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10:00 A.M. EDT
April 4, 1990

Testimony by

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before the

Subcommittee on Financial Institutions
Supervision, Regulation and Insurance

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

April 4, 1990

I appreciate the opportunity to be here today to present the views of the Federal Reserve Board on the implications of the decision of the U.S. Court of Appeals upholding the Board's Order in the Merchants National case. The decision is important for two reasons: the legal conclusion reached regarding the applicability of the Bank Holding Company Act to the direct activities of banks owned by bank holding companies, as well as the potential significance of the case for the regulation and supervision of the activities of federally insured banks and for the resources of the federal safety net.

The Merchants National case involved a proposal by Merchants National Corporation, an Indiana bank holding company, to acquire and retain two Indiana state banks that engaged directly in certain general insurance agency activities permitted state banks under Indiana law. One of these banks had conducted the insurance agency activities since its founding in 1916.

As required by the Bank Holding Company Act, Merchants National filed applications with the Board for prior approval to acquire the banks. Various insurance industry trade groups protested the applications, urging the Board to prohibit the banks from selling insurance after their acquisition by Merchants National. The protest turned on whether the nonbanking provisions of the Bank Holding Company Act apply to the direct activities of banks owned by a bank holding company in the same manner that these provisions apply to the bank holding company itself and to its nonbank subsidiaries.

Section 4 of the Bank Holding Company Act generally provides, with certain exceptions, that a bank holding company may not directly or indirectly acquire or retain the voting shares of any company that is not a bank or engage in any activity other than those authorized under the Act. The most significant exception to this prohibition is for companies whose activities the Board has determined to be closely related to banking. In 1982, Congress specifically legislated, however, that insurance activities, with certain specified exceptions, are not closely related to banking. As a result, Congress has removed the Board's discretion to permit these activities for bank holding companies and their nonbank subsidiaries as an exception to the general nonbanking prohibition in the Bank Holding Company Act. Congress has not, however, separately prohibited insurance activities for institutions not subject to the nonbanking restrictions of the Act.

The nonbanking restrictions of the Bank Holding Company Act do not, by their terms, apply to the acquisition of shares of banks or to the activities conducted directly by banks owned by bank holding companies. The Board has so interpreted the provisions of section 4 of the Bank Holding Company Act since the Act's passage in 1956, and it reaffirmed that interpretation in the <u>Merchants National</u> decision. Thus, insofar as the nonbanking restrictions of the Bank Holding Company Act are concerned, state banks may conduct directly those activities that

are authorized by state law, including the insurance agency activities at issue in Merchants National.

There is one caveat to this Board interpretation. Where the record indicates that a bank holding company is attempting to evade the restrictions of the Act by conducting activities directly in the bank, the Board has applied the restrictions of section 4 of the Act to the proposed activities. The Board took such action on a 1985 application by Citicorp to acquire a bank in South Dakota, where the bank's principal purpose was to market insurance services throughout the United States--except in South Dakota.

The Board found, based on the structure of the South Dakota law and the fact that the South Dakota bank would serve almost exclusively as an insurance subsidiary of Citicorp and conduct only insignificant banking activities, that the acquisition of the bank was primarily, if not solely, for the purpose of enabling Citicorp to engage through the bank in various insurance activities. Accordingly, the Board determined that it was precluded from approving Citicorp's application because the acquisition was simply a device to allow Citicorp to engage in insurance activities prohibited for bank holding companies under section 4 of the Bank Holding Company Act. In contrast, in the Merchants National case, the acquired banks were conducting a full banking business and the banks' insurance

agency activities were a small part of the bank's business and were to be conducted entirely within Indiana.

I would also emphasize that the Board's Merchants National interpretation pertains only where the nonbanking activities are conducted directly by a holding company bank. The Merchants National decision does not address the situation where the activities are conducted by a nonbank company whose shares are controlled by a holding company bank. The Board has consistently taken the position, in accordance with the explicit terms of the Act, that shares of a nonbank company owned by a holding company bank are indirectly controlled by the parent holding company and, thus, a nonbank company controlled by a holding company bank would be an indirect subsidiary of the parent holding company. As such, the ownership of the shares of the company by the bank holding company as well as the activities of the company must qualify under the closely related to banking exception, or one of the other exceptions to the nonbanking provisions in the Act.

In a 1971 regulation, however, the Board recognized a limited exception to this requirement for the acquisition of so-called "operation subsidiaries" by holding company banks. The regulation authorizes a state bank owned by a bank holding company to acquire and retain, without Board approval under the Act, all of the voting shares of a company so long as the company engages solely in activities the parent bank could conduct

directly and only at a location at which the bank could conduct the activities. The purpose of this regulation was to permit holding company state banks to compete on an equal footing with state banks that are not in a holding company system. The Board recognized that the regulation could potentially become the focus for evasion of the nonbanking restrictions of the Act over time, and therefore stated that it would review the merits of its decision from time to time in light of its experience in administering the Act.

In December 1988, in light of the increase in the conduct of nontraditional activities, such as real estate development, by state bank operating subsidiaries, the Board asked for comment on whether the 1971 regulation should be modified. The Board held a hearing on its proposal in April 1989, and has not taken further action on the proposal.

In addition to its significance for interpreting the scope of the Bank Holding Company Act, the Merchants National decision also has important implications for the regulation and supervision of the direct activities of holding company banks. Had the court decided the Merchants National case the other way, and determined that the direct activities of holding company banks are subject to the nonbanking restrictions of the Bank Holding Company Act, the activities of these banks would be limited to those the Board has determined by regulation or order to be closely related to banking.

The fact that the Court held that the direct activities of holding company banks are not subject to the nonbanking restrictions of the Act does not mean, however, that their activities are unregulated. The activities of national banks are determined by the Comptroller of the Currency under the provisions of the National Bank Act, and the activities of state-chartered banks are determined by the state banking laws under the supervision of the state banking commissioner. The activities of state banks are further regulated at the federal level--by the FDIC, in the case of insured state non-member banks, and by the Board, in the case of state banks that are members of the Federal Reserve System.

In exercising its supervisory authority over state member banks, the Board has recognized 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 the banking system, and has helped make it more responsive to the needs of both business and consumers. Nevertheless, a serious question must be raised about any state action that might have the potential of posing undue risk to the resources of the federal safety net. The framework in place for regulating and supervising state banks ensures that the federal interest is taken into account. While the states, as the chartering authority, establish in the first instance those activities that are permissible for state banks, limitations may

be placed on these activities by the Board, in the case of state member banks, and the FDIC, with respect to non-member federally insured banks.

The Board has ample statutory authority, under the Federal Reserve Act and related statutes, to ensure that the activities of a state member bank are consistent with safe and sound banking practices and do not pose an undue risk of loss to the federal safety net. Furthermore, as reinforced by the International Lending Supervision Act, these statutes enable the Board to require state member banks to maintain capital that is adequate in relation to the character and condition of its assets and liabilities. The Board also has authority, under the Financial Institutions Supervisory Act, as further amended and strengthened by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), to prevent, by order or rule, state member banks from engaging in activities that are unsafe or unsound.

In granting applications by state banks to become members of the Federal Reserve System, the Board takes into consideration whether the conduct of certain activities directly by banks could have a seriously adverse impact on the safety and soundness of the institution and the nation's banking system. The Board has required that banks applying for membership in the Federal Reserve System not engage in activities that the Board views as posing an undue risk for an institution with access to

the federal safety net. In addition, a state member bank may not, without obtaining the approval of the Board, cause or permit any change to be made in the general character of its business or in the scope of its corporate power exercised at the time of its admission to membership.

For example, the Board has, as a general condition of membership, not permitted state member banks to engage in real estate development activities, even though approximately 25 states permit banks to engage in such activities. Similarly, state member banks may not make direct investments in securities of less than investment grade, even where they are permitted to do so under their state charters. On the other hand, the Board has not found state authorization of insurance agency activities, which could be comparable to those conducted by Merchant National's subsidiary banks, or of similar agency activities to be inconsistent with Federal Reserve membership. Agency activities do not raise the risk-related and competitive concerns that would justify placing restrictions on the state-authorized powers.

Under the Federal Deposit Insurance Act and related statutes, the FDIC possesses authority that parallels that of the Board. Just as the Board considers corporate powers of a state bank when it acts on a bank membership application, the FDIC may take into consideration whether the corporate powers of a non-member state bank are consistent with the purposes of the Federal

Deposit Insurance Act when it acts on an application for deposit insurance.

In enacting some of the key reform provisions of the FIRREA, Congress recognized the risk to the federal safety net that can be caused where federally insured state-chartered thrift institutions are allowed to engage in a broad range of activities without adequate regard for the federal interest. In that statute, Congress prohibited a state thrift from engaging as principal in any type of activity that is not permissible for a federal thrift unless both parts of a two-part test are satisfied: (1) the FDIC has determined that the activity in question would pose no significant risk of loss to the deposit insurance fund, and (2) the thrift has sufficient capital to meet the fully phased-in capital standards prescribed in that statute. It should be noted that the legislative history of the FIRREA made it clear that the test of a "significant risk" of loss to the deposit insurance fund is not the relative or absolute size of the potential loss, but whether there is significant risk that the insurance fund will suffer a loss if a state thrift engages in the activity.

The FIRREA also prohibits a state thrift from acquiring or retaining any equity investment of a type or in an amount that is not permissible for a federal thrift to acquire and retain directly. This prohibition would apply to investments in real estate and equity securities. There is an exception for service

corporations, where the FDIC determines that the investment would not pose any significant risk of loss to the deposit insurance fund and where the thrift meets applicable capital standards on a fully phased-in basis.

The Board does not believe that legislative provisions similar to those discussed above are necessary to limit the activities of state-chartered banks, since a system similar to that adopted by Congress is already in place. As I have discussed, the activities of state banks are currently subject to the oversight of the FDIC or the Federal Reserve, as the case may be. In the case of state member banks, the Board has exercised its authority to prevent activities or investments considered to be too risky for a depository institution with access to the federal safety net.

In conclusion, the Board believes that it has correctly interpreted the Bank Holding Company Act in the *Merchants National* case in determining that the nonbanking restrictions of that Act do not apply to the direct activities of holding company subsidiary banks. While the conduct of nonbanking activities by depository institutions that have access to the federal safety net requires close attention, the Board also believes that the current regulatory scheme, which includes federal supervision and regulation of state-chartered federally insured institutions, is adequate to ensure the appropriate degree of supervisory oversight.