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Statement by

J. Charles Partee

Member, Board of Governors of the Federal Reserve System

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Subcommittee on Financial Institutions Supervision,
Regulation and Insurance

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I am pleased to appear before the Subcommittee today to present the Board's views on the so-called South Dakota loophole. This loophole, which is based on a recent South Dakota law authorizing out-of-state bank holding companies to acquire state chartered banks in South Dakota and to engage through these banks in all facets of the insurance business primarily outside of the state, conflicts with prevailing federal law and regulation. Indeed, there has been a proliferation in recent years of state laws authorizing federally insured banks and thrifts to engage in a broad range of nonbanking activities not previously deemed appropriate for depository institutions, including securities and real estate investment and development activities as well as insurance sales and underwriting.

This trend is of special concern because certain of these state laws do not appear to be motivated in any substantial measure by considerations relating to improving the banking or thrift structure or by any local need for the services authorized, but rather by a desire to attract new business and tax revenues to the states through the liberal use of a bank franchise.

A competitive race among the states to expand nonbanking powers would substantially increase the level of risk in the banking system. For example, the recently enacted Ohio law allows a state bank to invest as much as

50 percent of its assets in real estate. An Ohio bank could thus effectively transform itself from a banking institution into a real estate investment company of the type and with the potential for the problems that have occurred in Maryland recently. The same is true for the statutes that permit investment in equity securities. Similarly, so-called wildcard statutes or leeway provisions authorize investment of substantial amounts of banking assets in any activity not otherwise prohibited, thus allowing state banks to invest in nonbanking ventures of every type and description.

Congress has not authorized these activities for national banks or bank holding companies and indeed has specifically banned many of them as unsafe and unsound. The Glass-Steagall Act, for example, prohibits national banks and state member banks from engaging in, or being affiliated with a company engaged principally in, dealing or underwriting most types of securities. Title VI of the Garn-St Germain Depository Institutions Deregulation Act of 1982 prohibits bank holding companies from underwriting insurance. Real estate development activities are not permissible for national banks and have not been determined by the Federal Reserve to be closely related to banking and thus permissible for bank holding companies.

The proliferation of state laws authorizing new nonbanking activities appears to have developed in part in response to pressures from banking institutions that have turned to state law as a means of engaging in new nonbanking activities foreclosed to them by federal law. The states enacting these laws in turn are motivated in many cases by a desire to attract new employment and revenues by offering bank holding companies a means of exploiting ambiguities or "loopholes" in federal law. There is no gain in this for the economy as a whole and there could well be heavy costs to bear for the federal government and for the users of the financial system.

The legislation in South Dakota stands out as an example of state efforts to expand jobs and revenues at the expense of other considerations. The preamble to the South Dakota statute indicates that its purpose is to secure new employment and revenue for the state by enabling out-of-state bank holding companies to take advantage of a "unique opportunity" afforded by perceived loopholes in the national banking laws. South Dakota has, however, insulated its own domestic financial and insurance institutions against the competitive and other effects of these activities by specifically providing that a new South Dakota bank acquired by an out-of-state holding company must conduct its banking and insurance activities at a location and in a manner so as not to attract customers from the general public to the detriment of existing banks or insurance companies in the state. South Dakota thus has authorized its banks to engage, in every state other than South Dakota, in activities expressly prohibited under federal law and indeed under many state laws.

The Board's main concern with statutes such as this is that they are not appropriately balanced by considerations relating to the safety and soundness of the nation's banking system. We recognize, of course, the interest of the states in regulating banking within their borders. The dual banking system has contributed on balance to the flexibility and resiliency of our banking system, and has helped make it more responsive to the needs of both business and consumers. Nevertheless, serious questions must be raised about an undermining of the carefully established federal framework of authorized nonbanking powers for banks and thrifts through the actions of individual states, motivated not by concerns for safety and soundness, but by other parochial objectives. In view of the powers expansion in South Dakota and other states and the likelihood that this example could well be emulated elsewhere, we believe that Congress should enact legislation on banking and thrift powers that reconciles the states' legitimate need for flexibility with the federal government's concern about the problems of excessive risks for the banking and thrift system and the federal financial safety net.

The new state laws, and the South Dakota statute in particular, are premised in great part on lack of clarity in the Bank Holding Company Act as to its application to the direct activities of subsidiary banks of bank holding companies. The Act embodies the national policy against the commingling of banking and commerce by precluding bank holding companies from engaging in or acquiring companies engaged in activities that are not closely related to banking. The Board has long held that the provisions of the Act apply to acquisitions by holding company banks of voting shares of a nonbanking company. In 1971, with the expansion of the Act to cover one bank holding companies, the Board adopted a regulatory provision that allows wholly owned operating subsidiaries of bank holding company banks to engage in activities that the bank itself may engage in directly pursuant to state law. This provision was adopted to promote competitive equity between holding company banks and independent banks in the absence of evidence of abuse or evasion by bank holding companies of the nonbanking provisions of the Act.

In adopting this regulation, however, the Board expressly noted that a potential conflict could arise between the nonbanking restrictions of the Act and state law if state law was interpreted to permit nonbanking activities that were impermissible for a bank holding company under the Act. In a statement issued with the regulation, the Board specifically noted that it would review the provision from time to time to ensure that it was not being used to frustrate the Act's purposes.

Since 1971, holding company banks, relying on this regulatory provision, have engaged in a limited variety of nonbanking activities authorized by state law, for example, insurance agency and travel agency activities. Until the South Dakota statute, the Board did not feel that there had been significant abuse of this provision. State authorized activities generally had been of a limited nature, had not been authorized on a large scale, had generally been conducted in-state without the types of operating limitations in the South Dakota law, and, most importantly, had not posed significant risks to the banking system.

The application by Citicorp to acquire a South Dakota state bank for the purpose of engaging in broad insurance activities pursuant to the South Dakota law, in the Board's view, was inconsistent with the regulatory provision adopted by the Board in 1971. Citicorp's application, and the prospect of numerous similar applications as other states enacted new nonbanking powers for state banks, carried the potential for widespread evasion of the Bank Holding Company Act. Accordingly, the Board in January 1984 suspended processing of the application, as well as similar applications filed by BankAmerica Corporation and First Interstate Bancorp, noting its tentative judgment that it could not approve the proposals in view of existing law and expressions of Congressional intent. After Citicorp reactivated its application, the Board proceeded to reach a final decision on the case and denied the application as a circumvention of the provisions in the Bank Holding Company Act which sharply limit the scope of bank holding company insurance activities. The Board concluded that the overall effect of the South Dakota law on the proposed nationwide insurance activities of the state bank to be acquired by Citicorp would be that the bank would act as an insurance company in direct contravention of the Act's restrictions.

While the Board believes that it has authority under the Act to regulate the activities of nonbanking subsidiaries of bank holding companies, the additional question of whether the nonbanking restrictions of the Act apply to activities engaged in directly by a subsidiary bank has been raised in a number of contexts, including petitions to the Board and litigation. The Board has under consideration this question, as well as whether to revise its existing regulatory provision for operating subsidiaries of holding company banks.

In recognition of the serious risks posed by the expansion of nonbanking powers of state banks and thrifts, both the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board have undertaken regulatory initiatives that would set limits on the scope of nonbanking powers authorized by state law. The FDIC has proposed to establish operating and investment limitations on certain nonbanking activities of FDIC insured banks. The FHLBB has promulgated regulations that would establish a review procedure by the Federal Home Loan Banks on a case-by-case basis for direct investment by thrifts in certain nonbanking activities over a threshold amount.

Notwithstanding these actions, we would concur in the view that legislation is needed to provide a uniform national policy with respect to the proper scope of state authorized nonbanking activities consistent with a safe and sound financial structure. H.R. 1513 addresses the problem of South Dakota type statutes by limiting the ability of state banks to engage in activities not permissible for national banks or bank holding companies outside of the authorizing state. Similarly, savings and loan associations and savings banks would be prohibited from engaging outside of the authorizing state in activities not permissible for federal thrifts or multiple savings and loan holding companies. In addition, the bill applies the prohibitions on bank holding company insurance activities enacted in Title VI of the Garn-St Germain Depository Institutions Deregulation Act to bank subsidiaries of bank holding companies.

H.R. 1513 goes some distance toward dealing with the dangers posed by the broad state authorized activities for banking and thrift organizations. The bill is based on the premise that a state should not be able to insulate itself from the competitive and other effects of wide ranging and potentially damaging nonbanking activities that it authorizes for institutions it charters but which operate predominantly in other states.

In view of the proliferation of state laws authorizing extensive securities, insurance, equity investment and real estate activities, however, and the increased risks these activities pose for the federal safety net and the nation's banking system, the Board strongly believes that the limitations contained in H.R. 1513 should be expanded to cover activities even when conducted within the authorizing state if it is determined that they threaten safety and soundness. As I have stressed, it is not desirable, even within their own borders, for states to expose the banking system to the increased risks of nonbanking activities that Congress has determined are unsafe and unsound for federal institutions and bank holding companies.

It does seem desirable, however, to allow the states to retain flexibility to experiment with new initiatives in local banking and thrift services by authorizing nonbanking activities within state borders if such activities are not determined to be unsafe or unsound. For example, many state banks have operated insurance agencies and travel bureaus pursuant to state law for many years. These activities do not pose threats to the stability of the banking system since the risks associated with such activities are rather minimal. Indeed, Congress has allowed savings and loan holding companies to own and operate insurance agencies for many years and federal savings and loan associations also are permitted to operate insurance agencies through service corporations. National banks similarly have been authorized to operate insurance agencies in small localities.

We thus would favor retaining flexibility to allow the states to continue to authorize such activities. A provision such as in section 2 of H.R. 1513 that would apply all of the Title VI insurance prohibitions to subsidiary banks of bank holding companies is undesirable because it would limit the procompetitive aspect of insurance sales activities by banks. The Board has previously testified in favor of an appropriate expansion of bank holding company powers to accommodate the evolution of the financial services industry, and we would prefer to see a legislative solution along the lines of H.R. 1513 that still allows flexibility in this area, but with authority to limit risks that cause safety and soundness concerns.