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States Take the Lead

Currently, Congress is debating a number of proposals that would expand the permissible securities activities of the nonbank affiliates of bank holding companies (BHCs). However, while Congress debates, many states, including several in the West, already have acted to expand state-chartered banks' powers.

Permissible banking powers for state-chartered banks that are not members of the Federal Reserve System are set by state statutes. Some states now allow state banks and/or their subsidiaries to engage not only in full securities activities, but also in unrestricted insurance brokerage and underwriting, direct real estate investment and brokerage and general equity investment—activities not even under consideration by the Congress. More than half of all banks are state-chartered and not members of the Federal Reserve System.

Such changes in state law indirectly may open the door for expansion of BHC powers, even if Congress takes no action. BHCs may own state banks as well as national banks. Thus, depending on state law, a BHC may be able to engage in activities through a state bank subsidiary that would not be permissible for its national bank or nonbank subsidiaries.

In this *Letter*, we examine the additional powers permitted state-chartered banks in the West and the extent to which these powers are being used. We also discuss the likely effect of expanded state banking powers on BHCs.

Overview of state actions

Among the nine states in the Twelfth Federal Reserve District, the powers granted to state-chartered banks vary widely. Alaska and Hawaii do not permit any nontraditional activities, such as direct real estate investment, equity investment, and insurance brokerage. Although Utah and Nevada permit direct real estate investment, there are few, if any, banks in these states that are actively engaged in real estate investment. Similarly, Idaho law does not expressly authorize any of these nontraditional activities but neither does it prohibit them. Instead, applications to engage in new activities are considered on a case-by-case basis. Insurance brokerage appears to be the only nonbank activity in which any banks in Idaho currently are engaged. In contrast, Arizona, California, Oregon, and Washington have been the most active in expanding bank powers. The activities of the state-chartered banks in these four states are discussed below.

Arizona

Arizona permits state-chartered banks to engage in a wide range of activities, including investment in corporate equities, real estate development, and general insurance brokerage. A 1987 statute gives state-chartered banks investment banking powers. Through subsidiaries, banks are permitted to underwrite and broker mutual funds, municipal revenue bonds, commercial paper, and asset-backed securities. However, direct real estate investment and insurance appear to be the only areas in which state-chartered banks are engaged.

Arizona law also allows banks to enter new lines of business, including commercial enterprises, through equity investments. Banks must receive approval from the State Banking Department before engaging in such nonfinancial activities and are limited to investing no more than 10 percent of their assets in such equity investments. To date, banks in Arizona have not taken advantage of this authority to any significant extent.

California

California law permits both real estate investment and general equity investment. Through equity investment, banks can enter almost any line of business, except insurance sales or insurance underwriting, which are expressly prohibited. In fact, both real estate investment and equity investment have been fairly popular.

For example, according to the State Banking Department, over 100 of the 240 nonmember banks in California have approval to engage in

real estate activities, although only about 70 currently are active. Over time, state-chartered banks' real estate investment has increased from a total statewide investment of $50 million in mid-1985 to about $170 million at year-end 1987. Still, this total dollar level represents less than one percent of the active banks' assets—far below the state regulatory limit of 10 percent of assets.

Equity investment powers also have been widely used. Such investments cover a wide range, from car washes to securities affiliates. Moreover, many banks have purchased corporate equities for their own portfolios, often through the purchase of mutual fund shares. Banks' equity investments statewide (excluding real estate) now total about $200 million.

In principle, even though equity investment could be used to enter virtually any line of business (except insurance), banks have made only limited use of this power. In fact, banks' actual investments fall well below the statutory limitations, which stipulate that a bank's aggregate investment may not exceed 25 percent of its capital, and no more than 10 percent of its capital may be invested in the stock of any one company.

Oregon

Oregon does not permit equity investment or securities underwriting, but a law passed in 1987 does allow insurance brokerage and real estate investment. At present, there are few banks active in real estate investment activities.

In contrast, insurance brokerage does appear to be a relatively common activity for banks in Oregon. The passage of the 1987 law permitting banks to enter the insurance brokerage business was the result of a hard-fought battle in the state legislature between banking and insurance interests. Thus, it is not surprising that only one year after its passage, nearly two-thirds of the state nonmember banks are engaged in insurance brokerage. Most banks limit their involvement to life insurance and annuities, although six or seven banks offer full service insurance. Participation in insurance brokerage still is growing in Oregon and likely will continue to grow.

Washington

Washington law expressly forbids insurance underwriting and brokerage, although banks have been lobbying to change the statute prohibiting such activities. However, Washington has permitted real estate investment since 1985.

According to the State Banking Superintendent, about 20 percent of nonmember banks are active in this business and typically hold about one percent of their assets in real estate. Participation in real estate activities may be limited due to the newness of the law and the fact that many banks feel this activity is too risky to manage and control properly.

In 1987 Washington repealed its own "Glass-Steagall" law and now permits securities underwriting. However, banks generally have not taken advantage of this new power yet, perhaps because of the national moratorium on the securities activities of banks (which expired in March of this year) and uncertainty over pending federal legislation. However, it seems likely that some banks in Washington soon will engage in underwriting municipal revenue bonds.

Cautious response

Although a large number of banks in the West are engaging in new, nontraditional activities, many are not. Moreover, these new activities do not represent a large portion of income or assets even for most of the active banks. A number of factors help to explain the cautious response. First, many of these new activities just recently have been approved and banks simply have not had the time to start up new businesses yet.

Another factor is the basic conservatism both of state nonmember banks and state banking supervisors. The majority of these banks are small, privately-held banks with strong capital positions and limited managerial resources. As such, they may be reluctant to put that capital at risk in new activities that involve higher risk, strong competition from established providers, or require new management skills. State regulators also appear reluctant to approve applications for entry into new activities for which the bank cannot demonstrate sufficient expertise and financial resources.

Finally, state banks' cautious response to new powers also may reflect some uncertainty regarding the status of such activities when carried out in banks that are owned by BHCs. Specifically, there is considerable uncertainty regarding whether the Board of Governors of the Federal Reserve System would approve applications by BHCs to acquire banks that were engaged in these new activities, either directly or through bank subsidiaries.

BHC regulations and laws

At present, Section 4 of the Bank Holding Company Act (1956) permits BHCs to own nonbank subsidiaries only if those subsidiaries are engaged in activities determined by the Federal Reserve Board to be "closely related to banking and a proper incident thereto." Currently, real estate investment and development are not on the Fed's list (Regulation Y) of permissible activities. Moreover, only limited insurance brokerage and underwriting have been permitted. Likewise, only limited securities activities, which do not violate the "principally engaged" clause of the Glass-Steagall Act, recently were added to the list. Thus, the nonbank subsidiaries of BHCs are prohibited from engaging in many activities that are permissible for state nonmember banks in many states. Similarly, federal law limits the permissible activities of nationally-chartered banks and their affiliates.

However, a September 10, 1987, ruling by the Federal Reserve Board (the "Merchants National decision") concluded that Section 4 prohibitions are *not* applicable to the direct activities of bank subsidiaries of BHCs. The decision also suggests that the Board will not oppose BHCs wishing to acquire state banks that are engaged in insurance activities.

Moreover, the Board's Regulation Y for many years has permitted a state bank, which is owned by a BHC, to itself acquire a *wholly-owned* subsidiary that engages in activities in which the parent bank may engage. (However, a partly-owned subsidiary or joint venture would come under the Section 4 restrictions.) For example, in California about one-third of state nonmember banks engaging in real estate investment are owned by BHCs.

At the same time, however, the Board is required to evaluate the "financial and managerial resources and future prospects" of a BHC seeking to acquire a bank. In this context, some of the banks' activities might be considered so risky as to endanger the financial resources and future prospects of the organization. For example, the Board is considering a proposal which, on bank safety and soundness grounds, would prevent any acquisition by a BHC in which the banks involved conducted real estate activities, either directly or indirectly. However, this proposal would allow such activities to be conducted in a nonbank subsidiary, subject to various prudential limitations. Similarly, most proposals before Congress emphasize placing new activities in nonbank subsidiaries of BHCs and building "firewalls" between the bank and nonbank subsidiaries to prevent the risks from spilling over into the bank and the deposit insurance system.

A shortcut?

Most states in the West, as well as in many other parts of the country, already allow state-chartered banks to engage in at least one activity that is not permissible for nonbank subsidiaries of BHCs. If the states continue to loosen restrictions on the activities of state banks, the Congress may be forced to address the appropriate scope of powers of national banks and BHCs.

To the extent the Federal Reserve Board views new powers as being consistent with safety and soundness, BHCs may purchase state banks to enter lines of business that are not otherwise allowed. This may help to explain the growing interest of some BHCs in acquiring state nonmember banks. Coupled with the geographic flexibility allowed by new regional interstate banking compacts, state laws allowing state-chartered nonmember banks to enter into real estate, securities activities, equity investment, and insurance services likely will accelerate BHCs' movement into these once-forbidden activities. Such a patchwork approach ultimately may force Congress to address the appropriate scope of banking powers and ways to prevent the risks of these new activities from endangering the federal deposit insurance fund.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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