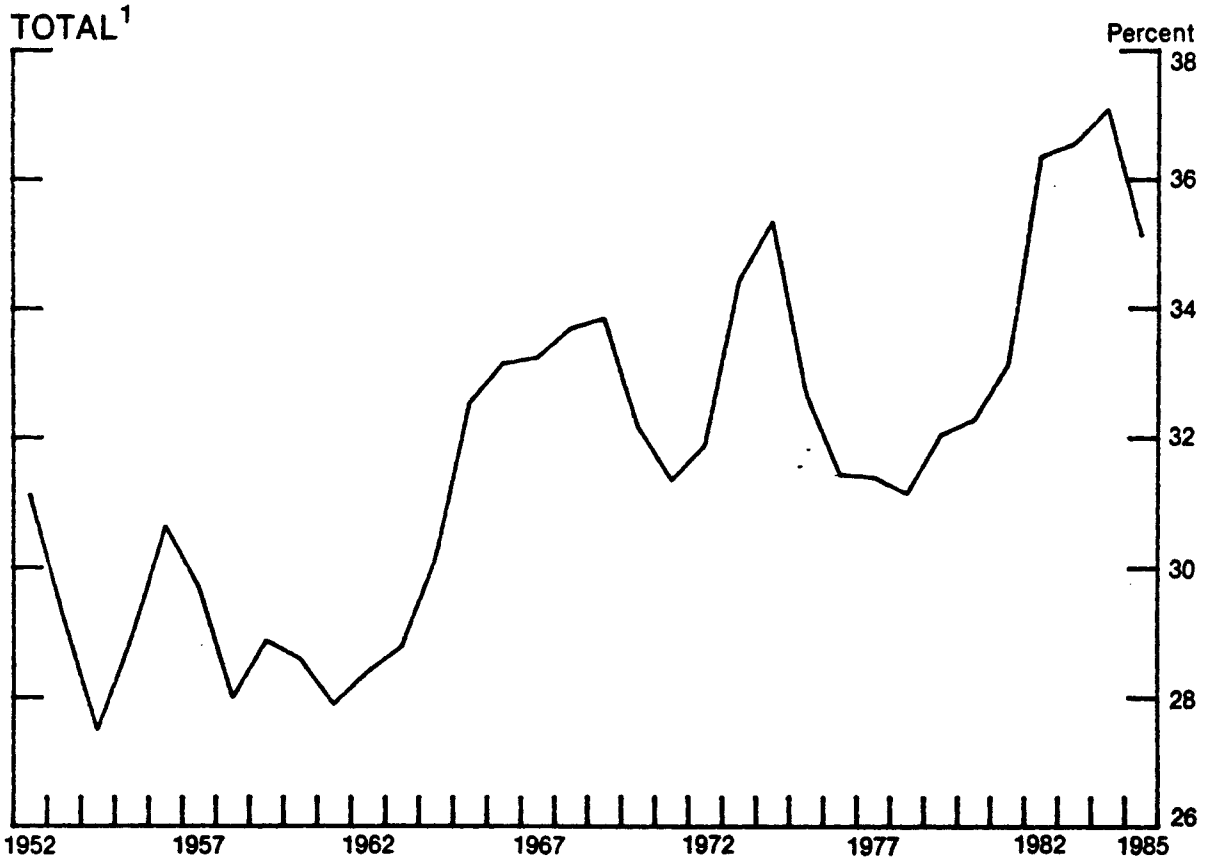
U.S. Banks' Share of Credit Extended to Domestic Nonfinancial Sectors

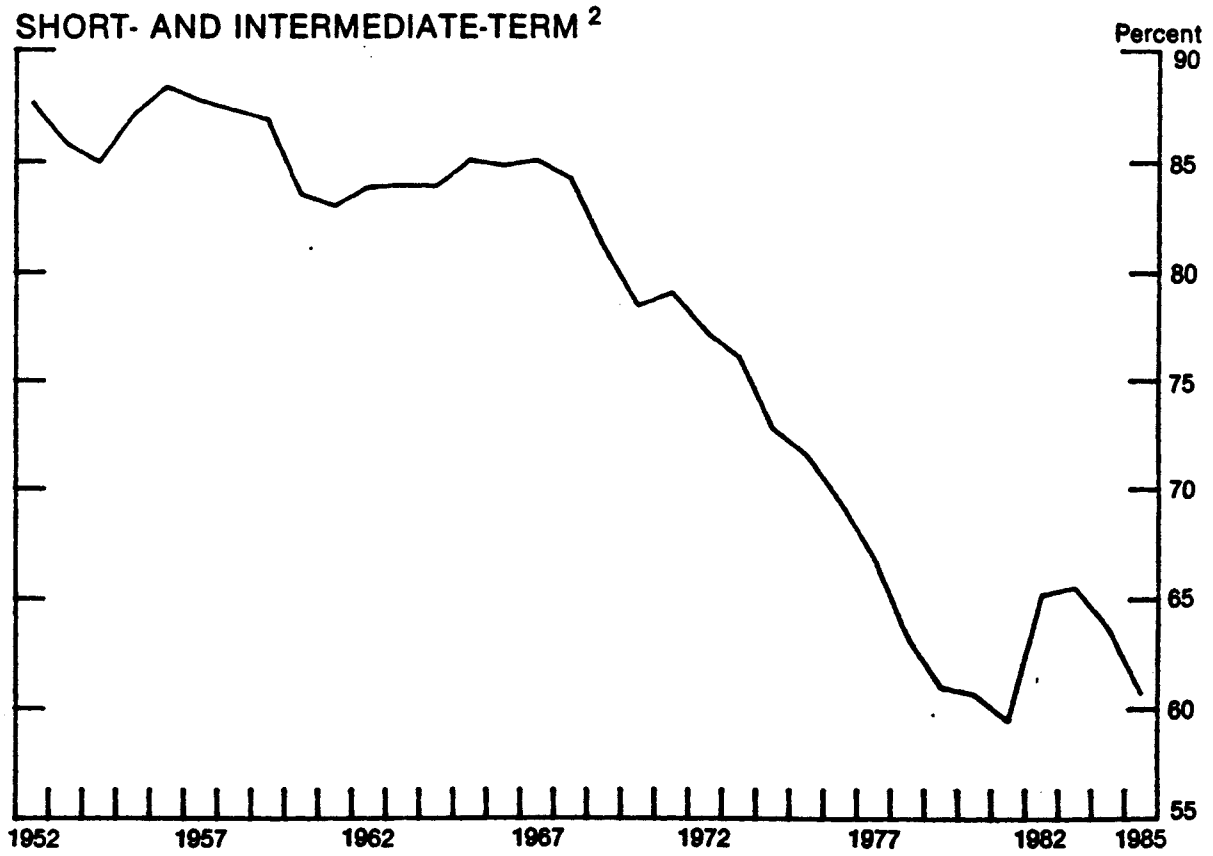


Source: Flow of Funds.

Chart 2

U.S. Banks' Share of Credit Extended to Domestic Nonfinancial Corporations





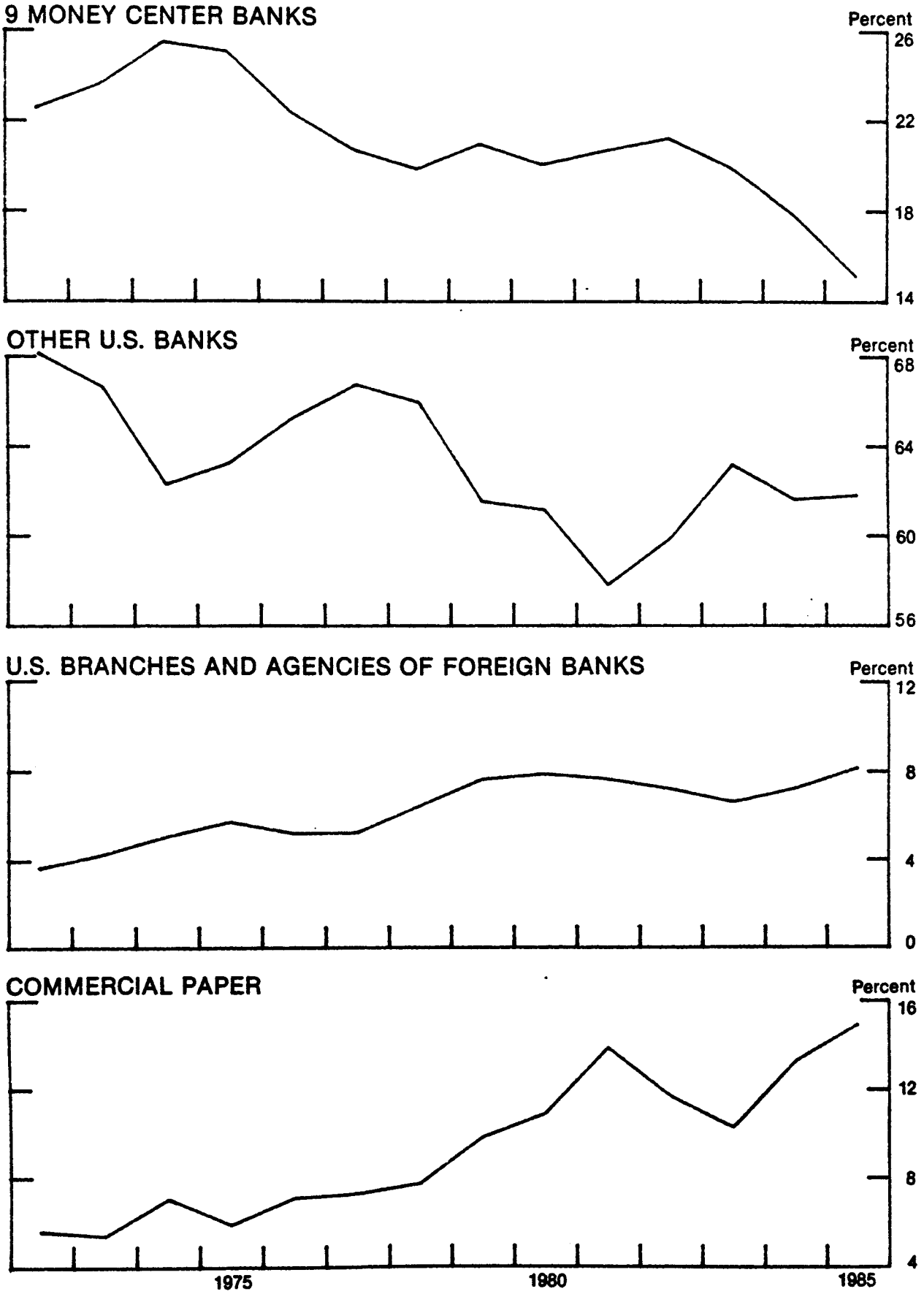
1. U.S. chartered commercial bank holdings of total loans, including those backed by real estate, extended to nonfinancial corporations, plus their holdings of short- and long-term securities issued by those corporations, all as a share of the total credit market debt of the domestic nonfinancial corporate sector.

2. U.S. banks' holdings of nonmortgage loans and short-term paper issued by nonfinancial corporations as a share of nonfinancial corporations' total nonmortgage loans plus short-term paper outstanding.

Source: Flow of Funds.

Chart 3

Shares of Short- and Intermediate-Term Business Credit[1]

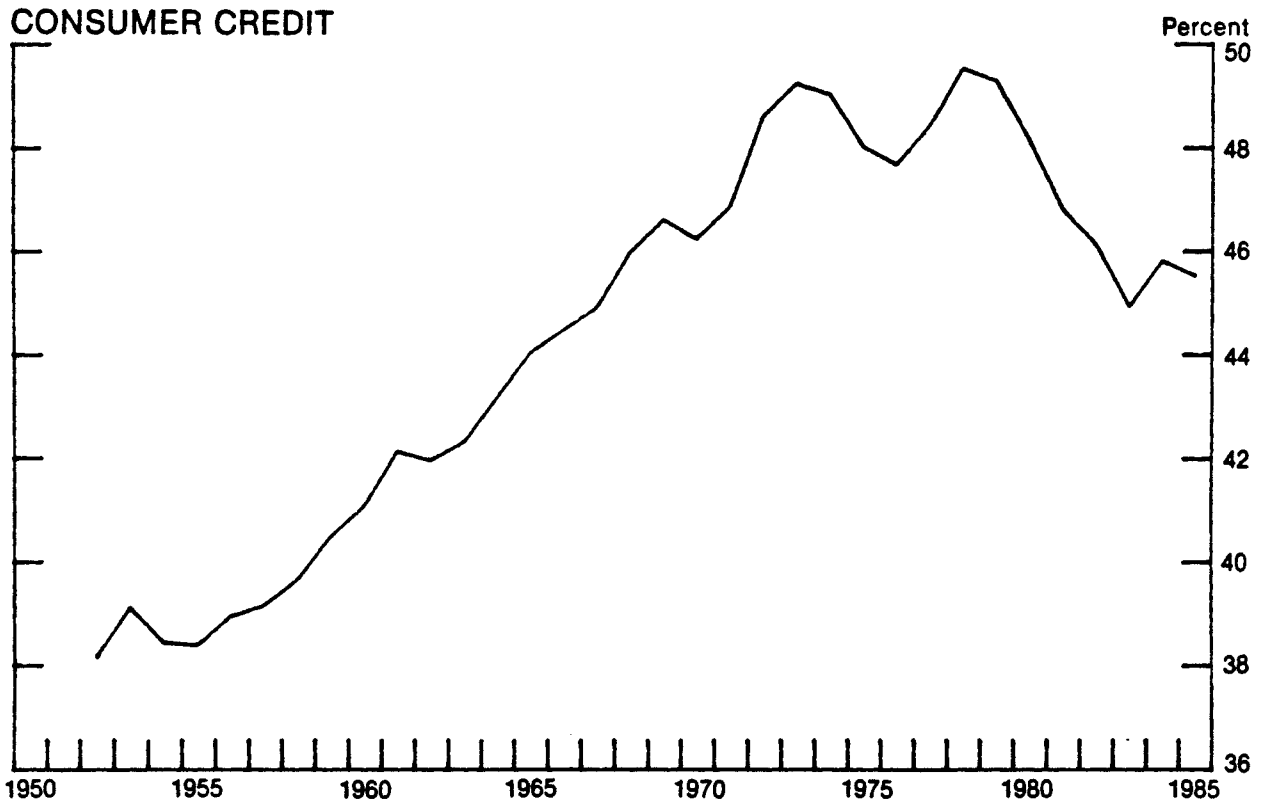


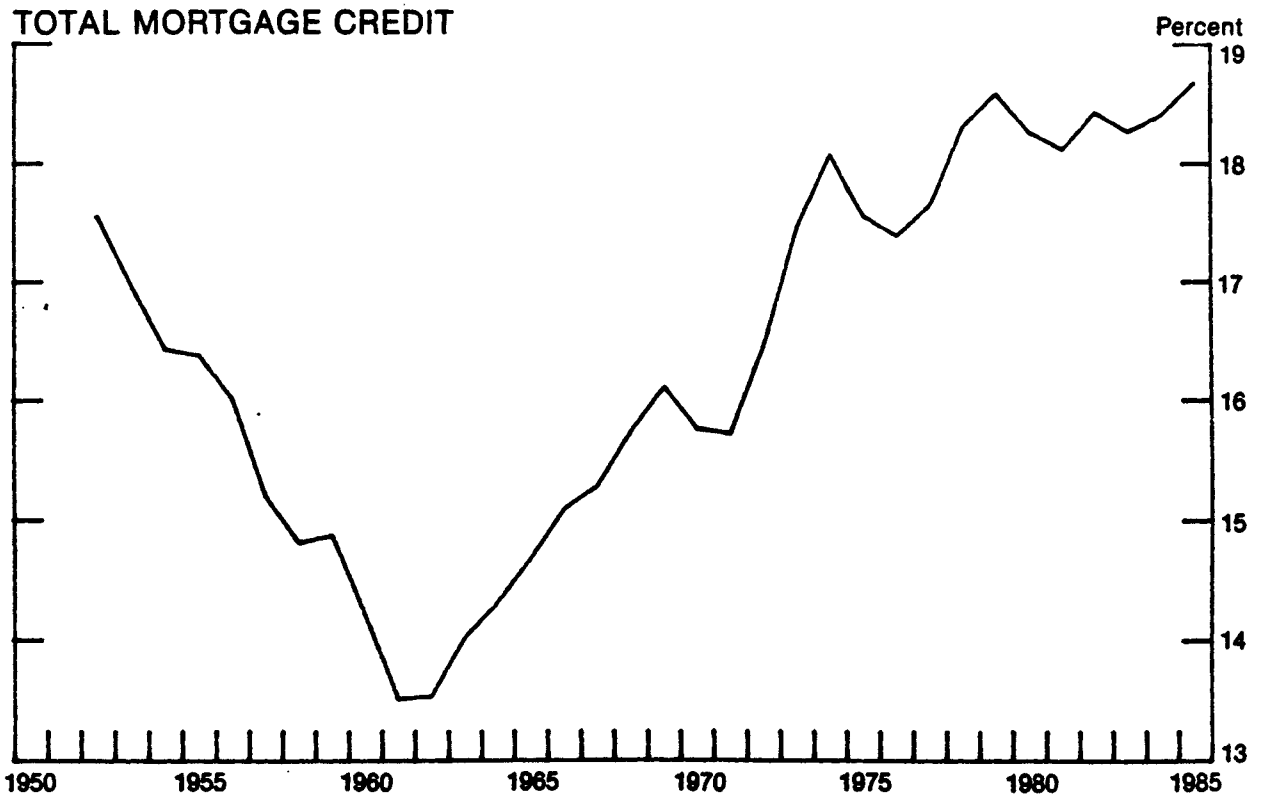
1. Commercial and industrial loans and commercial paper issued by nonfinancial businesses.

Source: Report of Condition and Income, and Bank Credit data.

Chart 4

Commercial Bank Share of Selected Credit Markets

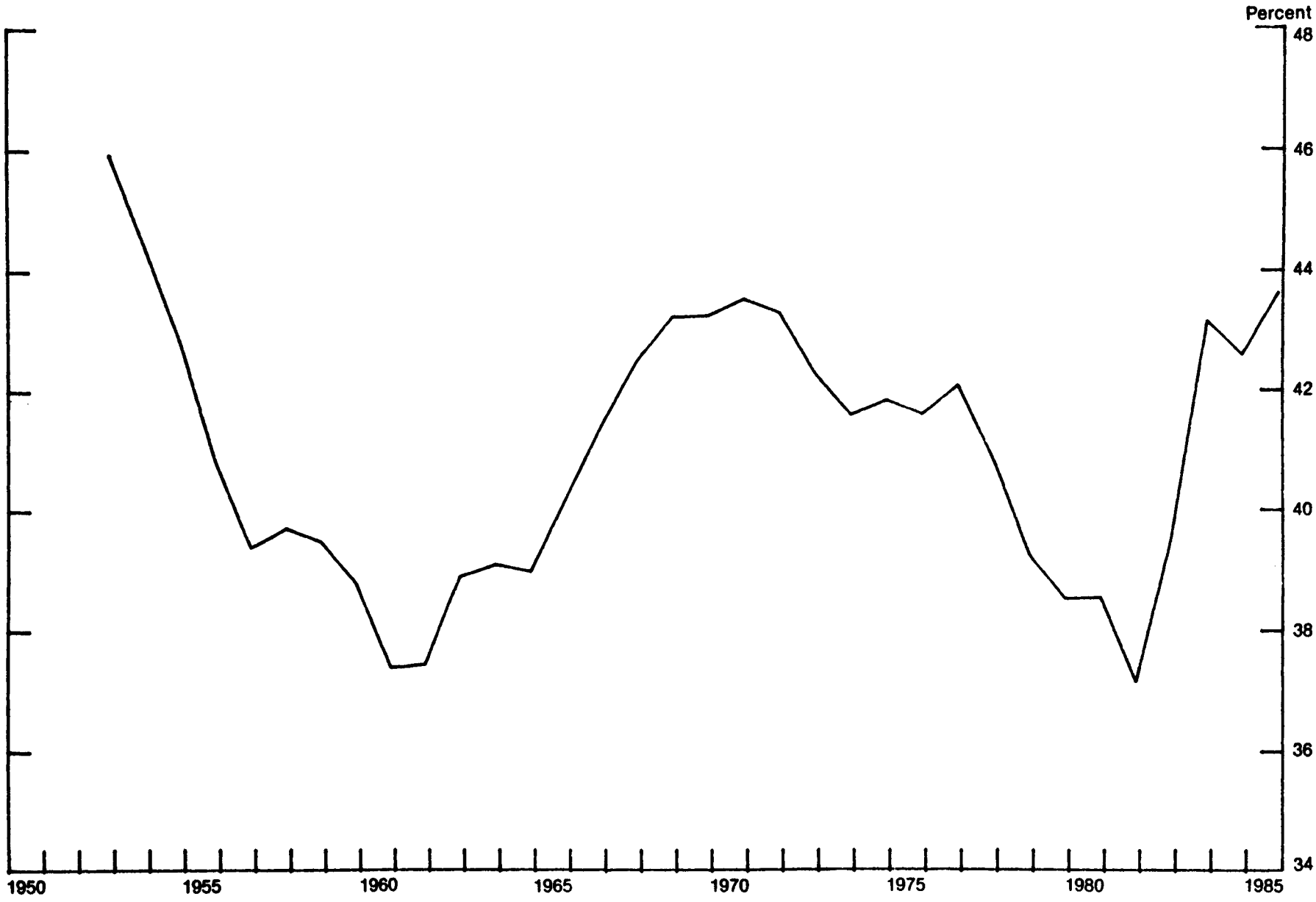




Source: Flow of Funds.

Chart 5

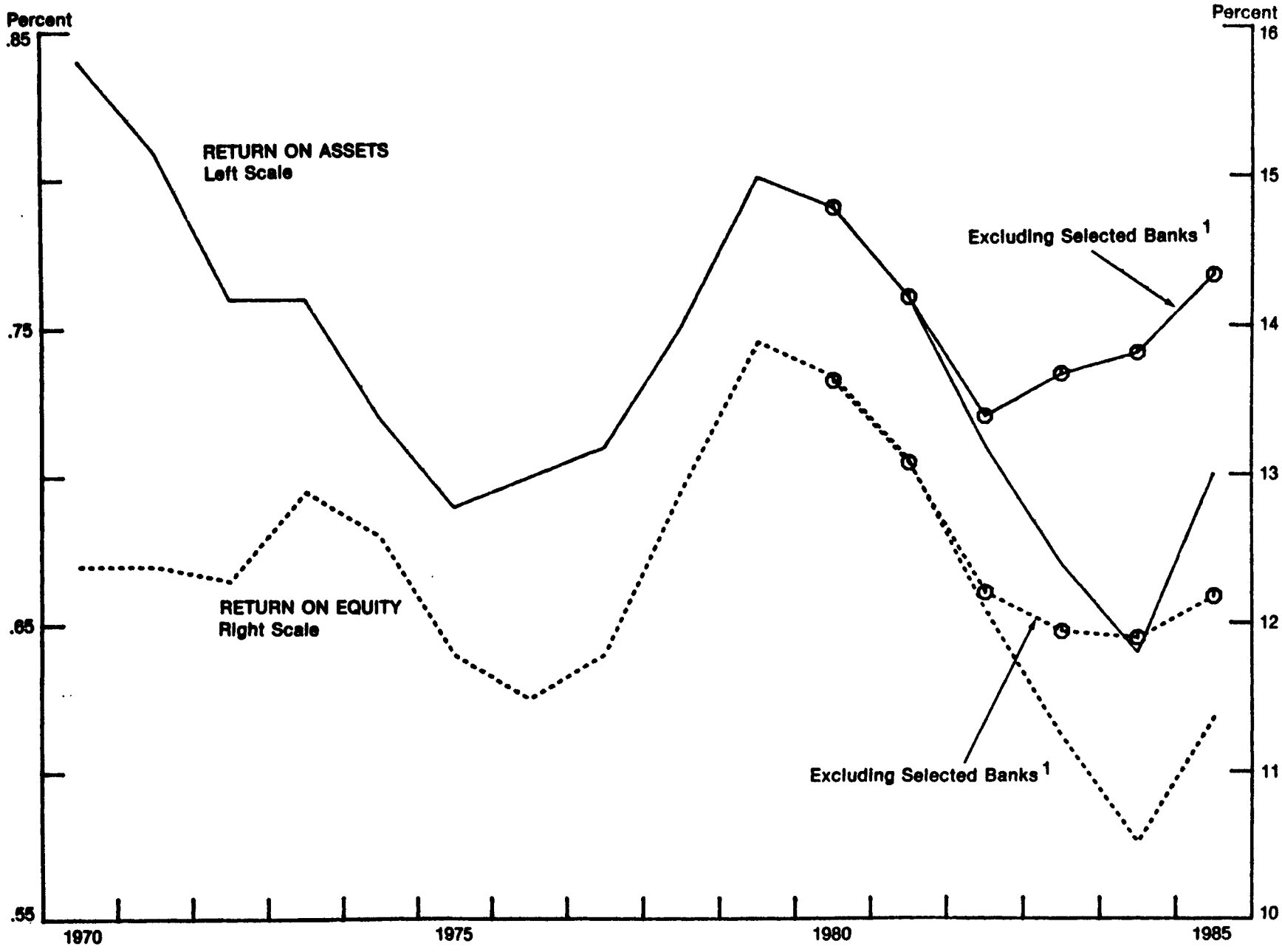
U.S. Banks' Share of Retail Nontransactions Accounts[1]



1. Retail nontransactions accounts are defined as savings and small time deposits at all depository institutions and money market mutual fund shares.

Source: Flow of Funds.

Net Income after Taxes
Insured Commercial Banks



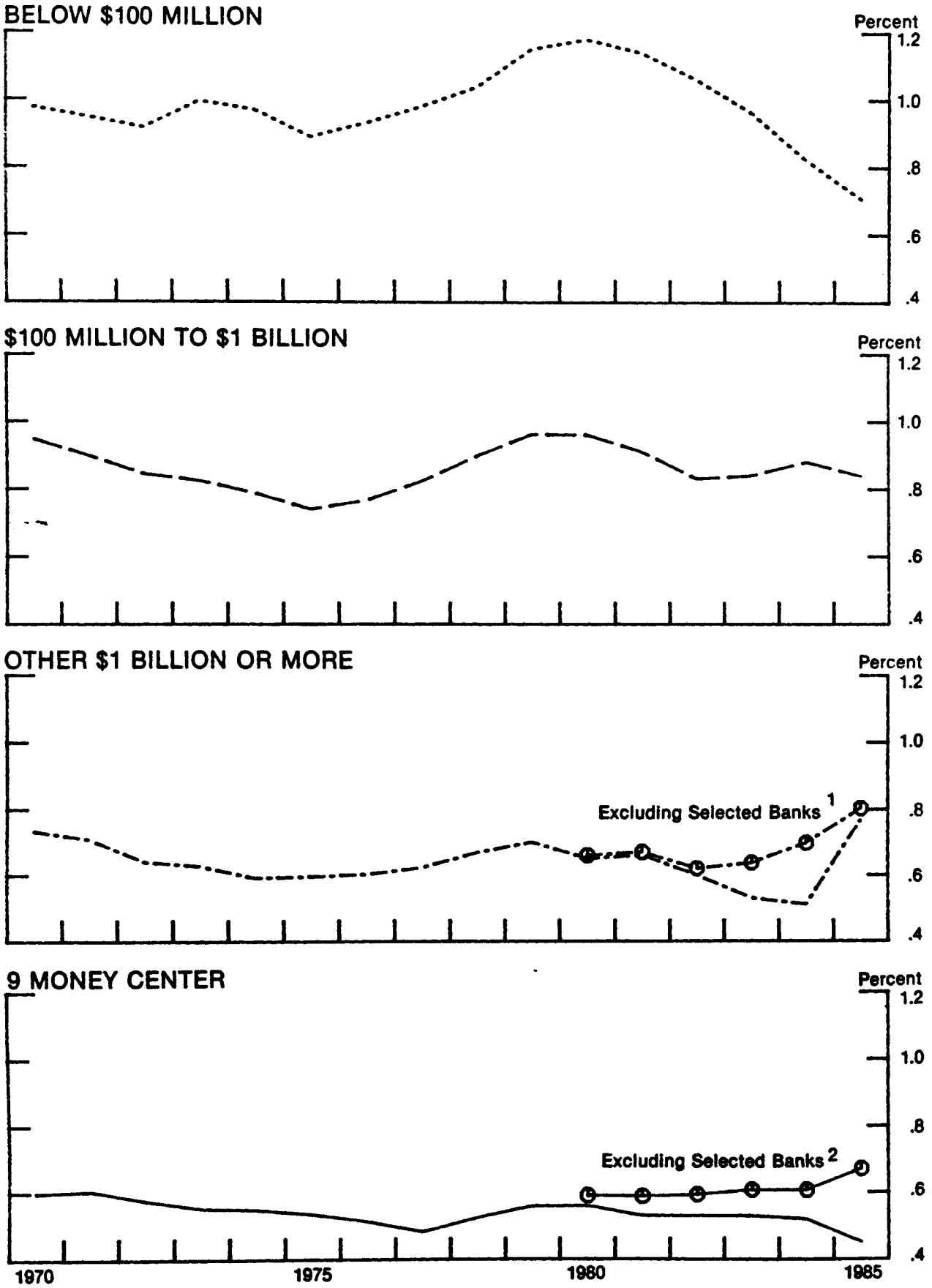
1. Excluding six banks that sustained significant earnings shortfalls in 1983, 1984, or 1985.

Source: Report of Condition and Income.

Chart 7

Return on Assets

Insured Commercial Banks
(By Size of Bank)

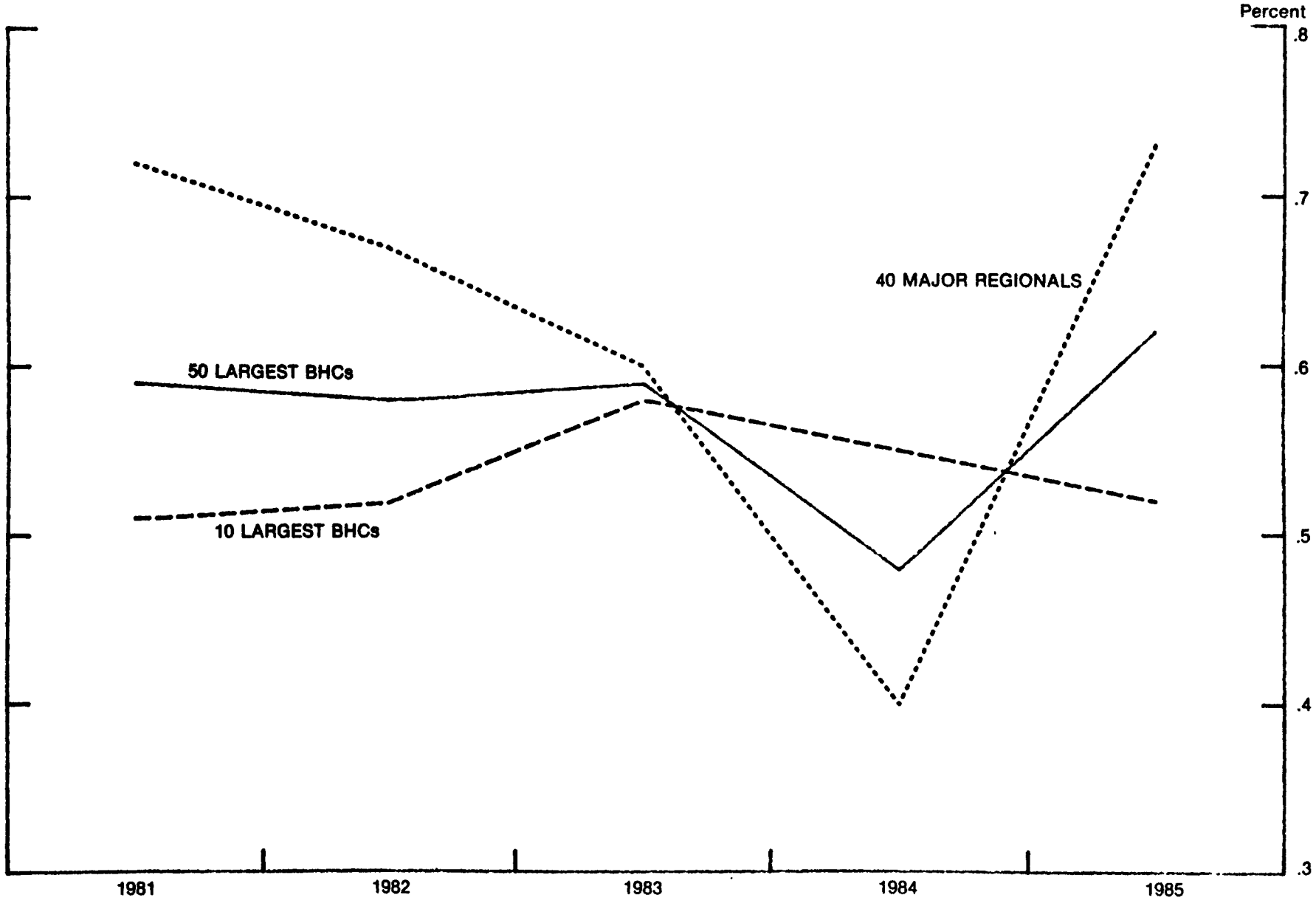


1. Excluding four banks that sustained significant earnings shortfalls in 1983, 1984, or 1985.
2. Excluding two banks that sustained significant earnings shortfalls in 1983, 1984, or 1985.

Chart 8

Return on Assets

Largest Bank Holding Companies

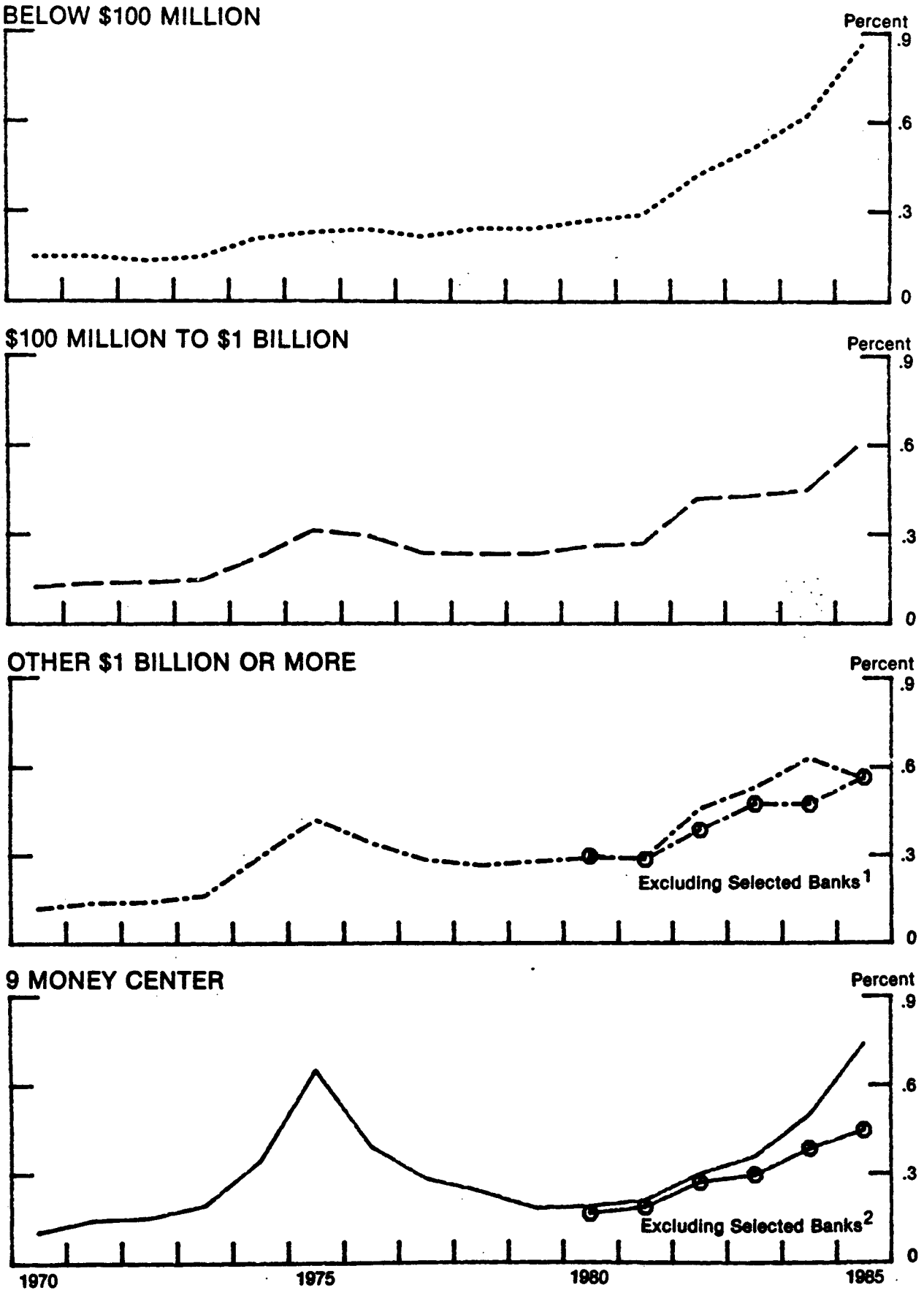


Source: Bank Holding Company Financial Supplement (Form Y-9) and published annual reports of the Bank Holding Companies.

Chart 9

Loan Loss Provision

Insured Commercial Banks
(By Size of Bank)

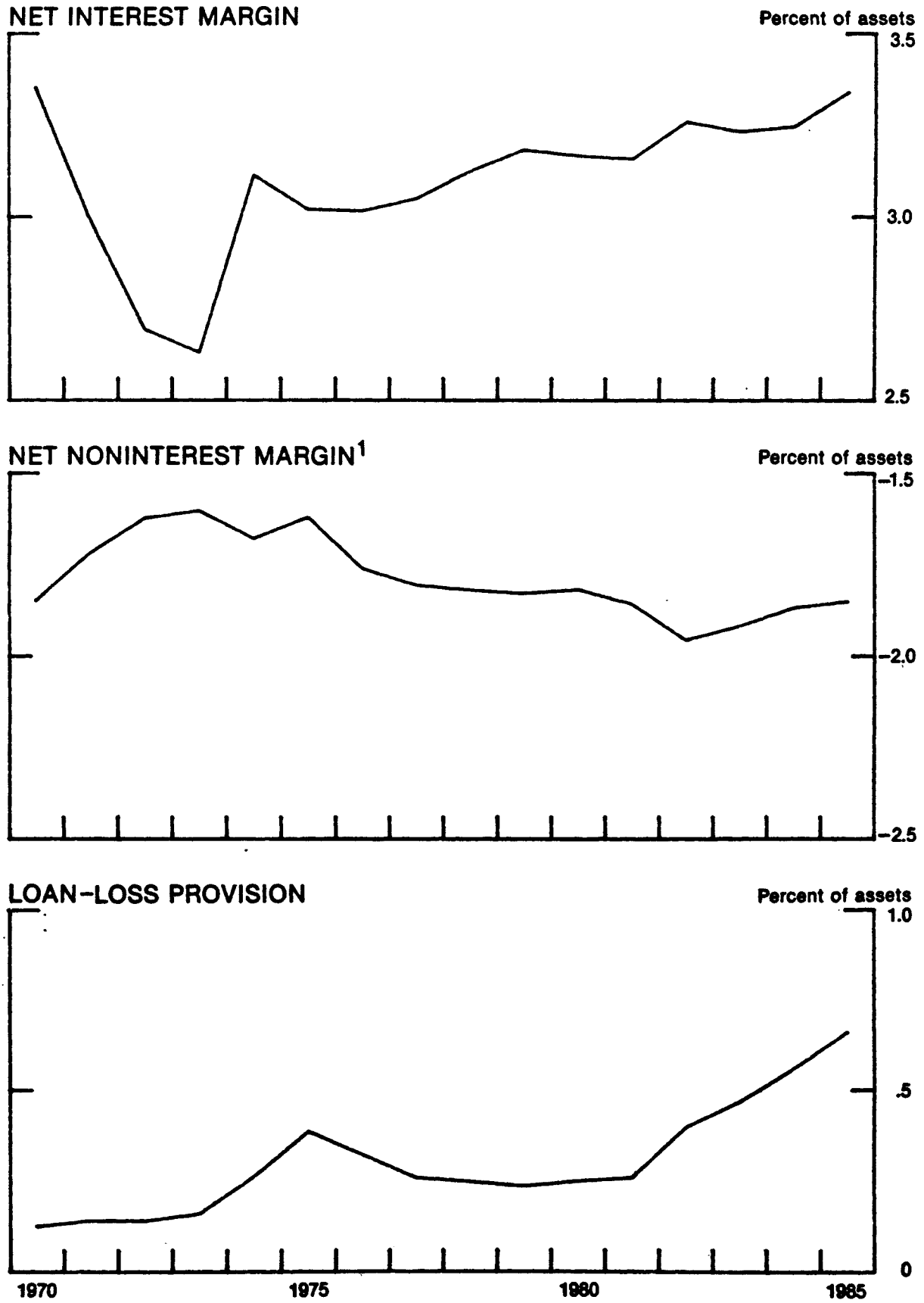


1. Excluding four banks that sustained significant earnings shortfalls in 1983, 1984, or 1985.
2. Excluding two banks that sustained significant earnings shortfalls in 1983, 1984, or 1985.

Chart 10

Components of Net Income

Insured Commercial Banks



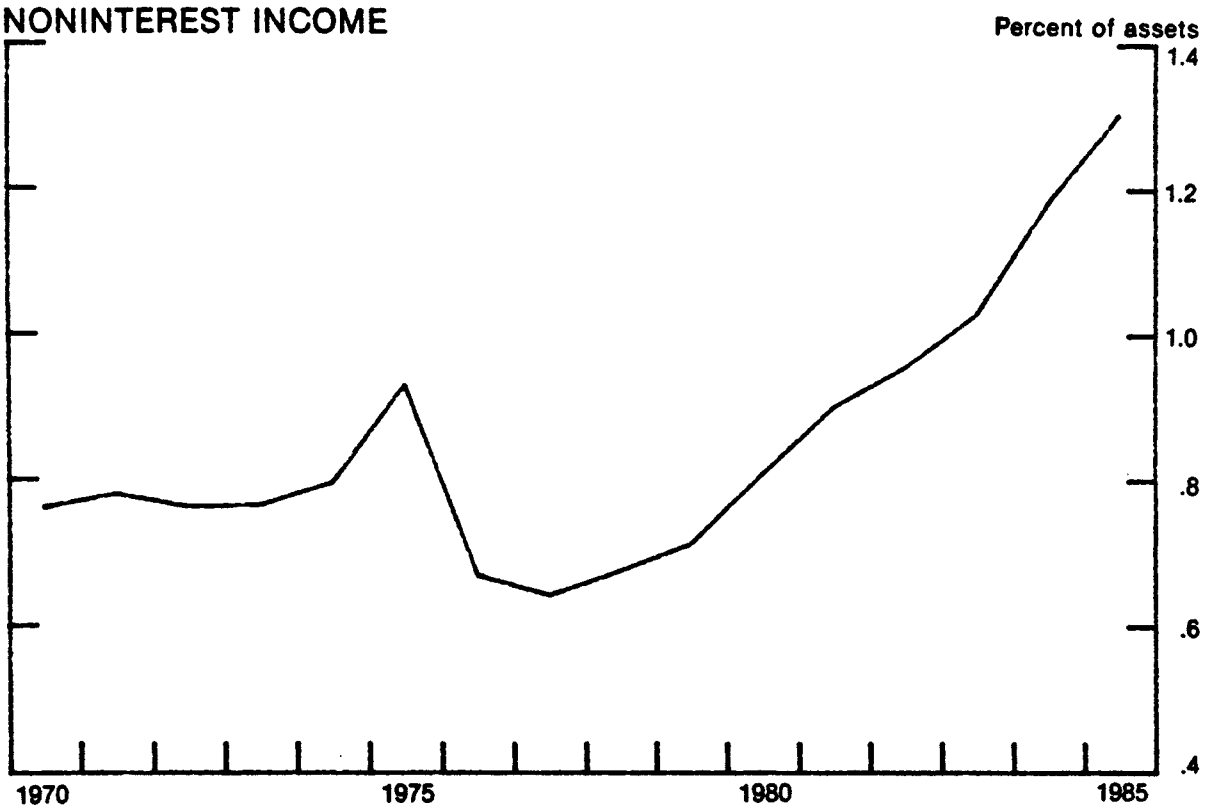
1. Excluding loan-loss provision.

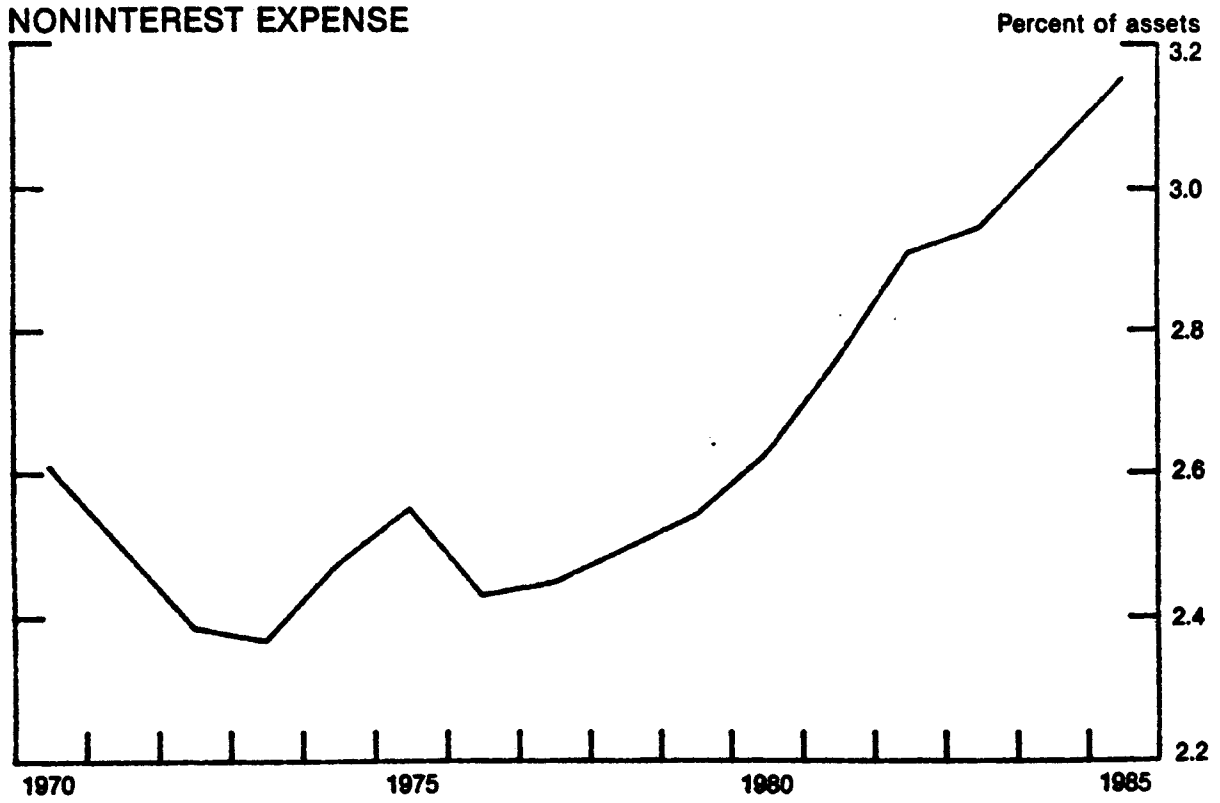
Source: Report of Condition and Income.

Chart 11

Components of Noninterest Margin

Insured Commercial Banks

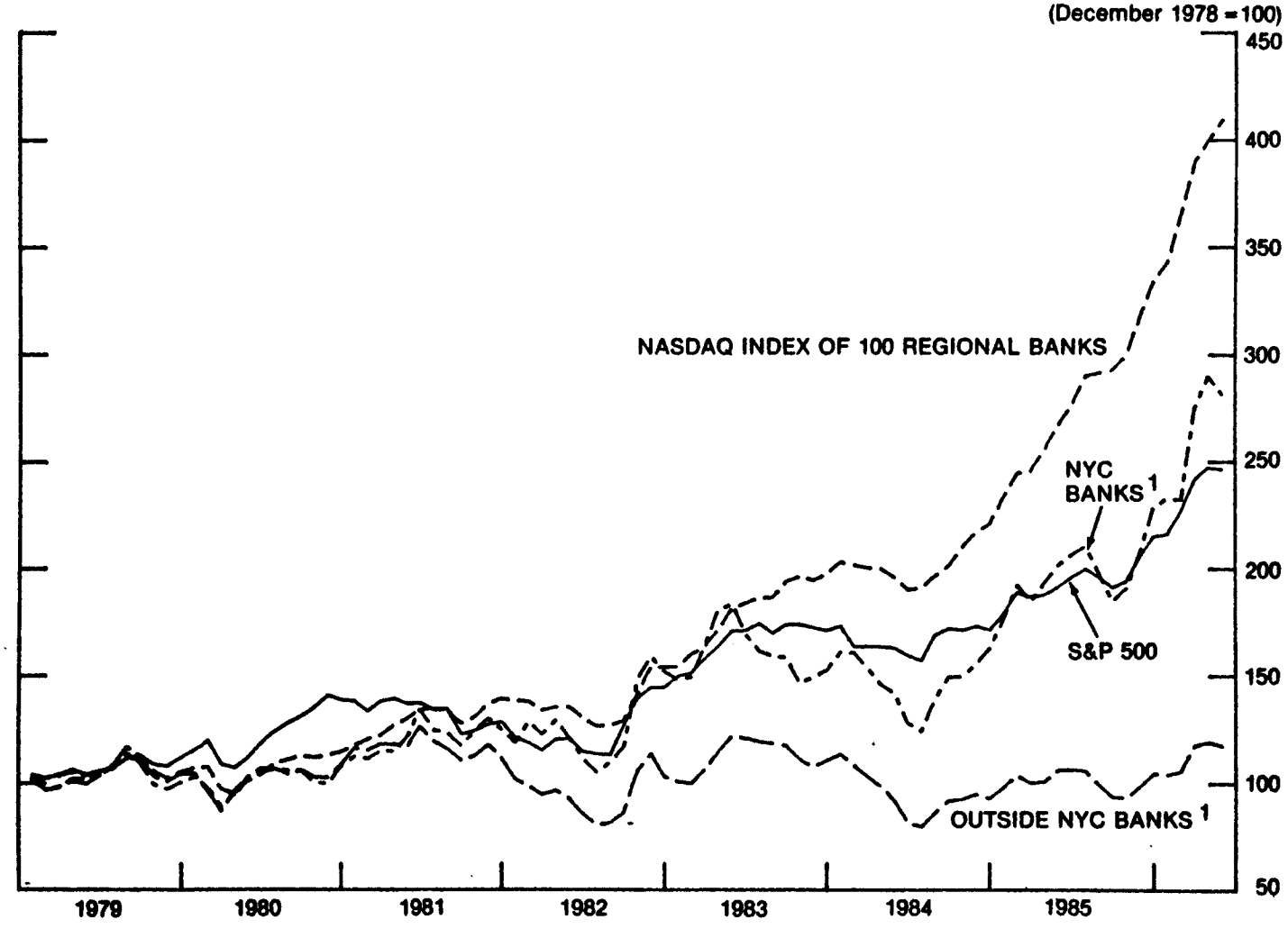




Source: Report of Condition and Income.

Chart 12

Levels of Selected Stock Indexes



1. S&P indexes of six New York City banks and ten large banks outside New York City, weighted by shares outstanding.

Payment System Risk

This appendix will discuss the mechanics of the operation of the payments system and the risks that arise from depository institutions' use of the payments system. It will also address the special risks that arise due to depository institutions' processing of payments on behalf of their affiliates and the inadequacy of current controls in dealing with these risks. Finally, it will discuss how depository institutions' use of Federal Reserve payments services can, in effect, provide nondepository institution affiliates of the depository institutions with access to the discount window.

Depository institutions using Federal Reserve payment services create certain risks to the Federal Reserve and to other users of Federal Reserve payments services because of the potential for a failure of an institution before its payments are settled. Some of these risks arise because payments transactions may result in final and irrevocable debits to depository institutions' accounts either before the Federal Reserve can determine whether the institution whose account is to be debited has sufficient funds in its account to cover the debit or the institution can post adequate collateral at the discount window to cover any deficiency in the account.

This type of risk is most acute in the case of Fedwire funds transfers where large volumes of high dollar transactions are initiated by depository institutions with on-line computer or terminal links to the Reserve Banks. These transactions are final and irrevocable when made. Similarly, book-entry government securities transfers against payment involve a large volume of high dollar on-line funds and securities transfers. Although book-entry government securities transfers are technically reversible, they may not be reversible in practice in the event of a bank failure because of the inter-relationships of these transactions in the government securities market. Other types of transactions such as payments by check and automated clearing house also pose risks although generally these risks are currently less significant, either because the dollar volume is currently low (ACH) or because the transactions are reversible (checks).

In addition to risks arising from individual transactions, significant systemic risks arise from net settlements, particularly those involving private large dollar wire systems where transactions are settled after they occur. These settlements raise the specter of a failure to settle requiring the reversal of numerous payments and thereby affecting a large number of transactions and potentially the solvency of other institutions.

The Federal Reserve must balance risks to the Federal Reserve against its responsibility to insure orderly markets and the smooth and safe flow of funds through the payments system. For example, although the Federal Reserve could seek to avoid risks by refusing to process certain payments, if such a refusal is apparent to the markets it could suggest that the Federal Reserve will no longer extend credit to the institution. Such a market perception could trigger a loss in confidence in the institution. A refusal to process payments for an institution could also trigger problems in other depository institutions in the case of net settlements, particularly settlements for large dollar transfer systems. In order to avoid these problems, the Federal Reserve may wish to process payments resulting in overdrafts but with the expectation that they will be covered at the end of the day by adequately secured discount window loans. In order to fully appreciate these risks, it is necessary to examine the mechanics of the individual payment systems.

Funds Transfer

In processing funds transfers on Fedwire, Federal Reserve Banks transfer funds on the order of the transferor depository institution from its account at a Federal Reserve Bank to the account of the transferee depository institution at a Federal Reserve Bank. Under Board regulations, the payment is final when the funds are transferred to the account of the transferee depository institution or when a Reserve Bank advises the transferee depository institution of the credit to its account. Funds transfers are generally large dollar transfers and have the highest potential risk. On an average day, depository institutions send 181,000 Fedwire funds transfers with a total value of $435 billion and an average size of $2.4 million. Ninety-nine percent of these transactions are on-line, *i.e.*, are initiated at terminals or computers at depository institutions linked to Federal Reserve Bank computers.

This paper was prepared by Oliver I. Ireland, Associate General Counsel for Monetary and Reserve Bank Affairs in the Federal Reserve Board's Legal Division.

The institution sending a funds transfer on behalf of its customer is at risk if the customer does not have collected funds in its account to cover the transfer at the time the transfer is made. The sending institution is committed on a Fedwire funds transfer when it is sent; the institution does not have a right to retract the transaction if the customer is unable to cover the transfer by the end of day.

On a Fedwire funds transfer there is a risk to the Federal Reserve that the sending bank will be unable to cover the transfer in its reserve or clearing account at the end of the day. During the day, an institution could overdraft its account by millions, or even billions, of dollars. Fedwire funds transfer overdrafts exceed $40 billion per day. The sender net debit caps established by the Board as part of its Policy Statement Regarding Reduction of Risks on Large-Dollar Transfer Systems are designed to address this risk. A depository institution's board of directors must review the institution's ability to control, monitor and evaluate its daylight overdraft exposure and evaluate the institution's creditworthiness before the institution may incur daylight overdrafts on Fedwire. The Federal Reserve monitors the depository institutions' position *ex post* and counsels those that exceed their cap. Current capabilities do not permit real time monitoring of all institutions' accounts. Consequently, generally only financially troubled institutions are monitored on a real time basis so that overdrafts can be prevented before they occur. The Federal Reserve controls its risk with respect to other institutions by keeping track of their overall condition.

There is no risk to receiving institutions on Fedwire funds transfers since the Federal Reserve provides immediate finality for these transfers.

A diagram of a funds transfer is set forth in Attachment A.

Book-Entry Government Securities Transfers

In book-entry government securities transfers over Fedwire, transfers of securities are generally initiated by a depository institution representing a seller of securities. The securities are transferred from the transferor-seller depository institution to the account of the transferee depository institution acting on behalf of the buyer. The transferee depository institution's funds account is debited in the amount of the sale and the transferor institution's funds account is credited. If the transferee has insufficient funds in its account, a daylight overdraft occurs. A transferee depository institution may reverse erroneous transfers.

Approximately $47 trillion in securities were transferred in eight million book-entry transactions through the Federal Reserve in 1985. Daily overdrafts from book-entry transfers also exceed $40 billion.

There is risk to the Federal Reserve in book-entry security transfers that the transferee depository institution does not have sufficient funds in its reserve account to cover the amount of securities being purchased, and will be unable to cover the amount of the transfer in its reserve account by the end of the day. To a great extent, the Federal Reserve relies on the institution receiving the transfer to police its customers' activity. While the Federal Reserve could attempt to take a security interest in these securities, it might not be able to obtain a perfected security interest because of conflicting interests of customers of the transferee depository institution who have paid that institution for the purchased securities. Assuming that the Federal Reserve could perfect a security interest in the securities, it still would be exposed to a market risk that the selling price of the securities would be less than the "purchase" price.

For example, when the Bank of New York had computer problems in November of 1985, the Federal Reserve was able to make a loan of $22.6 billion to that bank to carry it through until the computer problem was repaired. Although at the time that the loan was made, the Federal Reserve Bank of New York was not able to determine the proportion of the securities in which it could obtain a perfected security interest, it was able to secure the loan with $13 billion of other assets as well as the purchased securities that had created the overdraft. Such "other assets" may not be available in the case of an institution created solely to obtain access to the book-entry system for an affiliate.

The transferee depository institution would be exposed to similar risks if its customer purchasing the securities cannot cover the amount of the transaction. First, the security interest in the securities may not be perfected, and second, if the interest is perfected, the securities may be sold at a price less than the transfer amount.

The Board did not include book-entry overdrafts in the risk reduction program that became effective in March of this year because of concerns about potential impacts on the government securities market. The Board expects to consider new proposals to bring book-entry government securities overdrafts within the ambit of this policy this summer. A diagram of a book-entry securities transfer is set forth in Attachment B.

Automated Clearing House (ACH) Transactions

ACH transactions include both credit and debit transactions. In credit transactions, on the order of an originating depository institution, funds are transferred from the originating depository institution's ac-

count to the account of a receiving depository institution. These transfers are processed in batches and the payment information is distributed prior to a settlement date. ACH credit transfers are generally treated as final at the opening of business on the settlement date; however, a Reserve Bank may be able to reverse such transfers up until the time that they are posted on the settlement date. ACH debit transfers involve debits to the receiving depository institution's account that are initiated by the originating depository institution. The receiving depository institution has until midnight of the banking day following the settlement day to reject any such debits.

ACH transactions account for only a very small fraction of the total dollar value of interbank funds transfers. The ACH is primarily a small dollar payments mechanism although, increasingly, large dollar payments are made through it, and the aggregate amount of a credit or debit ACH file originated by an institution's corporate customer can be quite significant. The Board is concerned about the increase in large dollar payments, particularly debits, over the ACH and is evaluating the increased risk implications of these transactions. In 1985, the Federal Reserve processed 283 million commercial ACH transactions valued at $1.8 trillion.

The risks to the depository institutions initiating ACH credit transactions are conceptually similar to those for Fedwire funds transfers. Although the dollar risk on ACH is typically lower than in Fedwire funds transfers, the temporal risk is greater. ACH credit payments are submitted and processed one or two days prior to settlement, and the exposure to the originating institution extends from this time until the account of the originating customer is funded to cover the transfers.

The Federal Reserve's risk from ACH credit payments begins on the opening of business on settlement day, and stems from the possibility that the sending bank may be unable to cover the transfers in its reserve account at the end of the day.

The receiver of ACH credit transfers processed by the Federal Reserve is at risk if the originator of the transfers fails on the settlement day and the Federal Reserve is unable to debit the originating institution's account for the amount of the transfers. In this situation, the Federal Reserve reserves the right to reverse the credit entries, debiting the receiving institution's account, until the end of the settlement day. The National Automated Clearing House Association guidelines strongly urge institutions to make credit entries available to depositors at the opening of business on settlement date. Thus, the receiving institution is at risk to the extent that it is unable to recover the funds from the depositors receiving the credits. As a practical matter, it is unlikely that the Federal Reserve would reverse ACH credit entries on the settlement day.

Risks to an institution originating ACH debits arise when it makes funds available to the payee before it is assured that the debit transfers will not be returned. The likelihood of a loss to the Federal Reserve on debit transfers is relatively small. When the Federal Reserve delivers ACH debits to the receiving institution, it debits the reserve or clearing account of the receiving institution, and credits the account of the originating institution. If the receiving institution returns some of the debit items, the Federal Reserve would credit the receiving institution for the amount of the returned items, and debit the account of the institution that originated the items. If the return items were destined to an institution that had failed subsequent to its origination of the debit transfers, the Federal Reserve would be at risk for the amount of the return items destined to the failed institution.

There is no appreciable risk to the institution receiving ACH debit items. The receiving institution has until midnight of the next banking day to return an ACH debit. Thus, its only risk lies in failing to return on a timely basis an ACH debit that cannot be posted.

Diagrams of ACH credit and debit transactions are set forth in Attachment C.

Checks

Checks are the most common form of payment in this country, with the exception of cash. Forty billion checks are written annually, with an estimated value of $36 trillion dollars. The Federal Reserve processed approximately 16 billion checks in 1985.

The depository institution receiving a check is at risk if it makes funds available to its depositor before sufficient time has elapsed to be relatively sure that the checks deposited will not be returned. This risk could be significant in the case of large dollar checks used to transfer corporate account balances between depository institutions for cash management purposes. The risk to the Federal Reserve arises where it is holding return items destined to a payor institution that has failed. The Federal Reserve would have a claim on the assets of the failed institution and could pursue the drawer of the check. However, in certain cases, such as where a depository institution processes a large dollar volume of checks deposited by a customer that has also failed and the failure of the customer has caused the drawers of the checks to stop payment on them, these risks may be substantial and such remedies may not be available. Generally the risks to the payor institution relate primarily to its failure to properly dishonor or pay an item.

A diagram of a check collection transaction is set forth in Attachment D.

Net Settlements

The Federal Reserve is also at risk on private funds transfer networks or other private payments systems for which it settles. Further, these systems generate systemic risks for their participants. These systems range from large dollar wire transfer systems such as CHIPS to local check clearing house exchanges. In such systems, payments messages or checks are transferred between institutions during the day and the Federal Reserve settles these payments at the end of the day with a single net entry to each institution's account. If one of the participants on a private payments system were unable to settle its net debit position at the end of day, the settlement would be recast without the transfers of that participant. This may worsen the financial position of other participants. An institution in a net credit position before the settlement was recast could find itself in a net debit position. On a large dollar wire system, the debit position could be far in excess of its capital in the recomputed settlement, triggering the institution's inability to settle. Thus, a failure to settle by one institution could result in a systemic chain reaction of failures by other network participants. The Federal Reserve could be forced to "rescue" the settlement through a discount window loan to reduce the systemic risk that the failure of one institution to settle would jeopardize the financial positions of other network participants. Daily CHIPS overdrafts of approximately $35 to $45 billion reflect the extent of this risk.

Finally, there is risk to the receiver of a funds transfer that is sent over a private wire network. Funds sent on a private wire network do not become final until the end of the day. If a sending bank were unable to settle, the receiving bank is at risk if funds sent by the failed bank are withdrawn by the payee and not recovered. To reduce and control the risk to receiving institutions, the Board has called on participants in private networks to establish bilateral credit limits, to limit the potential exposure a receiving institution has against each sending institution, and network sender net debit caps applicable to each network in order to limit the maximum overdrafts on such systems by individual institutions.

Relations with Affiliates

Payment system risks may be increased by depository institutions dealings with their affiliates. First, it is unlikely that a depository institution will make an independent credit judgment concerning overdrafts initiated by their affiliates as they do on their unaffiliated commercial customers. In the case of payments services provided by depository institutions for their unaffiliated customers, institutions generally review the credit risk associated with providing these services and generally monitor at least some of their accounts. A review of institutions' practices indicates a variety of approaches to monitoring their own customers, ranging from monitoring all corporate customers, monitoring on-line customers, monitoring large transactions or monitoring customers with deteriorating credit quality. The Board's daylight overdraft policy requires depository institutions to be in a position to monitor and control their customers' overdraft positions. The Reserve Bank processing the payment may, in turn, make an evaluation of the institution making the payment. In the case of troubled institutions, Reserve Banks may make individual decisions on a case-by-case basis as to whether to process payments for such institutions. These decisions are based on the balance in the institution's account, the availability of collateral to cover any overdrafts, supervisory materials, including examination materials on the institution and its affiliates, as well as additional market factors bearing on any potential decision not to process a particular payment.

There are practical reasons to conclude that a depository institution will not apply such controls to their affiliates or will disregard them when processing payments on behalf of its affiliate. There is no reason to believe that depository institutions processing payments for their affiliates are any less subject to undue influence by the affiliate in processing such payments than they are in extensions of credit and other transactions that Congress has specifically limited under section 23A of the Federal Reserve Act and other legislation.

Second, the affiliate may take advantage of its relationship with the depository institution in order to obtain credit from the institution for itself or its customers contrary to safe and sound lending policies. Such abuses are particularly likely in times of financial stress on the affiliate when an affiliate may force credit extensions by overdrafting the depository institution's account. These abuses may threaten the safety and soundness of the depository institution and may precipitate its failure.

Third, risks to depository institutions and, through them, to the payments system are increased by the Federal Reserve's lack of familiarity with some depository institution affiliates. Where depository institutions are affiliated with companies that are not subject to the same level of scrutiny as bank holding companies, the company may fail with little prior notice to the Federal Reserve. The company's failure may, in turn,

precipitate the failure of the depository institution and attendant effects on the payments system. The lack of prior notice makes it more difficult for the Federal Reserve to arrange to monitor the institution's account on a real time basis or to evaluate collateral offered at the discount window in order to obtain adequate funds to cover the institution's payments until it can be closed or sold in an orderly fashion.

Inadequacy of Current Controls

Current statutes and procedures do not adequately address the risks arising from relations with affiliates. Section 23A of the Federal Reserve Act, which limits transactions between insured banks and their affiliates, and similar provisions applicable to federally insured thrift institutions, have not been interpreted to apply to daylight overdrafts. Further, section 23A does not apply to provision of immediate credit for checks in the process of collection or extension of credit to the extent that they are secured by government securities as may be the case in book-entry securities overdrafts by an affiliate. Further, section 23A is only enforced on an *ex post* basis and cannot prevent transactions, such as overdrafts, that threaten the safety and soundness of an institution before they happen even if it were interpreted to apply to such overdrafts.

Similarly, the current daylight overdraft risk reduction program, which is based on caps enforced through *ex post* monitoring, does not address the problem of overdrafts occurring in times of financial stress on the affiliate. At such times, the affiliate may prevail on the depository institution to make transfers in excess of its caps, which the affiliate is unable to cover. It is such transfers that are the essence of the risks presented by the institution's use of Federal Reserve services and it is such transfers that *ex post* monitoring is powerless to control.

Real time monitoring of a depository institution's accounts and rejection or delay of transactions that would create overdrafts would address the problem of overdrafts in times of stress, but even real time monitoring has a number of shortcomings. First, only three Reserve Banks have automated real time monitoring systems in place. The other Reserve Banks rely on manual systems. An automated system is generally necessary to process a large volume of payments. All the Reserve Banks are scheduled to have an automated capability by March of 1987. Until the automated monitoring arrangements are in place at all Reserve Banks, real time monitoring in some Reserve Banks would require that all funds and book-entry securities transfers be processed on an off-line, or manual, basis. Such off-line processing could substantially delay payments while the status of the account was checked and manually updated.

Second, the implementation of real time monitoring would inevitably result in the rejection or delay of funds transfers that would be discernable by the markets and might precipitate problems for the institution, or its affiliates, whose transfers were delayed or stopped. Thus, while solving the problem of the risk created by an individual transaction, real time monitoring creates the potentially greater problem of loss of confidence in monitored institutions and injects an element of instability into the markets.

Third, real time monitoring would not address the issue of book-entry securities overdrafts because they are not subject to overdraft caps. Even if such caps were established, rejection of those transactions destined for a buying-receiving institution would be immediately apparent to the selling-sending depository institution.

In sum, regulatory controls on the relationship between a depository institution and its affiliate either provide illusory protection, *e.g.*, an extension of section 23A to cover overdrafts, or, as in the case of rejection or delay of transfers, while solving certain problems such as the risk from the rejected or delayed transaction, creates greater problems in terms of loss of confidence in the payments system. The risks created by affiliate relationships are most effectively addressed by restricting the potential relationships that arise to those that are subject to ongoing supervision and regulation that will provide prior notice of developing problems and permit regulatory limitations to be tailored to the individual situation.

Discount Window Issues

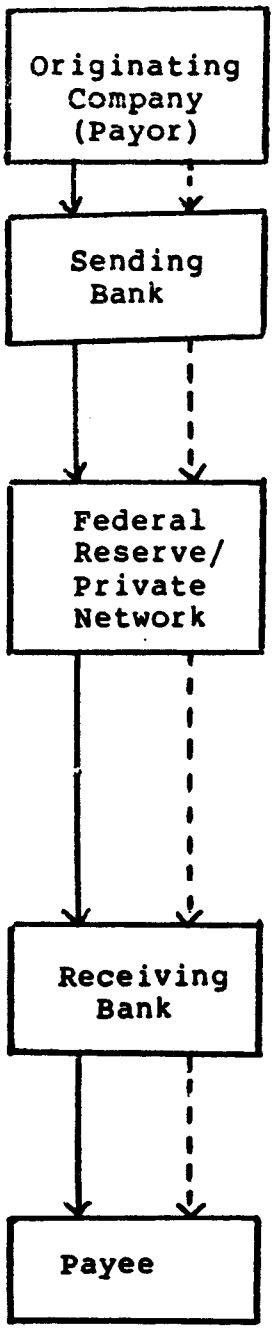
A loan to a depository institution to cover overdrafts of an affiliate, as might occur where a depository institution is established primarily to serve the payments needs of its affiliates, is in effect a loan to the nondepository institution affiliate. Under section 13 of the Federal Reserve Act, loans to nondepository institutions such as individuals, partnerships and corporations on the security of collateral other than United States Government and agency securities can only be made in unusual and exigent circumstances and require an affirmative vote of five members of the Board. Regulation A further specifies that such loans should only be made where failure to do so will adversely affect the economy (12 C.F.R. §201.3(c)). No loans have been made under this authority since the 1930s.

For example, an affiliate may purchase book-entry govenment securities and incur an overdraft at its account at the depository institution. This overdraft may result in an overdraft at the depository institution's

account at a Federal Reserve Bank. If the Reserve Bank must ultimately cover the overdraft with a discount window loan to the depository institution, the Reserve Bank has effectively extended credit to the affiliate. The ready extension of credit to nondepository institutions through affiliated banks is contrary to longstanding Congressional policy and would seriously distort the purposes of Federal Reserve credit.

ATTACHMENT A

FUNDS TRANSFER



Risk to sending bank

- Risk that customer sending transfer will not have sufficient funds to pay for the transaction.

Risk to Federal Reserve

- On a Fedwire transfer, risk that the sending bank will be unable to cover transfer in its reserve account.
- $40 billion in daylight overdrafts per day.
- Fed could be forced to "rescue" settlement of provate network through discount window accommodation.

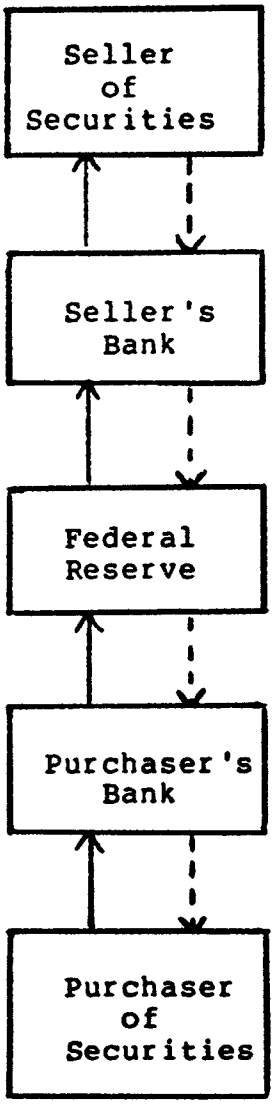
Risk to receiving bank

- On a private network, risk that sending bank will be unable to settle at end of day and funds made available to payee might not be recovered.

→ Funds flow

- - - - → Payments instructions

BOOK ENTRY SECURITIES



Risk to Federal Reserve

- Risk that there may not be a perfected security interest in the securities being transferred, and the security purchaser's bank cannot cover the amount of securities being purchased.
- Assuming a perfected security interest in the securities, and the securities purchaser's bank's inability to cover, there is a risk that the selling price of the securities would be less than the "purchase" price. (market risk).
- $40 billion in daylight overdrafts per day.

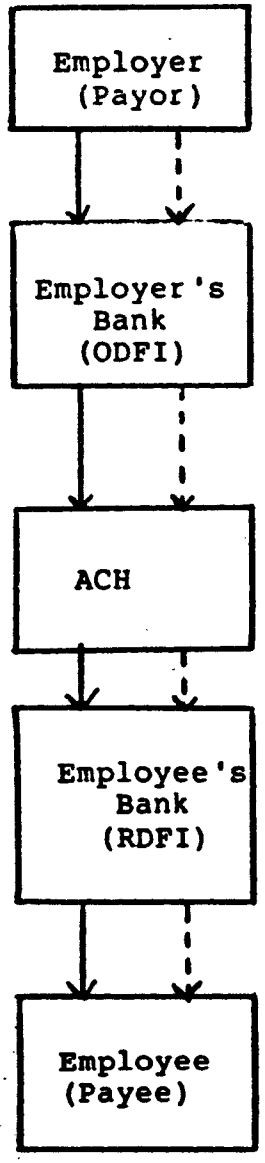
Risk to securities purchaser's bank

- Risk that there may not be a perfected security interest in the securities being transferred, and the purchaser of the securities cannot cover the amount of securities being purchased.
- Assuming a perfected security interest in the securities, and the securities purchaser's inability to cover, interest rate risk that the securities could sell for less than the amount of the transfer.

→ Funds flow

--------→ Securities flow

ACH CREDIT PAYMENTS
(Direct Deposit of Payroll)



Risk to originating bank

- Risk that payor will not be able to cover transfer on the settlement date.

Risk to Federal Reserve

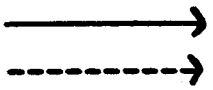
- On ACH transactions sent through the Federal Reserve, the Fed may be at risk if the sending bank is unable to cover transfers in its reserve account on settlement date.

Risk to receiving bank

- On ACH transactions not processed through the Fed, risk that originating bank will be unable to settle at end of day and funds made available to payee might not be recovered.

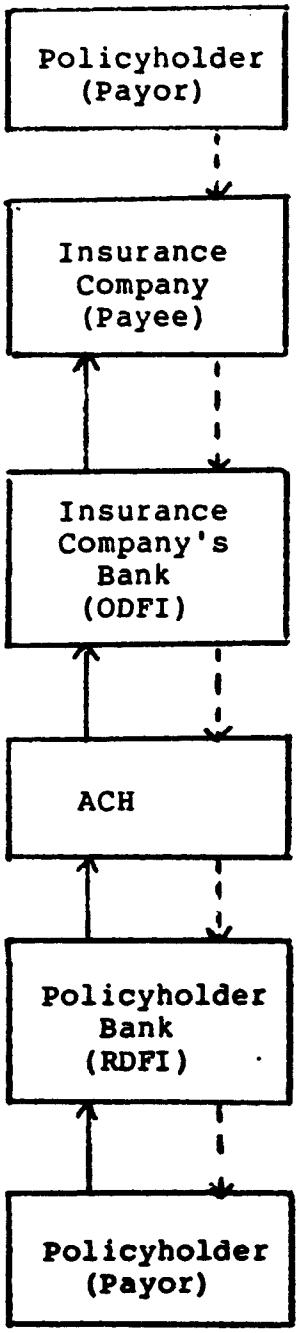
Security risk

- Since ACH is not a totally electronic environment, it is not as secure as funds transfer networks. Manual controls are less effective than automated controls. Multiple handlings due to physical delivery of tapes result in greater exposure to error and fraud.


Funds flow

Payments instructions flow

ACH DEBIT PAYMENTS
(Insurance Premium Payment)



Risk to originating bank

- Risk of payee withdrawing funds prior to finality of settlement, due to possibility that a receiving bank may be unable to settle.
- Risk of payee withdrawing funds before originating bank is assured that debit transfers will not be returned.

Risk to Federal Reserve

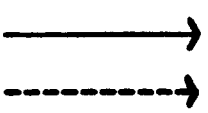
- Federal Reserve is at risk on return items destined to a failed institution.

Risk to receiving bank

- No appreciable risk, since receiving bank has until its midnight deadline to return an ACH debit (only risk in failing to return an ACH debit that cannot be posted).

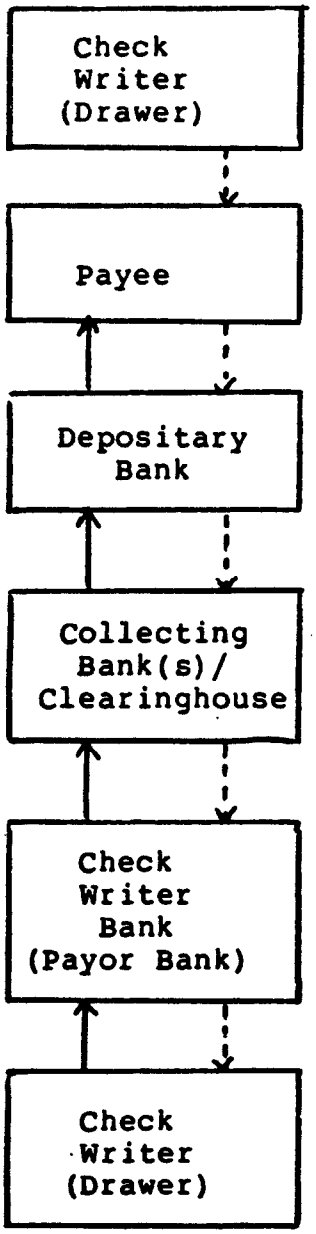
Security risk

- Since ACH is not a totally electronic environment, it is not as secure as funds transfer networks. Manual controls are less effective than automated controls. Multiple handlings due to physical delivery of tapes result in greater exposure to error and fraud.


Funds flow

Payments instructions flow

CHECK COLLECTION



Risk to depositary bank

- Bank makes funds available to its depositor from check that is dishonored.

Risk to Federal Reserve

- Federal Reserve may be at risk on return items destined to a failed institution.

Risk to payor bank

- Bank does not properly honor stop payment order.
- Bank does not return check drawn on an account with insufficient funds by its midnight deadline.
- Bank pays a check with a forged drawer's signature.

——————→ Funds flow

- - - - - - - - - → Payments instructions flow