FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10262**
October 12, 1988]

AMENDMENTS TO REGULATION Y

Limitations on Grandfathered Nonbank Banks

*To All Depository Institutions and Bank Holding Companies
in the Second Federal Reserve District, and Others Concerned:*

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

> The Federal Reserve Board has issued amendments to Regulation Y (Bank Holding Companies and Change in Bank Control) to implement the limitations placed on grandfathered nonbank banks by the Competitive Equality Banking Act of 1987 (CEBA).
>
> CEBA redefined the term "bank" in the Bank Holding Company Act to include any bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) and to prohibit the formation of new FDIC-insured nonbank banks.
>
> CEBA also contains a grandfather provision that permits a nonbanking company that controlled a nonbank bank on March 5, 1987 to retain the nonbank bank and not be treated as a bank holding company if the company and its subsidiary nonbank bank observe certain limitations.
>
> These limitations generally restrict the ability of nonbank banks to commence new activities or to engage in new cross-marketing activities with affiliates after March 5, 1987; to permit overdrafts by, or incur overdrafts on behalf of, affiliates at a Reserve Bank; and to expand their assets by more than 7 percent annually during any 12-month period after August 10, 1988.
>
> Specific details concerning limitations on growth, treatment of overdrafts, definition of activities, and curbs on cross-marketing are contained in the Board's notice.

Enclosed — for all depository institutions, bank holding companies, and those who maintain sets of the Board's regulations — is the complete text of the amendments to Regulation Y, which has been reprinted from the *Federal Register* of September 28; copies will be furnished to others upon request directed to the Circulars Division of this Bank (Tel. No. 212-720-5215 or 5216).

Questions regarding Regulation Y may be directed to our Domestic Banking Applications Division (Tel. No. 212-720-5861).

E. GERALD CORRIGAN,
President.

Board of Governors of the Federal Reserve System

BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

AMENDMENTS TO REGULATION Y

(Effective September 28, 1988)

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R-0637]

Limitations on Nonbank Banks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board has adopted rules and an interpretative ruling to implement provisions of the Competitive Equality Banking Act of 1987 ("CEBA") (Pub. L. No. 100-86), relating to so-called nonbank banks. CEBA amended the definition of "bank" in the Bank Holding Company Act (the "BHC Act" or the "Act") to include certain banking institutions that had previously been outside that definition (so called "nonbank banks"). CEBA also contained a grandfather provision that permitted nonbanking companies that controlled nonbank banks as of March 5, 1987, to retain control of the institution and not be treated as a bank holding company for purposes of the BHC Act if the company and its subsidiary nonbank bank observe certain restrictions. These limitations generally restrict nonbank banks from commencing new activities or certain cross-marketing programs with affiliates after March 5, 1987, increasing their assets at an annual rate of more than 7 percent during any 12-month period commencing after August 10, 1988, or permitting overdrafts by affiliates or incurring overdrafts on behalf of affiliates at a Federal Reserve Bank. 12 U.S.C. 1843(f) (2) and (3).

To implement these limitations, the rules and interpretation: (1) discuss how the term "activity" will be applied; (2) clarify the scope of the cross-marketing limitation; (3) describe how compliance with the 7 percent annual asset growth rate will be determined; and (4) define the restrictions on overdrafts.

This rule also amends the definition of "bank" in Regulation Y to reflect the changes in that definition made by CEBA.

EFFECTIVE DATE: This regulation is effective September 28, 1988, except for § 225.52 which will be effective January 1, 1989, and § 225.145, which will be effective October 28, 1988.

FOR FURTHER INFORMATION CONTACT: For information regarding §§ 225.2, 225.51 and 225.145, contact J. Virgil Mattingly, Deputy General Counsel (202/452-3430), Robert D. Frierson, Senior Attorney (202/452-3711), or Thomas M. Corsi, Attorney (202/452-3275); for information regarding section 225.52, contact Oliver I. Ireland, Associate General Counsel (202/452-3625); or Elaine M. Boutilier, Senior Attorney (202/452-2418), Legal Division, Board of Governors of the Federal Reserve System; or for the hearing impaired *only:* Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: CEBA amended the Bank Holding Company Act of 1956 ("BHC Act") by expanding the definition of "bank" to include any bank the deposits of which are insured by the Federal Deposit Insurance Corporation ("FDIC") as well as any other institution that accepts demand deposits or accounts with third party payment capabilities and that is engaged in the business of making commercial loans. This new definition covers certain institutions that had not previously been covered by the BHC Act ("nonbank banks") and prevents banking and nonbanking companies from forming new nonbank banks.

CEBA also contains a grandfather provision that permits a nonbanking company that controlled a nonbank bank on March 5, 1987, to retain the nonbank bank and not be treated as a bank holding company if the company and its subsidiary nonbank bank observe certain limitations designed to prevent unfair competition with banks owned by bank holding companies and to reduce risks posed to the payments system by nonbank banks. With certain limited exceptions, the grandfathered parent company may not after March 5, 1987, acquire control of an additional bank or thrift institution or more than 5 percent of its assets or shares. The grandfathered nonbank bank may not—

(1) Engage in any activity after March 5, 1987, unless it was lawfully engaged in that activity as of March 5, 1987;

(2) Offer or market products or

For this Regulation to be complete, retain:
1) Regulation Y pamphlet, effective February 3, 1984.
2) Amendments effective November 3, 1986, November 7, 1986, December 15, 1986, and June 16, 1987 *(included in slip sheet dated July 1987).*
3) This slip sheet.

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services of an affiliate that are not permissible for bank holding companies under the BHC Act or permit its products or services to be offered or marketed by an affiliate engaged in activities not permissible for bank holding companies under the BHC Act, unless the specific cross-marketing activity was conducted as of March 5, 1987, and then only in the same manner as conducted as of that date;

(3) Permit an overdraft (including an interday overdraft) by an affiliate, or incur an overdraft in its account at a Federal Reserve Bank on behalf of an affiliate; and

(4) Increase its assets at an annual rate of more than 7 percent during any 12-month period beginning after August 10, 1988.[1]

On June 3, 1988 (53 FR 21,462, June 8, 1988), the Board issued for comment proposed rules to implement these provisions of CEBA. In response to this request for comment, the Board received 92 public comments from interested individuals and organizations. Approximately 52 percent of these commenters (48) favored adoption of the regulations as proposed or with slight modifications. Forty-two of the commenters opposed the proposed regulations and suggested that they be substantially changed before being adopted as final rules.

During the regulatory comment period, the Board received several requests for a hearing. In response to these requests, the Board conducted a full-day informal hearing on July 29, 1988, to permit interested parties an additional opportunity to express their views on the proposal. The comments on the proposal received during the comment period and the informal hearing are summarized below.

The comments generally centered on the proper interpretation of the Congressional purposes in enacting CEBA and the appropriate degree of restrictiveness in the implementation of CEBA's limitations.

Commenters in favor of the proposed rule, principally from banking organizations and their trade groups, argue that the CEBA limitations should be adopted as written and that the impact of the rules on nonbank banks should not be ameliorated by administrative action. In their view, it was the overwhelming, if not uniform, view of Congress that nonbank banks present a serious potential for damage to the nation's banking system and that the CEBA limitations were intended to restrict the operations of nonbank banks in order to prevent to the extent possible these adverse effects, even at the risk of making nonbank banks less competitive or viable. For example, the chairman of the Senate Banking Committee stated that in establishing the CEBA restrictions, Congress rejected the testimony of nonbank banks that these limitations would impair competition, impede desirable innovation, jeopardize bank safety and soundness and increase risk to the FDIC. These commenters contend, based upon the statutory findings in CEBA, that the proposed rule properly implements the legislative intent to hold nonbank banks in place until Congress can formulate a permanent policy.

Comments unfavorable to the proposed rule, predominantly from the affected nonbank banks, interpret CEBA and its legislative history as reflecting a balancing approach intended to permit nonbank banks to be competitive. They contend that, although Congress chose to constrain grandfathered nonbank banks in significant and unprecedented ways, the limitations were not intended to be implemented in such a manner as to prevent nonbank banks from continuing to compete in the marketplace. These commenters maintain that the actual balance achieved by CEBA cannot be fully appreciated unless the language of the statute is considered in light of its legislative history, including particularly, statements by the chairman of the Senate Banking Committee during the Senate's consideration of CEBA.

As explained in the interpretive ruling, the Board resolved this issue with respect to particular provisions of the CEBA limitations with reference to the terms of the statute and the stated intent of the statute to minimize the potential for conflicts of interest, unsound banking practices, unfair competition, partiality in the credit-granting process and other adverse effects that would be associated with the grandfathered affiliations of federally insured nonbank banks and companies engaged in activities forbidden to regulated bank holding companies. Based on the statutory findings, the Board has not accepted the view of the unfavorable commenters that the nonbank bank restrictions must be applied to permit nonbank banks to maintain their unique competitive position.

The principal issues raised by the comments and at the public hearing regarding the proposed rules and the Board's resolution of these issues are discussed in the following sections as well as in the interpretative ruling:

1. *Activity Limitation:* CEBA provides that a nonbank bank may not—

> engage in any activity in which such bank was not lawfully engaged as of March 5, 1987 * * * 12 U.S.C. 1843(f)(3)(B)(i).

The proposed rule defined the term "activity" as applying to discrete lines of banking or nonbanking business and, consistent with legislative history of the provision, pointed out that this definition did not envision a product-by-product approach. To implement this definition, the proposed rule focused on five major categories of activities: deposit taking, lending, trust services, payment and clearing services, and nonbanking activities. Within these categories, examples of separate activities were set forth for purposes of applying the grandfather limitation. For example, deposit-taking activities were separated into demand deposits, non-demand checkable deposits, and time or savings deposits; and lending was divided into commercial lending and types of consumer lending (credit card, mortgage banking and other consumer loans).

Favorable comments considered these differentiations to be consistent with the express language in the statute and representative of recognized lines of banking or nonbanking activity, although some commenters urged the Board to narrow certain of the activities.

Commenters unfavorable to the proposal characterized the approach as being overly narrow and contradictory of legislative intent not to define activity on a product-by-product or customer-by-customer basis. In their view, Congress only intended to prevent grandfathered entities from becoming full-service banks or altering their basic character. As an alternative, these comments generally proposed to delete the subcategories within each major category of banking activity except where further differentiation was necessary to prevent a nonbank bank from becoming a full-service commercial bank. Thus, the commenters would favor the following categories based on so-called "core" banking activities: (1) deposits (differentiating between demand deposits and other deposits), (2) lending (differentiating between commercial loans and other types of lending), (3) trust services (including products and services incidental thereto), and (4) nonbanking (or non-core banking) activities permissible for

[1] 12 U.S.C. 1843(f) (2) and (3).

the bank under state law, such as travel agency, real estate development or general insurance brokerage. Some of these commenters would also include clearing and payment services, as a separate activity, while others regarded this activity as incidental to offering transaction accounts.

For the reasons stated in the interpretive ruling, the Board believes the term activity should be interpreted and applied with reference to prior Board and judicial precedent regarding this term as it appears in section 4 of the BHC Act, except in instances where CEBA requires modification of this analysis, as in the case of deposit-taking and lending activities. This approach is implemented through the following revised major categories of activities: deposit taking, lending, trust services and other activities consistent with recognized activities under section 4 of the BHC Act.[2]

Deposit-taking would include three activities: demand-deposit taking, non-demand deposits that the depositor may withdraw by check or similar means for payment to third parties, and other time and savings deposit-taking activity. Thus, an institution that did not offer demand or other transaction accounts on March 5, 1987, could not begin to offer these services after March 5. As explained in the interpretation, consistent with the Board's decisions under the activity provisions of section 4, lending would include the following activities: commercial lending, consumer mortgage lending, consumer credit card lending and other consumer lending.[3]

Some commenters stated that deposit-taking activity should be broken down only to reflect the distinction in the "bank" definition before CEBA between demand deposits and other deposits and that the Board should not treat non-demand transaction accounts as a separate activity. They rely on the fact that in *Board of Governors* v. *Dimension Financial Corp.*,[4] the Supreme Court held that NOW accounts may not be treated as a "deposit that the depositor has a legal right to withdraw on demand" under the pre-CEBA bank definition. As explained in the interpretive ruling, the treatment of transaction accounts as a separate activity from non-transaction account deposit-taking is consistent with the structure of the BHC Act, Board decisions regarding the term activity in section 4, and banking practice.

In this regard, the Board notes that the *Dimension* decision did not overturn the Board's decision that the taking of NOW accounts was a separate activity under section 4 of the Act. The decision ruled only that a NOW account was not "a deposit that the depositor has a legal right to withdraw on demand" in the pre-CEBA bank definition in the BHC Act. Indeed, in CEBA, Congress amended the bank definition in the BHC Act to treat the taking of transaction accounts as separate and distinct from the taking of non-transaction deposits, thus recognizing that transaction deposits have characteristics such that they should be viewed in the same manner as demand depsoits for purposes of the bank definition and not as traditional non-checkable savings or time deposits. This distinction between these types of deposits was carried over into the credit-card, trust company and certain other exceptions from the Act's definition of bank. The Board believes these amendments support the view that transaction accounts are a separate activity in the case of a nonbank bank that did not offer such a service as of March 5, 1987.

The Board has also considered the views of certain commenters that the reference in the proposed rules to section 225.25(b) of the Board's Regulation Y as a guide for defining activities other than lending or deposit services is inappropriate in that these provisions identify activities that the Board considers to be closely related to banking. These commenters contend that CEBA's activity restrictions, on the other hand, are applicable to core banking services and not activities closely related thereto. They also state that many of the activities identified in Regulation Y are incidental elements to core banking functions and should not be considered separate activities under CEBA. Moreover, the nonbanking activities list contains, for these commenters, duplication and overlap. Other commenters, including nonbank banks, stated that use of this regulation as a reference point for activities under CEBA was appropriate.

As noted in the interpretive rule, if Congress had intended the activity limitation in CEBA to distinguish only between demand deposit and commercial lending activity, Congress would have used the restriction it used in another section of CEBA dealing with nonbank banks owned by bank holding companies, which has this result. *See* 12 U.S.C. 1843(g). In accordance with the ordinary meaning of the term, the placement of the CEBA activity limitation in a section of the Act dealing with the activities of banking organizations, and the legislative history of the provisions, the Board believes the view of the term set out in the interpretive ruling is appropriate.

The Board believes that the commenters are mistaken in their view that reference to the activity limitation of section 4 is not appropriate in the case of activities conducted by banking companies. The Board's decisions and regulations under section 4 authorize deposit-taking, lending and associated banking functions for companies that do not qualify as banks, but, like the nonbank banks, are federally insured, operate under bank thrift or other depository institution charters, and exercise many of the powers of banks. See *e.g. U.S. Trust Corporation*, 70 Federal Reserve Bulletin 371 (1984); *Citizens Fidelity Corporation*, 70 Federal Reserve Bulletin 231 (1984); *Citicorp/Fidelity Federal Savings & Loan Association*, 68 Federal Reserve Bulletin 656 (1982). Finally, the Board also notes that the courts have set out standards by which one activity would be viewed as incidental to another under section 4. *National Courier Ass'n* v. *Board of Governors*, 516 F.2d 1229 (1975).

(a) *Meaning of "Engaged In"*. Under the proposed rule, a nonbank bank must demonstrate that it had a program in place to provide a particular product or service associated with the grandfathered activity to a customer and that it was in fact offering the product or service to the customer as of March 5, 1987. Comments in favor of this proposal stated that it carried out the Congressional intent of placing limitations on the activities of grandfathered entities by requiring an established program rather than a program in its planning stages. Unfavorable comments to the proposal stated that the rule should permit more flexibility in its concept of program and offered various approaches that were less formal than the standard proposed. Several commenters expressed concern

[2] Payment and clearing services, which were considered as a separate category of activity under the original proposal, have been deleted as a separate activity and will be considered under the general principles set out in the interpretation regarding other activities.

[3] The Board's decisions under section 4 have not generally differentiated between types of commercial lending. Accordingly, the Board believes that commercial lending should be viewed as a single activity under the CEBA limitation.

[4] 474 U.S. 361 (1986).

over the proposed rule's provision that an isolated transaction may not be sufficient to demonstrate that a grandfathered entity was engaged in a particular activity as of the grandfather date. In their view, this statement suggests that the Board is imposing a quantitative test.

The Board believes that the rule as proposed requires the appropriate degree of formalization in the marketing activities of a grandfathered entity to carry out the legislative intent that an activity must be "engaged in" in order to qualify for grandfathered treatment. The Board also notes that this interpretation is consistent with the meaning given the term "engaged in" in other provisions of section 4 of the BHC Act. The isolated transaction example stated in the rule is not a quantitative test because the rule expressly states that it would be insufficient unless evidence was presented indicating the existence of a program associated with the transaction.

(b) *Meaning of "As Of"*. The rule as proposed stated that the grandfather date "as of March 5, 1987" as used throughout section 4(f)(3) should refer to activities engaged in on March 5, 1987, or a reasonably short period of time preceding this date not exceeding 13 months. This period of time is expressly confirmed by the legislative history during colloquy in the Senate debates. Proponents commented that this approach was consistent with the legislative history. Certain opponents, on the other hand, commented that this period was too short and should be generally more comprehensive in scope to include, for example, promotional activities or activities that had received regulatory approval.

In this instance, the Board finds that the legislative history provides the necessary clarification on the appropriate scope of the grandfather date and that the proposed rule accurately reflects the Congressional intent of the provision.

The interpretation has been clarified, however, to provide that a nonbank bank may not commence an activity that it had terminated within this period. For example, a nonbank bank that had terminated commercial lending to avoid bank status within 13 months of March 5, 1987, could not recommence that activity after March 5, 1987.

2. *Cross-Marketing Limitation:* CEBA's second limitation prohibits grandfathered nonbank banks from offering or marketing an affiliate's products or services unless they would be permissible for bank holding companies, or permitting the bank's products or services to be offered or marketed by an affiliate engaged in impermissible nonbanking activities. This prohibition is subject to a grandfather provision for cross-marketing activities engaged in as of the March 5 grandfather date, but only in the same manner as conducted as of that date. Unlike the activity limitation, which applies to separate lines of business, the language of the statute specifies that the cross-marketing limitations apply to products or services.

At the outset, it is important to note that the cross-marketing restriction does not limit in any manner the direct marketing activities of nonbank banks. Moreover, the restriction does not prevent a nonbank bank from marketing any product or service of an affiliate that bank holding companies may offer or from permitting the bank's products and services to be offered or marketed by affiliates engaged in activities permissible for bank holding companies.[5]

(a) *Products or Services.* The interpretation published for comment did not attempt to define "product or service," but rather illustrated the application of the grandfather provision with an example that a securities company that marketed automobile loans from an affiliated nonbank bank on the grandfather date could not begin to offer checking accounts without loss of the privilege. The draft interpretation also made clear that an institution could change the terms and conditions of the product, referring to the statement of the chairman of the Senate Banking Committee during the debates on CEBA that a nonbank bank offering a three-year certificate of deposit through an affiliate could thereafter market a one-year certificate of a different amount and interest rate. 133 Cong. Rec. S3959 (daily ed. March 26, 1987).

Proponents of the proposed rule have stated that the express statutory focus of the cross-marketing limitations on specific products and services supports a narrow view of the limitation's scope. These commenters also argue that this approach is entirely consistent with the stated Congressional intent of the provision to prevent unfair competition with banks controlled by bank holding companies that may not offer such services and with the legislative history in which the broader approach for activities discussed above is contrasted with the more restrictive product-by-product approach.[6]

Opponents have countered that a narrow approach to the definition of product and service would be inconsistent with legislative intent and would limit innovation and competition. In their view, Congress intended product or service to be defined in functional terms and to be permitted to be changed in its character and design in response to market and technological innovations.[7] Under this approach, incidental aspects of products may be changed and enhancements may be developed. Finally, some comments suggested that the limitation should not apply to joint-marketing activities such as utilizing customer lists or back-office facilities that do not involve any public identification of the affiliate relationship in conducting the activities. The Board was also requested to provide for grandfathered treatment under the cross-marketing provisions if a grandfathered affiliate is reincorporated or otherwise subject to a corporate restructuring.[8]

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[5] Thus, for example, a nonbank bank may offer permissible credit-related insurance products of an affiliated insurance company. Similarly, the bank may offer any of its products and services through an affiliate engaged only in permissible activities, for example, through an affiliated consumer finance or mortgage banking company.

[6] During the Senate debate on CEBA, Chairman Proxmire stated:

> The word 'activity' is not defined in the bill, however, I want to confirm that the meaning stated in the report is what is intended and that no effort to measure activity unduly narrowly on a product-by-product, customer-by-customer basis is intended, so that if a nonbank bank were engaged in offering any type of loans on March 5, it may offer that same type of loan thereafter. 133 Cong. Rec. S4054–5 (daily ed. March 27, 1987).

[7] These commenters rely on Chairman Proxmire's confirmation during the Senate debate on CEBA of Senator Dodd's understanding that under the cross-marketing restriction:

> A grandfathered nonbank bank that was cross-marketing a specific product or service could at any time in the future cross-market a product or service which had been developed to reflect general changes in the grandfathered service's or product's character and design generated by competition, market innovation or technology. 133 Cong. Rec. S3957 (daily ed. March 26, 1987).

[8] In this regard, the Board notes that the legislative history indicates that the grandfather exception to the cross-marketing restriction applies "only to a specific company that was engaged in the activity as of March 5, 1987. An affiliate that was not engaged in a given joint-marketing activity as of March 5, 1987, may not commence that activity even if it was being conducted by another affiliate as of March 5, 1987." S. Rep. No. 100–19, 100th Cong., 1st Sess. 34–35 (1987).

The Board believes that the cross-marketing limitation in CEBA by referencing particular products and services is by its terms more restrictive in scope than the activity limitation. In this regard, the Board notes that all or nearly all of the commenters agree that an affiliate marketing one type of loan from a nonbank bank before the grandfather date would not be entitled to offer or market any other type of loan. The commenters, however, disagree over the precise degree of specificity required by CEBA's use of the term product or service. Some commenters have maintained that this formulation requires a narrow definition which, for example, distinguishes between automobile loans and boat loans. Other commenters have argued in favor of a general functional approach that would permit a product to evolve from one type of consumer lending to another type of consumer loan in response to market changes.

One commenter cited as an example of a change that would justify expansion of grandfathered cross-marketing the fact that after the changes in tax laws in 1986, many lines of credit offered by banks that were accessible by credit card or other means began to be secured by a home mortgage, so that the interest paid by the borrower is deductible for income tax purposes. This commenter stated that if a nonbank bank was cross-marketing credit cards on the grandfather date, it should consequently now be allowed to cross-market consumer home equity lines of credit.

As set forth more fully in the interpretive rule, the Board believes that the term product or service must be interpreted in light of its accepted ordinary commercial usage and the Congressional purpose underlying the limitation to minimize the potential for unfair competition and other adverse effects. To provide guidance as to the manner in which the limitation will be applied, the interpretation provides examples of the types of products and services covered by the cross-marketing restrictions in the areas of deposit-taking and lending. In other areas, the rule provides that the determination as to what constitutes a product or service will have to be made on a case-by-case basis consistent with the general principles set out in the interpretation.

The interpretation permits general changes in the character of a product or service as the result of market or technological innovation to the extent that these modifications do not transform the grandfathered product into a new product. In the Board's view, however, this approach would not permit the evolution of credit card lending discussed in the commenter's example above because unsecured lending by credit card or otherwise is clearly a different product or service from that of secured lending. Indeed, several nonbank banks commenting on the proposal, whose activities would be directly affected by the proposal, stated in their comments that secured and unsecured consumer lending constitute distinct products for purposes of the cross-marketing restriction.

(b) *Cross-Marketing "Only in the Same Manner"*. With respect to CEBA's limitation that grandfathered products or services may be offered or marketed "only in the same manner," the proposed interpretation stated that the method of offering or marketing the product or service must remain the same. The interpretation illustrated this limitation by indicating that an affiliate not using direct mailings as a marketing technique for the particular product may not commence this activity after the grandfather date.

Proponents of the rule state that the limitation on cross-marketing to the same manner in which it was conducted on the grandfather date must be applied as written in order to minimize the potential for unfair competitive advantage. They contend that defining the term to include broad categories of marketing techniques would read the limitation out of the statute.

Opponents of the rule, however, disagreed with the Board's approach. Some commenters stated that it was inappropriate to consider the media or medium used to cross-market in applying the limitations. Other commenters suggested that, in light of the constitutional protections accorded commercial free speech, marketing methods should be broken down into broad categories, and if companies were using any market method within a particular category as of the grandfather date, then all of the methods in that category would be available under the limitation. Although different categories were suggested, the most commonly suggested categories were: (a) mass media, (b) direct mail or direct response marketing, and (c) personal or face-to-face solicitation. Some commenters favored even broader categories: (a) mass marketing and (b) direct marketing.

As noted, the proposed interpretation did not define the term "in the same manner" other than to indicate that the means of offering or marketing the product or service must remain the same. Because a determination with respect to a particular cross-marketing effort under this standard would necessarily depend on the particular facts and circumstances in a given case, the revised interpretation indicates that the scope of the restriction would be applied based on a case-by-case basis consistent with the guiding principles set out in the interpretation.

3. *Eligibility for Grandfathered Nonbank Bank Status*: The proposed rule stated that institutions that had not commenced operations on August 10, 1987, could not qualify for grandfather privileges under CEBA. One affected company urged the Board to recognize grandfathered status if the company had received preliminary approval from its chartering authority and had established a plan for operation. For the reasons stated in the rule, the Board has decided to adopt the interpretation as proposed.

4. *Enforcement*: The proposed rule noted that under section 4(f) of CEBA, a company that controls a nonbank bank would lose its grandfathered status if it or a subsidiary nonbank bank acquires control of an additional bank or thrift, acquires more than 5 percent of voting shares of a bank or thrift (subject to certain exceptions), or violates the other CEBA limitations. Section 4(f)(4) of CEBA provides for the penalty of divestiture within 180 days of the loss of grandfather exemptions through failure to comply with the CEBA limitations.

Commenters argued that imposition of divestiture as the only sanction under these circumstances was unwarranted under the Act and its legislative history. According to these comments, both of these sources indicate that the Board has a range of administrative enforcement options to deal with CEBA violations. Some commenters urged the Board to clarify that divestiture would be reserved only for willful, material, recurring or wanton violations. Others requested the Board to apply this penalty only prospectively and provide prompt CEBA interpretations to requesters.

By its terms, the statute provides for loss of grandfather rights for violations of the CEBA limitations, and, in this regard, the Conference Report states that nonbank banks that violate the overdrafts provisions of CEBA "lose their grandfathered status". H.R. Rep. No. 100–261 at 127–128. The Conference Report, however, also indicates that the Conferees expected the Board to use its cease and desist or other supervisory

authority as appropriate. *Id.* at 125.

The Board has deleted reference to the divestiture provision of CEBA as Board rules do not normally contain provisions relating to enforcement. The Board's responsibility under CEBA would be to enforce the statute and implementing rules in each case, taking into account the terms of the statute, its legislative history, and the particular facts and circumstances of the case. Taking these factors into account, the Board would use its prosecutorial discretion to determine the appropriate enforcement action.

The Board is prepared to provide prompt guidance in individual cases regarding the scope or application of the CEBA limitations.

5. *Seven Percent Growth Rate Limitation*: Under CEBA, a nonbank bank's asset growth is limited to an annual rate of 7 percent during any 12-month period beginning after August 10, 1988. Two principal issues are raised by this provision: the method for determining the base against which the 7 percent growth limit is to be applied during the initial 12-month period and the period over which the calculation will be made. In its proposed rule, the Board noted that under CEBA, the 7 percent growth limitation would not be applicable for one year following the date of enactment of CEBA. Accordingly, the proposed rule indicated that nonbank banks could, at their option, choose to use the actual amount of assets reported on their books on August 10, 1988, as the initial base or the average total assets reported on the call report for the quarter ending September 30, 1988. The latter option was provided in order to eliminate the need for additional reporting by permitting use of the quarterly report of condition for the bank.

The proposed rule stated that the growth limit would be applied on a rolling twelve-month basis, commencing initially on August 10, 1988, and thereafter at the start of each quarterly call report period (*i.e.* September 1, 1988, January 1, 1989, April 1, 1989, July 1, 1989, and so on). The rule proposed further noted compliance would be determined using the institution's average assets over the 12-month period in accordance with the directive in the CEBA Conference Report.[9]

Under this approach, compliance with the 7 percent growth limit would be measured for the first 12-month period by comparing the average assets for the third quarter of 1989 as reported on Schedule RC–K of the Report of Condition [10] with either the assets on August 10, 1988, or the average assets for the third quarter of 1988, at the nonbank bank's option. Thereafter, growth would be measured by comparing the average assets for each quarter with the average assets for the previous quarter.

The alternate method of calculating the initial base figure by using the average assets for the third quarter of 1988 was not opposed, provided the final rule would continue to permit a nonbank bank to use its actual assets on the bank's books on August 10, 1988. Commenters opposed to the proposed rule stated that the proposed rolling 12-month method of measuring compliance was in conflict with the statutory language and the legislative intent that growth be measured on an annual average basis. They also argued that this method of measuring compliance could lock then into quarterly business patterns of growth and reduction that might be inconsistent with their normal growth patterns or cause them to make unsound business decisions solely to comply with this needlessly restrictive method of measuring growth. This approach would also inhibit successful marketing compaigns and restrict opportunities in the market place.

Finally, the comments from certain of the commenting nonbank banks urged the Board to avoid the "use it or lose it" result under the proposed rule's method of using each year's actual average annual assets as the base for measuring the following year's growth. To avoid this result, they proposed an annual asset cap that would be projected forward for each grandfathered nonbank bank from the bank's base figure, at 7 percent, compounded annually. Thus, an institution that failed to achieve a 7 percent growth rate in one year could make up for this in the following year by increasing its growth rate by a corresponding amount above 7 percent.

The comments in favor of the rule supported the Board's approach, indicating that the alternate approach advocated by the nonbank banks, which would allow growth in excess of 7 percent, would by its terms violate CEBA's limitation on asset growth during any 12-month period to no more than 7 percent.

(a) *Initial Base for Growth Limit.* The revised rule retains both of the methods specified in the proposed rule for calculation of the initial base.

The Board has also provided a third option. A nonbank bank may, in its discretion, elect to use at its initial base its total assets over the four quarters ending September 30, 1988, as reported on Schedule RC–K of its report of condition. This option would avoid the problem of having to annualize growth during the first year and may be a desirable alternative for nonbank banks that experienced even or no growth during the year after August 10, 1987.

A nonbank must advise the Board by October 15, 1988 of the method it has chosen to calculate its base figure for the initial 12-month compliance period. If the nonbank bank elects to use its actual assets on August 10, 1988, as its initial base, in must report that figure to the Board by October 15, 1988, along with its average assets for the third quarter of 1988 prepared in accordance with the rules in Schedule RC–K of the Report of Condition. While not required, a nonbank bank electing to use the August 10, 1988 figure, may provide the Board with its assets at the end of the third quarter or any additional information it believes may be of assistance to the Board in reviewing the August 10 figure in light of the concerns over "window dressing" transactions discussed below.

The revised rule addresses concerns raised that an institution could effect "window-dressing" transactions on August 10, 1988, by engaging in extraordinary short-term transactions to inflate artificially its assets. The revised rule notes that if the Board determines that a reporting nonbank bank's assets have been inflated on August 10, 1988, without reference to the customary business activity of the institution, the Board would disallow the window-dressing transactions or require that the initial date for the first 12-month period be adjusted to a date following August 10, 1988. The Board believes these rules are consistent with the terms of the

[9] The Conference Report states that the Board should "in determining compliance with the 7 percent growth rate, [to] utilize a procedure that computes the grandfathered institution's growth rate on an average basis." H.R. Rep. No. 100–261 at 125.

[10] Banking institutions with $100 million in assets or more must file with their reports of condition their average assets over the quarter calculated either on a daily basis or a weekly basis (*i.e.*, an average of the Wednesday of each week of the quarter). Institutions with less than $100 million may report using an average of the four month-end figures.

statute [11] and the Board's authority to act to prevent evasions of the BHC Act. Comments from certain nonbank banks stated that such window-dressing transactions could be disallowed in determining the initial base.

(b) *Frequency of Measurement of Growth Limit.* After considering the public comments, the Board has decided to revise the rule to permit nonbank banks to measure compliance with the growth limitation once a year at the end of the third quarter of each year. Thus, compliance with the growth rate would be determined for 12 month periods beginning on October 1 of each year and ending on September 30 of the following year. The initial 12-month period would begin on October 1, 1988 and end of September 30, 1989.

After the first 12-month period, compliance for all nonbank banks will be determined by measuring the average assets over the four quarters during the year (*e.g.,* the fourth quarter of 1989 and the first three quarters of 1990) with the average assets for the proceeding four quarters (*e.g.,* the fourth quarter 1988 and the first three quarters of 1989). This approach would pose the least administrative burden while maintaining consistency with the intent of the statute to limit the overall asset growth of nonbank banks. Moreover, this approach avoids locking the nonbank banks into the same patterns of growth during the year.

Compliance with the growth limit for the initial 12-month period commencing October 1, 1988, will be determined by comparing the average total assets (as reported on Schedule RC–K) for the four quarters ending with the third quarter of 1989 with the initial based figure chosen by the nonbank bank.

—*Annualization Required for Initial 12-Month Period.* Because the nonbank bank's average assets over the initial year will be compared to its average assets over the immediately preceding quarter, or its assets on a single day in that quarter (August 10, 1988), the simple rate of asset growth between these periods will differ from the annual rate of asset growth as limited by the statute.[12] A 7 percent simple growth rate over this period would convert to an annual rate of growth of over 10 percent. For example, a nonbank bank with assets in the amount of $100 million on August 10, 1988, and which had average assets of $107 million over the four quarters ending with the third quarter of 1989, would grow at a simple rate of 7 percent. At an annual rate, however, this growth would be 10.97 percent.

Adjusting the simple growth rate for this initial period is accomplished by using a factor that converts a simple growth rate into an annual growth rate.[13] This factor is calculated as the ratio of 365 days, the number of days in a year, to the number of days between the midpoint of the base period and the midpoint of the first compliance period, *i.e.,* the four quarters ending with the third quarter of 1989.[14] The ratio is therefore based on comparable measurements (*i.e.,* the midpoint of the third quarter of 1988 with the midpoint of the first 12-month period following the end of this quarter).

For a nonbank bank electing to use its assets on August 10, 1988 as its base figure for the initial 12-month compliance period, the annualizing ratio is 1.597 (365 days divided by 233 days from August 10, 1988 to March 31, 1989). The nonbank bank's average assets over the first 12-month period could not exceed its assets on August 10, 1988 by more than 7 percent divided by this annualizing ratio. In the previous example, the simple growth rate permissible during the initial period would be about 4.5 percent and assets could average no more than $104.47 million over the first compliance period under this option.

Nonbank banks selecting the average assets over the third quarter of 1988 as the base figure for the initial 12-month period would apply an annualizing ratio of 1.601 (365 days divided by 228 days from August 15, 1988 to March 31, 1989). The nonbank bank's average assets over the first 12-month period could not exceed the average total assets for the third quarter of 1988 by more than 7 percent divided by this annualizing ratio. In the previous example, the simple growth rate permissible during the initial period would be about 4.4 percent and assets could average no more than $104.37 million over the first compliance period.

Nonbank banks electing to use the average total assets for the four calendar quarters ending with the third quarter of 1988 as the initial base period would not be required to annualize because like-periods, one year apart, are being compared. As noted, annualization for all 12-month periods after the initial period (ending September 30, 1989) is also not necessary because like periods, one year apart, are being compared.

—*Compliance on a Quarterly Basis.* The Board has also decided to permit a nonbank bank, at its option, to measure compliance with the 7 percent annual growth rate limitation under the rolling quarterly approach originally proposed. A nonbank bank deciding to elect this method must advise the Board of this decision by October 15, 1988.

Finally, escrow deposit accounts are treated as deposits for purposes of the call report (*see* Schedule RC–E) and the Board does not believe it appropriate to exclude such deposits from the asset base. The Board is also constrained by the terms of the statute from permitting a nonbank bank to grow at an annual rate greater than 7 percent during a 12-month period, because during some preceding period, the nonbank bank failed to achieve a 7 percent growth rate. Accordingly, the Board has decided not to adopt the view of certain commenters that the Board should permit a nonbank bank to establish an asset cap based on 7 percent of the nonbank bank's assets on August 10, 1988, projected forward.

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[11] The statute provides that the growth rate be applied during any 12-month period beginning after August 10, 1988. Thus, the Board need not start the first annual period on August 10, 1988, particularly where the record shows that the nonbank bank has manipulated its assets on the dated unrelated to its legitimate business activities.

[12] Because compliance during all subsequent 12-month periods will be determined by comparing comparable periods (*i.e.* average assets over a year to average assets over the preceding year), no annualization is required for those periods.

[13] Calculating annual growth rates requires three pieces of information: the value of the item whose growth is being measured for the initial or base period; the same information for the final period; and the length of time between these periods. The annual rate of growth then may be calculated as follows:

$$G = \frac{(F-I)*}{I} 100 * \frac{365}{L}$$

Where: G is the annual rate of growth, not compounded. F is the value of the quantity whose growth is being measured as of the final period. I is the value of the quantity whose growth is being measured as of the initial period. L is the length of time between the initial and final periods, expressed in days.

The first part of this formula, $\frac{(F-I)*}{I}$ 100, expresses the percent change in the series as a simple growth rate. The second term, 365/L, converts the simple growth rate to an annual rate of growth, not compounded.

[14] The midpoint of the third quarter of 1988 is August 15, 1988 and the midpoint of the four calendar quarters ending with the third quarter of 1989 is March 31, 1989.

6. *Overdrafts:* The fourth limitation on nonbank banks prohibits a nonbank bank from permitting an overdraft by an affiliate and from incurring an overdraft in its account with a Federal Reserve Bank on behalf of an affiliate.

CEBA states that a nonbank bank:

shall not * * * after the date of the enactment of [CEBA], permit any overdraft (including an intraday overdraft), or incur any such overdraft in such bank's account at a Federal Reserve bank, on behalf of an affiliate, other than an overdraft [due to an inadvertent accounting or computer error or a secured overdraft on behalf of an affiliate that is a primary dealer]. 12 U.S.C. 1843(f)(3)(B)(iii).

The language of this statute clearly prohibits overdrafts by affiliates on the books of nonbank banks.[15] The statute also prohibits overdrafts by the nonbank bank in its account at its Federal Reserve Bank on behalf of an affiliate. The language "on behalf of an affiliate" is unclear. To read this language to preclude only those overdrafts at a Federal Reserve Bank where the affiliate has also overdrawn its account at the nonbank bank would render the language unnecessary, because the overdraft by the affiliate is already specifically prohibited. As the rules of statutory construction generally disfavor interpretations that render statutory language meaningless, it is appropriate to resort to extrinsic aids, such as the legislative history, in order to interpret this language. The Conference Report to CEBA states:

Overdrafts in an affiliate's accounts at a nonbank bank are difficult to police, particularly in times of financial difficulty of the affiliate, when the potential for overdrafts resulting in losses is highest. Accordingly, the overdraft restrictions provide that nonbank banks lose their grandfathered status if they incur overdrafts at Federal Reserve banks. Federal Reserve banks are in a position to monitor such overdrafts on a real time basis. H.R. Rep. 100–261, pp. 127–128.

This report indicates that Congress contemplated that the Federal Reserve would monitor overdrafts by the nonbank banks in their accounts at Federal Reserve Banks, and that such an overdraft could result in the loss of the bank's grandfathered status.

CEBA and its legislative history indicate that Congress was concerned about overdrafts by nonbank banks' affiliates because of the risks they present to uninsured depositors and creditors of the bank, as well as the Federal Reserve and the FDIC, because a nonbank bank would be unable to make an independent evaluation of the creditworthiness of an affiliate making payments through the nonbank bank.[16] Congress also restricted overdrafts by the nonbank bank in its account with the Reserve Bank even though the affiliate's account at the nonbank bank had not been overdrawn. This latter restriction was included, in part, for ease of monitoring.

To implement the statutory language prohibiting overdrafts on behalf of affiliates by nonbank banks at Federal Reserve Banks, the proposed rule provided that an overdraft by a nonbank bank in the nonbank bank's account at a Federal Reserve Bank would be deemed to be on bahalf of an affiliate whenever: (1) a nonbank bank holds an account for an affiliate from which third party payments can be made; and (2) the aggregate balance of all of an affiliate's accounts with the nonbank bank is less, at the time the nonbank bank incurred an overdraft in its account at a Federal Reserve Bank, than the aggregate balance of all of the affiliate's accounts maintained by the nonbank bank at the opening of business on the day on which the nonbank bank incurred the overdraft.

'Thirty-five comments discussed this definition of when a nonbank bank overdraft at its Reserve Bank was "on behalf of an affiliate". Eight of the comments stated that *all* overdrafts by a nonbank bank should be prohibited. Of the remaining twenty-seven comments, twenty-one were opposed to the definition, and six supported the definition.

Those comments opposed to this section objected to the presumption that a drawdown by an affiliate at any time on the day a nonbank bank had an overdraft caused the overdraft. They requested that a clearer causal connection be made. Although some comments suggested that the statute merely intended to prohibit overdrafts by affiliates in their accounts with nonbank banks, this is clearly not the case because such interpretation would make the reference to overdrafts "on behalf of an affiliate" superfluous. To implement this language, yet clarify the causal connection, the revised rule defines an overdraft "on behalf of an affiliate" to occur when the posting of an affiliate's transaction to the nonbank bank's account at a Reserve Bank creates or increases the nonbank bank's overdraft at its Reserve Bank. The affiliate would not necessarily have to overdraw an account with the nonbank bank for an overdraft at the Reserve Bank to be deemed to be on its behalf; rather, the transaction would have to put the nonbank bank into an overdraft position at its Federal Reserve Bank or increase the amount of an already existing overdraft by a nonbank bank in its account with the Federal Reserve Bank.

The Board recognizes that a decrease in an affiliate's account at its nonbank bank may cause a subsequent overdraft in the nonbank bank's account at its Federal Reserve Bank. Therefore, if a nonbank bank shows a consistent pattern of incurring overdrafts at its Federal Reserve Bank, after allowing an affiliate to draw down its account, the Board may view the pattern as evidence that the nonbank bank is evading the provisions of the Bank Holding Company Act.

To facilitate administration of this rule, under the proposal, nonbank banks were to be required to report to their Reserve Bank accounts held for affiliates from which third party payments could be made. All six comments received on this section opposed it as too burdensome and unnecessary. By dropping the reporting requirement, the Board will have to monitor overdrafts of all nonbank banks, instead of just those with transaction accounts for affiliate. Nevertheless, the Board believes that the overdraft restrictions can be implemented without this requirement, and has deleted the reporting requirement from the final regulation.

In addition to the CEBA overdraft restrictions, the Board considered imposing a zero "cap" for purposes of the Board's general risk reduction program on all nonbank banks that offer to their affiliates accounts with third party payment capabilities. Eighteen comments were received on this issue, and fourteen of those comments were opposed to it. Commenters objected to

[15] This overdraft prohibition does not prevent nonbank banks from making loans to affiliates consistent with other laws, *e.g.*, sections 23A and 23B of the Federal Reserve Act, applicable bank lending limits, and CEBA's restriction on new activities. A nonbank bank that was not making commercial loans prior to March 5, 1987, would violate the new activity restrictions of CEBA by making loans to affiliates after that date. Where a debit is posted to an account, overdraws the account, and is not covered by a loan at that time, it is an overdraft.

[16] *See*, H.R. Rep. No. 100–261, 100th Cong., 1st Sess. 127–128; comments of Chairman Proxmire (floor manager), 133 Cong. Rec. S3801 (daily ed. March 25, 1987).

this proposal as discriminatory and unjustified. The Board has therefore determined that the zero cap should not be imposed at this time, but the question may be studied further under the ongoing large dollar risk reduction program.

Nevertheless, each Reserve Bank will pay particular attention to nonbank banks when monitoring the depository institutions in its District, but no specific procedures have been adopted for monitoring nonbank banks. Any nonbank bank that becomes a "problem" institution (as defined by a Federal Reserve Bank) will be monitored most closely.

—Posting. Posting is the procedure whereby the debit or credit adjustments resulting from payments transactions are made to the appropriate account. In order for nonbank banks to avoid overdrafts at Reserve Banks, they must know when entries will be posted to their accounts. Similarly, posting rules are necessary to determine whether an overdraft has occurred at a nonbank bank. Without posting rules, nonbank banks could evade the purpose of the statute by posting entries at such times of the day as to mask overdrafts. Accordingly, the Board proposed posting rules for the accounts of nonbank banks at Federal Reserve Banks and affiliates' accounts at nonbank banks.

Sixteen comments discussed these proposed posting rules, with three in favor and 13 opposed. Those opposed considered them to be burdensome and unnecessary. The Board, however, believes that uniform posting rules are necessary to ensure equal treatment of all nonbank banks and their affiliates, because the posting procedures currently in place are not uniform throughout the industry. These rules only apply for the purposes of measuring overdrafts under CEBA and nonbank banks may continue to use other posting procedures for other purposes. These rules do not apply to depository institutions that are not nonbank banks covered by CEBA and are in addition to rules applicable to depository institutions' accounts at Federal Reserve Banks under the Board's general risk reduction policy.

This procedure differs from the posting rules used by the Board's ex post monitoring system under the risk reduction program. Although the ex post monitor method used in the risk reduction program is familiar to depository institutions, the Board believes that it is inappropriate to apply its posting rules to nonbank banks for the purposes of applying the CEBA overdraft restrictions. The ex post monitor posting rules were developed for a voluntary program which does not involve the serious divestiture (or loss of exemption, in the case of industrial banks) consequences that can result from an overdraft under CEBA. The Board is continuing to review the ex post monitor in light of this and other issues, and the Board wishes to note that changes may be made to the CEBA posting rules in conjunction with any future modification of the ex post monitor posting rules.

—Posting by Federal Reserve Banks. Reserve Banks will post funds and book-entry securities transfers as they are made. For check, ACH, and noncash transactions, net settlement entries, and nonelectronic transactions, all credits will be posted as of the opening of business and all debits at the close of business.

With regard to discount window loans, the Board proposed to post credits for discount window loans as of the close of business on the day the loan is made, and to post debits for repayment of loans as of the close of business at the maturity of the loan. Commenters suggested that credit for discount window loans should be posted at the time of day the loan was actually made. In general, a discount window loan will be posted as of the close of business. However, it is within a Federal Reserve Bank's discretion to grant a discount window loan that is requested during the day to cover intraday transactions. Therefore, under the final rule where it is expressly agreed to by the Federal Reserve Bank at the time of the loan is made, a discount window loan may be posted prior to the close of business.

In addition to the posting rules, Reserve Banks will pay particular attention to depository transfer checks and ACH cash concentration debits used by affiliates of nonbank banks. These transactions are likely to present risks that are not addressed by the proposed posting rules. For example, where an affiliate of a nonbank bank deposits depository transfer checks with a nonbank bank in order to transfer funds to its account at the nonbank bank from its account at another depository institution, it is likely that the check will be returned in the event of failure of the affiliate. Failure of the affiliate, in turn, may precipitate failure of the nonbank bank. The returned check will come to the Federal Reserve after the day when the credits for these transactions are posted to a nonbank bank's account, and therefore the risks presented by these returns are not addressed by posting rules. Consequently, where appropriate to protect against risk of return of these transactions, nonbank banks may be required to establish a special clearing balance at their Reserve Bank to be maintained at all times at a sufficient level to protect against these risks.

—Posting by Grandfathered Banks. Because depository institutions' rights with respect to their customers differ from the rights that a Reserve Bank has with respect to transactions that it processes, particularly in the area of check and ACH transactions, the posting rules do not require nonbank banks to post all transactions for CEBA monitoring purposes at the same time that the transactions are posted by Reserve Banks. The regulation permits nonbank banks to post checks and ACH transfers at any time during the day of the transaction—i.e., settlement day for ACH transactions or the day of presentment or credit to the nonbank banks for check transactions—so long as debits are posted no later than the time that the nonbank bank's account at the Reserve Bank is debited for the transaction for purposes of CEBA overdraft monitoring, and credits are posted no earlier than the time when the credit for the transaction is posted to the nonbank bank's account for purposes of CEBA overdraft monitoring.

Some commenters opposed the posting provisions, stating that they would be burdensome and unnecessary. One commenter suggested that any *bona fide* posting system should be acceptable unless it discriminated against nonaffiliates. The Board, however, continues to believe that posting rules are necessary to ensure equal treatment of all nonbank banks and their affiliates, because the posting procedures currently in place are not uniform throughout the industry.

A modification to the regulation has been made to accomodate the provisions of another title of CEBA—the Expedited Funds Availability Act—and state funds availability laws. These laws require that, in certain cases, funds from check deposits must be made available for withdrawal by the depositor prior to collection (posting). Therefore, in those situations where state or federal law requires a nonbank bank to make funds available to its affiliate prior to the "normal" posting time for such check deposits set by the proposed regulation, the nonbank bank may post the transaction to its affiliate's account as of the time availability must be provided under the Expedited Funds

Availability Act or state law.

Another question raised by the comments was whether affiliates' accounts at a nonbank bank may be aggregated for determination of whether an affiliate had incurred an overdraft at the nonbank bank. Aggregation of the accounts of separate affiliates is not permitted by the regulation, but a nonbank bank that has a legal right to offset one affiliate's account against another could post transactions that would overdraft an individual affiliate's account to another affiliate's account. A nonbank bank may aggregate the separate accounts of an individual affiliate for the purpose of determining whether that affiliate has incurred an overdraft.

Nonbank banks may keep two sets of books for posting: one for affiliates for CEBA purposes and another for other purposes. No posting to an affiliate's account is necessary for CEBA purpose if a nonbank bank returns a check or an ACH debit transfer in accordance with applicable law.

One concern of the commenters on the posting issue was the receipt of timely account information from the Federal Reserve Bank. As set out more fully below, nonbank banks currently have access to sufficient information to monitor their account balances. In addition, in mid-1989, the Federal Reserve Banks expect to offer a service allowing institutions to check their actual balance in their reserve account on a real-time basis.

—Exemptions. CEBA provides two exemptions from the restriction on overdrafts. One exemption is for overdrafts on behalf of an affiliate that is a primary dealer, where the overdraft is fully secured;[17] and the other exemption is for inadvertent computer or inadvertent accounting errors that are beyond the control of both the grandfathered nonbank bank and the affiliate.

—Primary Dealers. CEBA defines a primary dealer as one that is recognized as a primary dealer by the Federal Reserve Bank of New York. Currently, there are 42 such primary dealers, but only eight are affiliated with nonbank banks. Some of these eight primary dealers do not currently clear book-entry securities transfers through their nonbank banks.

The overdraft prohibition in CEBA does not prohibit primary dealers from incurring overdrafts at affiliated nonbank banks and the affiliated nonbank banks from incurring overdrafts at their Federal Reserve Bank on behalf of the primary dealer affiliate, provided that these overdrafts are fully secured, "as required by the Board, by bonds, notes, or other obligations which are direct obligations of the United States or on which the principal and interest are fully guaranteed by the United States or by securities and obligations eligible for settlement on the Federal Reserve Book, entry system."[18] The proposed regulation defined "fully secured" as secured by a perfected security interest in specific, identified obligations listed in the statute with a market value that, in the Reserve Bank's judgment, is sufficiently in excess of the amount of the overdraft to provide a margin of protection against a volatile market or the chance that the securities would need to be liquidated quickly.

Eleven comments were received on the Board's proposed implementation of the primary dealer exception. Only one comment supported the proposal. The remaining comments expressed concern about the discretion given to the Reserve Bank to determine what constitutes "fully secured". In general, the commenters expressed the belief that any "haircuts" on collateral should be set the same as for collateral posted by other depository institutions. The Board believes that generally haircuts should be based on the quality of the collateral offered rather than the institution offering the collateral. Haircuts for discount window lending have historically been the province of the Federal Reserve Banks, and the Board believes that it is inappropriate to specify haircuts by regulation absent a compelling reason. Nevertheless, the Board believes that Federal Reserve Banks should be encouraged to adopt comparable collateral valuation procedures for book entry securities for nonbank banks and other depository institutions.

One primary dealer was particularly concerned about the interaction of the definition of overdrafts "on behalf of an affiliate" and the collateralization requirement for primary dealer overdrafts. This commenter believed that due to the drafting of the proposal, a primary dealer faced the possibility that nonaffiliate securities overdrafts would be deemed to be on its behalf and consequently requiring collateralization. The regulation has been revised to clarify that it does not require collateralization of overdrafts by customers other than affiliates.

The Board proposed establishing a cap or ceiling on the level of securities-related overdrafts to be permitted by any one nonbank bank. Such a cap was to be set through self-evaluation procedures similar to those used in the risk reduction program, and nonbank banks exceeding the cap would be counseled or subject to other action by their Federal Reserve Bank, in accordance with the Board's risk reduction policy. Only two comments were received on this question—one in favor and one opposed. After further consideration, the Board has determined that a cap should not be imposed in conjunction with the CEBA overdraft regulation.

—Inadvertent Errors. CEBA also exempts from the overdraft restrictions those overdrafts resulting from inadvertent computer or inadvertent accounting errors that are beyond the control of both the nonbank bank and the affiliate. An inadvertent accounting error is an error involving the recordation of entries to an account of a nonbank bank or affiliate resulting in an overdraft that was not reasonably foreseeable or preventable by the nonbank bank or the affiliate. A misposting of an entry by a Reserve Bank would not result in an overdraft in a nonbank bank's account because no extension of credit had been made. Similarly, a misposting of an entry by a nonbank bank to an affiliate's account would not result in an overdraft.

An inadvertent computer error is an error resulting from a computer malfunction or from computer processing of adjustments in an account that results in an overdraft that was not reasonably foreseeable or preventable. Such errors would include problems where a nonbank bank or affiliate could not avoid book-entry securities overdrafts from inbound securities transfers, because it could not originate off-setting outbound transfers of securities or where a nonbank bank received a book-entry securities transaction sent to it in error. On the other hand, if a Federal Reserve Bank's computer should go down so as to prevent a Fedwire funds transfer from being sent to the nonbank bank, any overdraft due to outband Fedwire funds transfers would be within the control of the nonbank bank, because the nonbank bank could have waited until it had sufficient funds in its account to cover

[17] This exemption does not apply to industrial banks.

[18] An overdraft is on behalf of a primary dealer affiliate only to the extent that the primary dealer has drawn down its accounts; the overdraft does not include any drawdown or overdraft on the books of the nonbank bank by a nonaffiliate of the nonbank bank.

the outbound transfer.

Sixteen commenters argued that this definition of inadvertent error should be broadened to include overdrafts where the nonbank bank executes a transaction on behalf of an affiliate that results in a debit to its account, and incurs an overdraft because an anticipated transaction that would have created an offsetting credit to its account is delayed because of Federal Reserve Bank computer problems. The Board believes that it would be inappropriate to broaden the definitions of inadvertent error to this extent. Nonbank banks should be responsible for controlling their own accounts. Although some nonbank bank commenters argued that they had a responsibility to make some transfers to prevent the customer's default on an obligation, customer account agreements between banks and their customers generally permit banks to delay customer transactions where necessary.

The posting rules and the Federal Reserve's advice services enable a nonbank bank to monitor its account balance. Under the posting rules, generally the only debits that are posted intraday result from funds and securities transfers. Credits for other transactions are posted in the morning and debits at the end of the day. A nonbank bank can get its opening balance each day from its Federal Reserve Bank at the time Fedwire opens for business in its district. The nonbank bank will know the amount of any ACH credits for which it has previously received advices, all its cash letters sent for collection, and the amount of any ACH debits that it originated and can add these credits to its opening balance. A Federal Reserve bank gives an automatic advice to on-line institutions of each funds or securities transfer when it is posted to the reserve account. Those institutions that are not on-line can have a standing request for a telephone advice for each such transfer. Therefore, the nonbank bank can adjust its balance throughout the day to reflect funds and securities transfers. And when the cash letter and ACH tape are presented to the nonbank bank, it can make the debit adjustments to its account as of the close of business. Thus, the nonbank bank should be able to closely monitor its balance with the Federal Reserve Bank according to the regulation's posting rules.

Finally, if the inadvertent error provision is expanded to cover Federal Reserve Bank computer outages, it would be difficult to justify not expanding it to cover outages at other banks. Staff believes that such a definition would lead to extremely complex inquiries into individual overdrafts and should be rejected. Nevertheless, staff recommends that the definition of an inadvertent error be expanded to include overdrafts due to the receipt of book entry securities transfers that are promptly returned as erroneous transfers.

7. *Definition of Bank:* The proposed rules amended the definition of bank in Regulation Y to reflect the changes to the bank definition in the BHC Act made by CEBA. They also added the definition of "affiliate" from CEBA and a definition of nonbank bank. The Board received no comment on the bank and affiliate definitions and is adopting them as proposed. The Board is adopting the nonbank bank definition to describe those institutions that were covered by the CEBA amendments.

Conclusion: Except for the limitation on overdrafts (§ 225.52) which is effective in 90 days, these amendments to Regulation Y are effective immediately. The amendments to section 225.2 merely set forth the definition of "bank", "nonbank bank", and "affiliate" that are provided in CEBA. The new section 225.51 defines the limitation on the asset growth of nonbank banks established by CEBA.

The Board finds good cause to make these amendments effective immediately. The amendments to the section on definitions conform the regulation to the change in the statute. As a result of the enactment of CEBA, these definitions are already effective. The addition of section 225.51 is effective immediately because CEBA requires that grandfathered nonbank banks limit their annual asset growth for 12-month periods after August 10, 1988. This new section sets forth the means by which the Board will measure this growth. Because the statutory annual growth rate requirement is already in effect, the Board finds that there is good cause to make the regulation implementing that requirement effective immediately to allow nonbank banks to plan their business activities so as to conform to the method the Board will use to measure compliance with the limitation.

Paperwork Reduction Act Notice

The Board finds good cause for instituting a new collection of information without providing an opportunity for public comment. The new collection of information is a one-time occurrence. To comply with the statutory requirements of CEBA, nonbank banks must report the base asset figure against which the 7 percent limitation on growth will be measured. The rules provide that the nonbank banks with three options for determining their initial base figure. The nonbank bank must advise the Board by October 15, 1988 of the method elected. Should a nonbank bank elect to use the August 10, 1988 base date, it must file a report of that asset figure by October 15, 1988, along with its average assets for the third quarter of 1988. (Should a nonbank bank elect to use the third calendar quarter 1988 data or the average assets for the four quarters ending September 30, 1988, the information is already collected in Schedule RC–K of its Report of Condition.)

A nonbank bank electing to measure compliance with the growth rate on a rolling quarterly basis as permitted by the Board's rules, must report that election to the Board also by October 15, 1988.

The new collection of information must be instituted quickly and public participation in the approval process would substantially interfere with the Board's ability to perform its statutory obligation of enforcing the 7 percent growth limitation set forth in CEBA.

The information to be collected from nonbank banks is contained in a new information collection, the "Report by Nonbank Banks of Total Assets on August 10, 1988" (form FR 3050; OMB No. 7100–0236). This information collection consists of a free-form voluntary report of the method chosen by the nonbank banks to calculate their initial base figure and the total assets of these institutions on August 10, 1988, if this method for calculating the annual base is elected along with the institution's average assets for the third quarter of 1988. This report was approved by the Board under delegated authority from the Office of Management and Budget ("OMB") at the same time the Board approved this final rule. The Board estimates that the disclosure requirement will result in a one-time reporting burden of 28 hours.

Final Regulatory Flexibility Act Analysis

Of the items required to be obtained in a final regulatory flexibility analysis by 5 U.S.C. § 604(a), the first (a statement of the need for and objectives of the rule) and the second (a summary of the issues raised by the commenters,

the Board's assessment of the issues, and the changes made to the proposed rule in response to the comments) are contained elsewhere in this preamble.

The third item required for a final regulatory flexibility analysis is a description of the significant alternatives to the rule consistent with the objectives of applicable statutes and designed to minimize any significant economic effect of the rule on small entities considered by the Board, and why these were rejected.

The Board proposed that all requirements of the amended rules be applicable to all nonbank banks and industrial banks subject to the rules regardless of size. The small entities most likely to be affected by this rulemaking are the industrial banks that are subject to the limitations on overdrafts. No comments were received requesting exemption of industrial banks due to their small size. According to Board records on overdrafts under the current risk reduction policy, very few industrial banks reporting to the Board have incurred overdraft since the enactment of CEBA. Thus, it does not appear that a substantial number of industrial banks will be affected by the rule.

No comments were received stating that the new rules impose burdens specifically on small banks. Some comments stated that certain requirements, such as the posting rules, were burdensome and should not be required, but rather, that the Board should accept any *bona fide* posting system that did not discriminate against nonaffiliated depositors. As stated elsewhere in this preamble, the Board considered this comment but determined that uniform posting rules are necessary to ensure equal treatment of all industrial banks, nonbank banks and their affiliates, because the posting procedures currently in place are not standardized throughout the industry.

Other than the overdraft rules for which the posting rules were set, the limitations established by these rules apply only to nonbank banks. There are approximately 55 of these institutions, and less than half are small entities. The Board considered exempting small banks from the rule's requirements, but CEBA does not provide an exempiton according to the size of the nonbank bank.

List of Subjects in 12 CFR Part 225

Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in this notice, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956 (12 U.S.C. 1844), the Board amends 12 CFR Part 225 as follows:

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

1. The authority citation for Part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1843(c)(8), 1844(b), 3106, 3108, 3907 and 3909.

2. In § 225.2 paragraphs (a) through (f) and (g) through (l) are redesignated as paragraphs (b) through (g) and (i) through (n) respectively; new paragraphs (a) and (h) are added; and newly redesignated paragraph (b) is revised to read as follows:

§ 225.2 Definitions.

* * * * *

(a) "Affiliate" means any company that controls, is controlled by, or is under common control with, a bank or nonbank bank.

(b)(1) "Bank" means:

(i) An insured bank as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)); or

(ii) An institution organized under the law of the United States which both:

(A) Accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and

(B) Is engaged in the business of making commercial loans.

(2) "Bank" does not include those institutions qualifying under the exceptions listed in section 2(c)(2) of the BHC Act (12 U.S.C. 1841(c)(2)).

* * * * *

(h) "Nonbank bank" means any institution that:

(1) Became a bank as a result of enactment of the Competitive Equality Amendments of 1987 (Pub. L. No. 100–86), on the date of such enactment (August 10, 1987); and

(2) Was not controlled by a bank holding company on the day before the enactment of the Competitive Equality Amendments of 1987 (August 9, 1987).

* * * * *

3. The heading "Appendices to Subparts A through E" is revised to read "Appendices to Subparts." Subpart F, consisting of §§ 225.51 and 225.52, is added immediately following Subpart E to read as follows:

Subpart F—Limitations on Nonbank Banks

225.51 Seven percent growth limit for nonbank banks.
225.52 Limitation on overdrafts.

Subpart F—Limitations on Nonbank Banks

§ 225.51 Seven percent growth limit for nonbank banks.

(a) *Period for determining compliance.* A nonbank bank's annual rate of asset growth for purposes of paragraph (b) of this section shall be determined for twelve-month periods that begin on October 1 of each year and end on September 30 of the following year, unless the bank elects to use the alternative method described in paragraph (c) of this section. The initial 12-month period shall commence on October 1, 1988, and expire on September 30, 1989, unless the Board establishes a different period pursuant to paragraph (d) of this section.

(b) *Computing annual rate of asset growth.*—(1) *Initial 12-month period.* For the initial 12-month period beginning on October 1, 1988, the average of the nonbank bank's Total Assets as reported on Schedule RC–K of its Report of Condition for the four quarters during this period may not increase by more than 7 percent of the nonbank bank's initial base. The nonbank bank may determine its initial base under any of the following methods:

(i) Its Total Assets as reported on Schedule RC–K of its Report of Condition for the quarter ending September 30, 1988, divided by 1.601; or

(ii) Its total assets on August 10, 1988, divided by 1.567, unless the Board determines pursuant to paragraph (d) that such amount may not be used; or

(iii) The average of its Total Assets as reported on Schedule RC–K of its Report of Condition for the fourth quarter of 1987 and the first three quarters of 1988.

(2) *Succeeding 12-month periods.* For each 12-month period after the initial period, the average of the nonbank bank's Total Assets as reported on Schedule RC–K of its Report of Condition for the four quarters during that period may not increase by more than 7 percent of the average of its Total Assets as reported on Schedule RC–K of its Report of Condition for the four quarters in the preceding 12-month period.

(c) *Alternative method to compute annual rate of asset growth.*—(1)

Quarterly measurement permitted. In lieu of the methods for measuring compliance with the asset growth rate described in paragraph (b) of this section, a nonbank bank may elect to have its compliance with the growth rate determined in the following manner: its Total Assets as reported on Schedule RC–K of its Report of Condition for each quarter ending after August 10, 1989, may not increase by more than 7 percent of its Total Assets as reported on Schedule RC–K of its Report of Condition for the same quarter of the previous year.

(2) *Initial quarter.* In measuring compliance with the growth rate under paragraph (c)(1) of this section for the third quarter of 1989, the nonbank bank may elect to use its assets on August 10, 1988, as the base rather than the Total Assets for the third quarter of 1988 as reported on Schedule RC–K of its Report of Condition.

(3) *Notice required.* A nonbank bank electing to compute its asset growth pursuant to this paragraph shall notify the Board by Ocober 15, 1988, of this election. The nonbank bank may not thereafter alter its election.

(d) *Determination of total assets on August 10, 1988.* If the Board determines that a nonbank bank has engaged in transactions that have artificially inflated its total assets on August 10, 1988, and that are unrelated to its normal business activities, the Board may require that—

(1) The nonbank exclude such amounts in calculating its total assets on August 10, 1988, for purposes of paragraph (b)(1)(ii); or

(2) The initial 12-month period for determining compliance with the 7 percent growth rate shall commence on a date later than August 10, 1988, and the institution's total assets on that later date shall be used instead of the bank's total assets on August 10, 1988, for purposes of measuring compliance with the 7 percent growth rate under paragraph (b)(1).

(e) *Required reports.* (1) A nonbank bank shall file with the Board by October 15, 1988, a statement indicating the method it has elected to compute its initial base for purposes of paragraph (b)(1). of this section.

(2) A nonbank bank electing to use its actual total assets on August 10, 1988, as its initial base for purposes of paragraph (b)(1) of this section, shall report that figure to the Board by October 15, 1988, and the nonbank bank's Total Assets for the third calendar quarter of 1988 as required to be reported on Schedule RC–K of its Report of Condition for that quarter.

§ 225.52 Limitation on overdrafts.

(a) *Definitions.* For purposes of this section—

(1) "Account" means a reserve account, clearing account, or deposit account as defined in the Board's Regulation D (12 CFR 204.2(a)(1)(i)), that is maintained at a Federal Reserve Bank or nonbank bank.

(2) "Cash item" means (i) a check other than a check classified as a noncash item; or (ii) any other item payable on demand and collectible at par that the Federal Reserve Bank of the district in which the item is payable is willing to accept as a cash item.

(3) "Discount window loan" means any credit extended by a Federal Reserve Bank to a nonbank bank or industrial bank pursuant to the provisions of the Board's Regulation A (12 CFR Part 201).

(4) "Industrial bank" means an institution as defined in section 2(c)(2)(H) of the BHC Act (12 U.S.C. 1841(c)(2)(H)).

(5) "Noncash item" means an item handled by a Reserve Bank as a noncash item under the Reserve Bank's "Collection of Noncash Items Operating Circular" (*e.g.*, a maturing bankers' acceptance or a maturing security, or a demand item, such as a check, with special instructions or an item that has not been preprinted or post-encoded).

(6) "Other nonelectronic transactions" include all other transactions not included as funds transfers, book-entry securities transfers, cash items, noncash items, automated clearing house transactions, net settlement entries, and discount window loans (*e.g.*, original issue of securities or redemption of securities).

(7) An "overdraft" in an account occurs whenever the Federal Reserve Bank, nonbank bank, or industrial bank holding an account posts a transaction to the account of the nonbank bank, industrial bank, or affiliate that exceeds the aggregate balance of the accounts of the nonbank bank, industrial bank, or affiliate, as determined by the posting rules set forth in paragraphs (d) and (e) of this section and continues until the aggregate balance of the account is zero or greater.

(8) "Transfer item" means an item as defined in Subpart B of Regulation J (12 CFR 210.25 *et seq*).

(b) *Restriction on overdrafts.*—(1) *Affiliates.* Neither a nonbank bank nor an industrial bank shall permit any affiliate to incur any overdraft in its account with the nonbank bank or industrial bank.

(2) *Nonbank banks or industrial banks.* (i) No nonbank bank or industrial bank shall incur any overdraft in its account at a Federal Reserve Bank on behalf of an affiliate.

(ii) An overdraft by a nonbank bank or industrial bank in its account at a Federal Reserve Bank shall be deemed to be on behalf of an affiliate whenever:

(A) A nonbank bank or industrial bank holds an account for an affiliate from which third-party payments can be made; and

(B) When the posting of an affiliate's transaction to the nonbank bank's or industrial bank's account at a Reserve Bank creates an overdraft in its account at a Federal Reserve Bank or increases the amount of an existing overdraft in its account at a Federal Reserve Bank.

(c) *Permissible overdrafts.* The following are permissible overdrafts not subject to paragraph (b) of this section:

(1) *Inadvertent error.* An overdraft in its account by a nonbank bank or its affiliate, or an industrial bank or its affiliate, that results from an inadvertent computer error or inadvertent accounting error, that was not reasonably forseeable or could not have been prevented through the maintenance of procedures reasonably adopted by the nonbank bank or affiliate to avoid such overdraft; and

(2) *Fully secured primary dealer affiliate overdrafts.* (i) An overdraft incurred by an affiliate of a nonbank bank, which affiliate is recognized as a primary dealer by the Federal Reserve Bank of New York, in the affiliate's account at the nonbank bank, or an overdraft incurred by a nonbank bank on behalf of its primary dealer affiliate in the nonbank bank's account at a Federal Reserve Bank; *provided:* the overdraft is fully secured by bonds, notes, or other obligations which are direct obligations of the United States or on which the principal and interest are fully guaranteed by the United States or by securities and obligations eligible for settlement on the Federal Reserve book-entry system.

(ii) An overdraft by a nonbank bank in its account at a Federal Reserve Bank that is on behalf of a primary dealer affiliate is fully secured when that portion of its overdraft at the Federal Reserve Bank that corresponds to the transaction posted for an affiliate that caused or increased the nonbank bank's overdraft is fully secured in accordance with paragraph (c)(2)(iii) of this section.

(iii) An overdraft is fully secured under paragraph (c)(2)(i) when the

nonbank bank can demonstrate that the overdraft is secured, at all times, by a perfected security interest in specific, identified obligations described in paragraph (c)(2)(i) with a market value that, in the judgment of the Reserve Bank holding the nonbank bank's account, is sufficiently in excess of the amount of the overdraft to provide a margin of protection in a volatile market or in the event the securities need to be liquidated quickly.

(d) *Posting by Federal Reserve Banks.* For purposes of determining the balance of an account under this section, payments and transfers by nonbank banks and industrial banks processed by the Federal Reserve Banks shall be considered posted to their accounts at Federal Reserve Banks as follows:

(1) *Funds transfers.* Transfer items shall be posted:

(i) To the transferor's account at the time the transfer is actually made by the transferor's Federal Reserve Bank; and

(ii) To the transferee's account at the time the transferee's Reserve Bank sends the transfer item or sends or telephones the advice of credit for the item to the transferee, whichever occurs first.

(2) *Book-entry securities transfers against payment.* A book-entry securities transfer against payment shall be posted: (i) to the transferor's account at the time the entry is made by the transferor's Reserve Bank; and (ii) to the transferee's account at the time the entry is made by the transferee's Reserve Bank.

(3) *Discount window loans.* Credit for a discount window loan shall be posted to the account of a nonbank bank or industrial bank at the close of business on the day that it is made or such earlier time as may be specifically agreed to by the Federal Reserve Bank and the nonbank bank under the terms of the loan. Debit for repayment of a discount window loan shall be posted to the account of the nonbank bank or industrial bank as of the close of business on the day of maturity of the loan or such earlier time as may be agreed to by the Federal Reserve Bank and the nonbank bank or required by the Federal Reserve Bank under the terms of the loan.

(4) *Other transactions.* Total aggregate credits for automated clearing house transfers, cash items, noncash items, net settlement entries, and other nonelectronic transactions shall be posted to the account of a nonbank bank or industrial bank as of the opening of business on settlement day. Total aggregate debits for these transactions and entries shall be posted to the account of a nonbank bank or industrial bank as of the close of business on settlement day.

(e) *Posting by nonbank banks and industrial banks.* For purposes of determining the balance of an affiliate's account under this section, payments and transfers through an affiliate's account at a nonbank bank or industrial bank shall be posted as follows:

(1) *Funds transfers.* (i) Fedwire transfer items shall be posted:

(A) To the transferor affiliate's account no later than the time the transfer is actually made by the transferor's Federal Reserve Bank; and

(B) To the transferee affiliate's account no earlier than the time the transferee's Reserve Bank sends the transfer item, or sends or telephones the advice of credit for the item to the transferee, whichever occurs first.

(ii) For funds transfers not sent or received through Federal Reserve Banks, debits shall be posted to the transferor affiliate's account not later than the time the nonbank bank or industrial bank becomes obligated on the transfer. Credits shall not be posted to the transferee affiliate's account before the nonbank bank or industrial bank has received actually and finally collected funds for the transfer.

(2) *Book-entry securities transfers against payment.* (i) A book-entry securities transfer against payment shall be posted:

(A) To the transferor affiliate's account not earlier than the time the entry is made by the transferor's Reserve Bank; and

(B) To the transferee affiliate's account not later than the time the entry is made by the transferee's Reserve Bank.

(ii) For book-entry securities transfers against payment that are not sent or received through Federal Reserve Banks, entries shall be posted:

(A) To the buyer-affiliate's account not later than the time the nonbank bank or industrial bank becomes obligated on the transfer; and

(B) To the seller-affiliate's account not before the nonbank bank or industrial bank has received actually and finally collected funds for the transfer.

(3) *Other transactions.*—(i) *Credits.* Except as otherwise provided in this paragraph, credits for cash items, noncash items, ACH transfers, net settlement entries, and all other nonelectronic transactions shall be posted to an affiliate's account on the day of the transaction (*i.e.*, settlement day for ACH transactions or the day of credit for check transactions), but no earlier than the Federal Reserve Bank's opening of business on that day. Credit for cash items that are required by federal or state statute or regulation to be made available to the depositor for withdrawal prior to the posting time set forth in the preceding paragraph shall be posted as of the required availability time.

(ii) *Debits.* Debits for cash items, noncash items, ACH transfers, net settlement entries, and all other nonelectronic transactions shall be posted to an affiliate's account on the day of the transaction (*e.g.*, settlement day for ACH transactions or the day of presentment for check transactions), but no later than the Federal Reserve Bank's close of business on that day. If a check drawn on an affiliate's account or an ACH debit transfer received by an affiliate is returned timely by the nonbank bank or industrial bank in accordance with applicable law and agreements, no entry need to be posted to the affiliate's account for such item.

4. Section 225.145 is added to read as follows:

§ 225.145 Limitations established by the Competitive Equality Banking Act of 1987 on the activities and growth of nonbank banks.

(a) *Introduction.* Effective August 10, 1987, the Competitive Equality Banking Act of 1987 ("CEBA") redefined the term "bank" in the Bank Holding Company Act ("BHC Act" or "Act") to include any bank the deposits of which are insured by the Federal Deposit Insurance Corporation as well as any other institution that accepts demand or checkable deposit accounts and is engaged in the business of making commercial loans. 12 U.S.C. 1841(c). CEBA also contained a grandfather provision for certain companies affected by this redefinition. CEBA amended section 4 of the BHC Act to permit a company that on March 5, 1987, controlled a nonbank bank (an institution that became a bank as a result of enactment of CEBA) and that was not a bank holding company on August 9, 1987, to retain its nonbank bank and not be treated as a bank holding company for purposes of the BHC Act if the company and its subsidiary nonbank bank observe

certain limitations imposed by CEBA.[1] Certain of these limitations are codified in section 4(f)(3) of the BHC Act and generally restrict nonbank banks from commencing new activities or certain cross-marketing activities with affiliates after March 5, 1987, increasing their assets at an annual rate exceeding 7 percent during any 12 month period after August 10, 1988, or permitting overdrafts for affiliates or incurring overdrafts on behalf of affiliates at a Federal Reserve Bank. 12 U.S.C. 1843(f)(3).[2] The Board's views regarding the meaning and scope of these limitations are set forth below and in provisions of the Board's Regulation Y (12 CFR 225.51 and 52).

(b) *Congressional findings.* (1) At the outset, the Board notes that the scope and application of the Act's limitations on nonbank banks must be guided by the Congressional findings set out in section 4(f)(3) of the BHC Act. Congress was aware that these nonbank banks had been acquired by companies that engage in a wide range of nonbanking activities, such as retailing and general securities activities that are forbidden to bank holding companies under section 4 of the BHC Act. In section 4(f)(3), Congress found that nonbank banks controlled by grandfathered nonbanking companies may, because of their relationships with affiliates, be involved in conflicts of interest, concentration of resources, or other effects adverse to bank safety and soundness. Congress also found that nonbank banks may be able to compete unfairly against banks controlled by bank holding companies by combining banking services with financial services not permissible for bank holding companies. Section 4(f)(3) states that the purpose of the nonbank bank limitations is to minimize any such potential adverse effects or inequities by restricting the activities of nonbank banks until further Congressional action in the area of bank powers could be undertaken. Similarly, the Senate Report accompanying CEBA states that the restrictions CEBA places on nonbank banks "will help prevent existing nonbank banks from changing their basic character * * * while Congress considers proposals for comprehensive legislation; from drastically eroding the separation of banking and commerce; and from increasing the potential for unfair competition, conflicts of interest, undue concentration of resources, and other adverse effects." S. Rep. No. 100–19, 100th Cong., 1st Sess. 12 (1987). *See also* H. Rep. No. 100–261, 100th Cong., 1st Sess. 124 (1987) (the "Conference Report").

(2) Thus, Congress explicitly recognized in the statute itself that nonbanking companies controlling grandfathered nonbank banks, which include the many of the nation's largest commercial and financial organizations, were being accorded a significant competitive advantage that could not be matched by bank holding companies because of the general prohibition against nonbanking activities in section 4 of the BHC Act. Congress recognized that this inequality in regulatory approach could inflict serious competitive harm on regulated bank holding companies as the grandfathered entities sought to exploit potential synergies between banking and commercial products and services. *See* Conference Report at 125–126. The basic and stated purpose of the restrictions on grandfathered nonbank banks is to minimize these potential anticompetitive effects.

(3) The Board believes that the specific CEBA limitations should be implemented in light of these Congressional findings and the legislative intent reflected in the plain meaning of the terms used in the statute. In those instances when the language of the statute did not provide clear guidance, legislative materials and the Congressional intent manifested in the overall statutory structure were considered. The Board also notes that prior precedent requires that grandfather exceptions in the BHC Act, such as the nonbank bank limitations and particularly the exceptions thereto, are to be interpreted narrowly in order to ensure the proper implementation of Congressional intent.[3]

(c) *Activity limitation.*—(1) *Scope of "activity".* (i) The first limitation established under section 4(f)(3) provides that a nonbank bank shall not "engage in any activity in which such bank was not lawfully engaged as of March 5, 1987." The term "activity" as used in this provision of CEBA is not defined. The structure and placement of the CEBA activity restriction within section 4 of the BHC Act and its legislative history do, however, provide direction as to certain transactions that Congress intended to treat as separate activities, thereby providing guidance as to the meaning Congress intended to ascribe to the term generally. First, it is clear that the term "activity" was not meant to refer to banking as a single activity. To the contrary, the term must be viewed as distinguishing between deposit taking and lending activities and treating demand deposit-taking as a separate activity from general deposit-taking and commercial lending as separate from the general lending category.

(ii) Under the activity limitation, a nonbank bank may engage only in activities in which it was "lawfully engaged" as of March 5, 1987. As of that date, a nonbank bank could not have been engaged in both demand deposit-taking and commercial lending activity without placing it and its parent holding company in violation of the BHC Act. Thus, under the activity limitations, a nonbank bank could not after March 5, 1987, commence the demand deposit-taking or commercial lending activity that it did not conduct as of March 5, 1987. The debates and Senate and Conference Reports on CEBA confirm that Congress intended the activity limitation to prevent a grandfathered nonbank bank from converting itself into a full-service bank by both offering demand deposits and engaging in the business of making commercial loans.[4] Thus, these types of transactions provide a clear guide as to the type of banking transactions that would constitute activities under CEBA and the degree of specificity intended by Congress in interpreting that term.

(iii) It is also clear that the activity limitation was not intended simply to prevent a nonbank bank from both

[1] 12 U.S.C. 1843(f). Such a company is treated as a bank holding company, however, for purposes of the anti-tying provisions in section 106 of the BHC Act Amendments of 1970 (12 U.S.C. 1971 *et seq.*) and the insider lending limitations of secton 22(h) of the Federal Reserve Act (12 U.S.C. 375b). The company is also subject to certain examination and enforcement provisions to assure compliance with CEBA.

[2] CEBA also prohibits, with certain limited exceptions, a company controlling a grandfathered nonbank bank from acquiring control of an additional bank or thrift institution or acquiring, directly or indirectly after March 5, 1987, more than 5 percent of the assets or shares of a bank or thrift institution. 12 U.S.C. 1843(f)(2).

[3] *E.g., Maryland National Corporation,* 73 Federal Reserve Bulletin 310, 313–314 (1987). *Cf., Spokane & Inland Empire Railroad Co.* v. *United States,* 241 U.S. 344, 350 (1915).

[4] Conference Report at 124–25; S. Rep. No. 100–19 at 12, 32; H. Rep. No. 99–175, 99th Cong., 1st Sess. 3 (1985) ("the activities limitation is to prevent an institution engaged in a limited range of functions from expanding into new areas and becoming, in essence, a full-service bank"); 133 Cong. Rec. S4054 (daily ed. March 27, 1987); (Comments of Senator Proxmire).

accepting demand deposits and making commercial loans; it has a broader scope and purpose. If Congress had meant the term to refer to just these two activities, it would have used the restriction it used in another section of CEBA dealing with nonbank banks owned by bank holding companies which has this result, *i.e.*, the nonbank bank could not engage in any activity that would have caused it to become a bank under the prior bank definition in the Act. *See* 12 U.S.C. 1843(g)(1)(A). Indeed, an earlier version of CEBA under consideration by the Senate Banking Committee contained such a provision for nonbank banks owned by commercial holding companies, which was deleted in favor of the broader activity limitation actually enacted. Committee Print No. 1, (Feb. 17, 1987). In this regard, both the Senate Report and Conference Report refer to demand deposit-taking and commercial lending as examples of activities that could be affected by the activity limitation, not as the sole activities to be limited by the provision.[5]

(iv) Finally, additional guidance as to the meaning of the term "activity" is provided by the statutory context in which the term appears. The activity limitation is contained in section 4 of the BHC Act, which regulates the investments and activities of bank holding companies and their nonbank subsidiaries. The Board believes it reasonable to conclude that by placing the CEBA activity limitation in section 4 of the BHC Act, Congress meant that Board and judicial decisions regarding the meaning of the term "activity" in that section be looked to for guidance. This is particularly appropriate given the fact that grandfathered nonbank banks, whether owned by bank holding companies or unregulated holding companies, were treated as nonbank companies and not banks before enactment of CEBA.

(v) This interpretation of the term activity draws support from comments by Senator Proxmire during the Senate's consideration of the provision that the term was not intended to apply "on a product-by-product, customer-by-customer basis." 133 Cong. Rec. S4054–5 (daily ed. March 27, 1987). This is the same manner in which the Board has interpreted the term activity in the nonbanking provision of section 4 as referring to generic categories of activities, not to discrete products and services.

(vi) Accordingly, consistent with the terms and purposes of the legislation and the Congressional intent to minimize unfair competition and the other adverse effects set out in the CEBA findings, the Board concludes that the term "activity" as used in section 4(f)(3) means any line of banking or nonbanking business. This definition does not, however, envision a product-by-product approach to the activity limitation. The Board believes it would be helpful to describe the application of the activity limitation in the context of the following major categories of activities: deposit-taking, lending, trust, and other activities engaged in by banks.

(2) *Deposit-taking activities.* (i) With respect to deposit-taking, the Board believes that the activity limitation in section 4(f)(3) generally refers to three types of activity: demand deposit-taking; non-demand deposit-taking with a third party payment capability; and time and savings deposit-taking without third party payment powers. As previously discussed, it is clear from the terms and intent of CEBA that the activity limitation would prevent, and was designed to prevent, nonbank banks that prior to the enactment of CEBA had refrained from accepting demand deposits in order to avoid coverage as a "bank" under the BHC Act, from starting to take these deposits after enactment of CEBA and thus becoming full-service banks. Accordingly, CEBA requires that the taking of demand deposits be treated as a separate activity.

(ii) The Board also considers nondemand deposits withdrawable by check or other similar means for payment to third parties or others to constitute a separate line of business for purposes of applying the activity limitation. In this regard, the Board has previously recognized that this line of businesss constitutes a permissible but separate activity under section 4 of the BHC Act. Furthermore, the offering of accounts with transaction capability requires different expertise and systems than non-transaction deposit-taking and represented a distinct new activity that traditionally separated banks from thrift and similar institutions.

(iii) Support for this view may also be found in the House Banking Committee report on proposed legislation prior to CEBA that contained a similar prohibition on new activities for nonbank banks. In discussing the activity limitation, the report recognized a distinction between demand deposits and accounts with transaction capability and those without transaction capability:

> With respect to deposits, the Committee recognizes that it is legitimate for an institution currently involved in offering demand deposits or other third party transaction accounts to make use of new technologies that are in the process of replacing the existing check-based, paper payment system. Again, however, the Committee does not believe that technology should be used as a lever for an institution that was only incidentally involved in the payment system to transform itself into a significant offeror of transaction account capability.[6]

(iv) Finally, this distinction between demand and nondemand checkable accounts and accounts not subject to withdrawal by check was specifically recognized by Congress in the redefinition of the term "bank" in CEBA to include an institution that takes demand deposits or "deposits that the depositor may withdraw by check or other means for payment to third parties or others" as well as in various exemptions from that definition for trust companies, credit card banks, and certain industrial banks.[7]

(v) Thus, an institution that as of March 5, 1987, offered only time and savings accounts that were not withdrawable by check for payment to third parties could not thereafter begin offering accounts with transaction capability, for example, NOW accounts or other types of transaction accounts.

(3) *Lending.* As noted, the CEBA activity limitation does not treat lending as a single activity; it clearly distinguishes between commercial and other types of lending. This distinction is also reflected in the definition of "bank" in the BHC Act in effect both prior to and after enactment of CEBA as well as in various of the exceptions from this definition. In addition, commercial lending is a specialized form of lending involving different techniques and analysis from other types of lending. Based upon these factors, the Board would view commercial lending as a separate and distinct activity for purposes of the activity limitation in section 4(f)(3). The Board's decisions under section 4 of the BHC Act have not generally differentiated between types of commercial lending, and thus the

[5] Conference Report at 124–125; S. Rep. No. 100–19 at 32.

[6] H. Rep. No. 99–175, 99th Cong., 1st Sess. 13 (1985).

[7] See 12 U.S.C. 1841(c)(2) (D), (F), (H), and (I).

Board would view commercial lending as a single activity for purposes of CEBA. Thus, a nonbank bank that made commercial loans as of March 5, 1987, could make any type of commercial loan thereafter.

(i) *Commercial lending.* For purposes of the activity limitation, a commercial loan is defined in accordance with the Supreme Court's decision in *Board of Governors v. Dimension Financial Corporation*, 474 U.S. 361 (1986), as a direct loan to a business customer for the purpose of providing funds for that customer's business. In this regard, the Board notes that whether a particular transaction is a commercial loan must be determined not from the face of the instrument, but from the application of the definition of commercial loan in the *Dimension* decision to that transaction. Thus, certain transactions of the type mentioned in the Board's ruling at issue in *Dimension* and in the Senate and Conference Reports in the CEBA legislation [8] would be commercial loans if they meet the test for commercial loans established in *Dimension*. Under this test, a commercial loan would not include, for example, an open-market investment in a commercial entity that does not involve a borrower-lender relationship or negotiation of credit terms, such as a money market transaction.

(ii) *Other lending.* Based upon the guidance in the Act as to the degree of specificity required in applying the activity limitation with respect to lending, the Board believes that, in addition to commercial lending, there are three other types of lending activities: consumer mortgage lending, consumer credit card lending, and other consumer lending. Mortgage lending and credit card lending are recognized, discrete lines of banking and business activity, involving techniques and processes that are different from and more specialized than those required for general consumer lending. For example, these activities are, in many cases, conducted by specialized institutions, such as mortgage companies and credit card institutions, or through separate organizational structures within an institution, particularly in the case of mortgage lending. Additionally, the Board's decisions under section 4 of the Act have recognized mortgage banking and credit card lending as separate activities for bank holding companies. The Board's Regulation Y reflects this specialization, noting as examples of permissible lending activity: consumer finance, credit card and mortgage lending. 12 CFR 225.25(b)(1). Finally, CEBA itself recognizes the specialized nature of credit card lending by exempting an institution specializing in that activity from the bank definition. For purpose of the activity limitation, a consumer mortgage loan will mean any loan to an individual that is secured by real estate and that is not a commercial loan. A credit card loan would be any loan made to an individual by means of a credit card that is not a commercial loan.

(4) *Trust activities.* Under section 4 of the Act, the Board has historically treated trust activities as a single activity and has not differentiated the function on the basis of whether the customer was an individual or a business. *See* 12 CFR 225.25(b)(3). Similarly, the trust company exemption from the bank definition in CEBA makes no distinction between various types of trust activities. Accordingly, the Board would view trust activities as a separate activity without additional differentiation for purposes of the activity limitation in section 4(f)(3).

(5) *Other activities.* With respect to activities other than the various traditional deposit-taking, lending or trust activities, the Board believes it appropriate, for the reasons discussed above, to apply the activity limitation in section 4(f)(3) as the term "activity" generally applies in other provisions of section 4 of the BHC Act. Thus, a grandfathered nonbank bank could not, for example, commence after March 5, 1987, any of the following activities (unless it was engaged in such an activity as of that date): discount securities brokerage, full-service securities brokerage investment advisory services, underwriting or dealing in government securities as permissible for member banks, foreign exchange transaction services, real or personal property leasing, courier services, data processing for third parties, insurance agency activities,[9] real estate development, real estate brokerage, real estate syndication, insurance underwriting, management consulting, futures commission merchant, or activities of the general type listed in § 225.25(b) of Regulation Y.

(6) *Meaning of "engaged in".* In order to be "engaged in" an activity, a nonbank bank must demonstrate that it had a program in place to provide a particular product or service included within the grandfathered activity to a customer and that it was in fact offering the product or service to customers as of March 5, 1987. Thus, a nonbank bank is not engaged in an activity as of March 5, 1987, if the product or service in question was in a planning state as of that date and had not been offered or delivered to a customer. Consistent with prior Board interpretations of the term activity in the grandfather provisions of section 4, the Board does not believe that a company may be engaged in an activity on the basis of a single isolated transaction that was not part of a program to offer the particular product or to conduct in the activity on an ongoing basis. For example, a nonbank bank that held an interest in a single real estate project would not thereby be engaged in real estate development for purposes of this provision, unless evidence was presented indicating the interest was held under a program to commence a real estate development business.

(7) *Meaning of "as of".* The Board believes that the grandfather date "as of March 5, 1987" as used throughout section 4(f)(3) should refer to activities engaged in on March 5, 1987, or a reasonably short period preceding this date not exceeding 13 months. 133 Cong. Rec. S3957 (daily ed. March 26, 1987). (Remarks of Senators Dodd and Proxmire). Activities that the institution had terminated prior to March 5, 1988, however, would not be considered to have been conducted or engaged in "as of" March 5. For example, if within 13 months of March 5, 1987, the nonbank bank had terminated its commercial lending activity in order to avoid the "bank" definition in the Act, the nonbank bank could not recommence that activity after enactment of CEBA.

(d) *Cross-marketing limitation.—(1) In general.* Section 4(f)(3) also limits cross-marketing activities by nonbank banks and their affiliates. Under this provision, a nonbank bank may not offer or market a product or service of an affiliate unless the product or service may be offered by bank holding companies generally under section 4(c)(8) of the BHC Act. In addition, a nonbank bank may not permit any of its products or services to be offered or marketed by or through a nonbank affiliate unless the

[8] S. Rep. No. 100-19 at 31; Conference Report at 123.

[9] In this area, section 4 of the Act does not treat all insurance agency activities as a single activity. Thus, for example, the Act treats the sale of credit-related life, accident and health insurance as a separate activity from general insurance agency activities. See 12 U.S.C. 1843(c)(8).

affiliate engages only in activities permissible for a bank holding company under section 4(c)(8). These limitations are subject to an exception for products or services that were being so offered or marketed as of March 5, 1987, but only in the same manner in which they were being offered or marketed as of that date.

(2) *Examples of impermissible cross-marketing.* The Conference Report illustrates the application of this limitation to the following two covered transactions: (i) products and services of an affiliate that bank holding companies may not offer under the BHC Act, and (ii) products and services of the nonbank bank. In the first case, the restrictions would prohibit, for example, a company from marketing life insurance or automotive supplies through its affiliate nonbank bank because these products are not generally permissible under the BHC Act. Conference Report at 126. In the second case, a nonbank bank may not permit its products or services to be offered or marketed through a life insurance affiliate or automobile parts retailer because these affiliates engage in activities prohibited under the BHC Act. *Id.*

(3) *Permissible cross-marketing.* On the other hand, a nonbank bank could offer to its customers consumer loans from an affiliated mortgage banking or consumer finance company. These affiliates could likewise offer their customers the nonbank bank's products or services provided the affiliates engaged only in activities permitted for bank holding companies under the closely-related-to-banking standard of section 4(c)(8) of the BHC Act. If the affiliate is engaged in both permissible and impermissible activities within the meaning of section 4(c)(8) of the BHC Act, however, the affiliate could not offer or market the nonbank bank's products or services.

(4) *Product approach to cross-marketing restriction.* (i) Unlike the activity restrictions, the cross-marketing restrictions of CEBA apply by their terms to individual products and services. Thus, an affiliate of a nonbank bank that was engaged in activities that are not permissible for bank holding companies and that was marketing a particular product or service of a nonbank bank on the grandfather date could continue to market that product and, as discussed below, could change the terms and conditions of the loan. The nonbank affiliate could not, however, begin to offer or market another product or service of the nonbank bank.

(ii) The Board believes that the term "product or service" must be interpreted in light of its accepted ordinary commercial usage. In some instances, commercial usage has identified a group of products so closely related that they constitute a product line (*e.g.*, certificates of deposit) and differences in versions of the product (*e.g.*, a one-year certificate of deposit) simply represent a difference in the terms of the product.[10] This approach is consistent with the treatment in CEBA's legislative history of certificates of deposit as a product line rather than each particular type of CD as a separate product.[11]

(iii) In the area of consumer lending, the Board believes the following provide examples of different consumer loan products: mortgage loans to finance the purchase of the borrower's residence, unsecured consumer loans, consumer installment loans secured by the personal property to be purchased (*e.g.* automobile, boat or home appliance loans), or second mortgage loans.[12] Under this interpretation, a nonbank bank that offered automobile loans through a nonbank affiliate on the grandfather date could market boat loans, appliance loans or any type of secured consumer installment loan through that affiliate. It could not, however, market unsecured consumer loans, home mortgage loans or other types of consumer loans.

(iv) In other areas, the Board believes that the determination as to what constitutes a product or service should be made on a case-by-case basis consistent with the principles that the terms "product or service" must be interpreted in accordance with their ordinary commercial usage and must be narrower in scope than the definition of activity. Essentially, the concept applied in this analysis is one of permitting the continuation of the specific product marketing activity that was undertaken as of March 5, 1987. Thus, for example, while insurance underwriting may constitute a separate activity under CEBA, a nonbank bank could not market a life insurance policy issued by the affiliate if on the grandfather date it had only marketed homeowners' policies issued by the affiliate.

(5) *Change in terms and conditions permitted.* (i) The cross-marketing restrictions would not limit the ability of the institution to change the specific terms and conditions of a particular grandfathered product or service. The Conference Report indicates a legislative intent not to lock into place the specific terms or conditions of a grandfathered product or service. Conference Report at 126. For example, a nonbank bank marketing a three-year, $5,000 certificate of deposit through an affiliate under the exemption could offer a one-year $2,000 certificate of deposit with a different interest rate after the grandfather date. *See* footnote 11 above. Modifications that alter the type of product, however, are not permitted. Thus, a nonbank bank that marketed through affiliates on March 5, 1987, only certificates of deposit could not commence marketing MMDA's or NOW accounts after the grandfather date.

(ii) General changes in the character of the product or service as the result of market or technological innovation are similarly permitted to the extent that they do not transform a grandfathered product into a new product. Thus, an unsecured line of credit could not be modified to include a lien on the borrower's residence without becoming a new product.

(6) *Meaning of "offer or market".* In the Board's opinion, the terms "offer or market" in the cross-marketing restrictions refer to the presentation to a customer of an institution's products or service through any type of program, including telemarketing, advertising brochures, direct mailing, personal solicitation, customer referrals, or joint-marketing agreements or presentations. An institution must have offered or actually marketed the product or service on March 5 or shortly before that date (as discussed above) to qualify for the grandfather privilege. Thus, if the cross-marketing program was in the planning stage on March 5, 1987, the program would not quality for grandfather

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[10] American Bankers Association, *Banking Terminology* (1981).

[11] During the Senate debates on CEBA, Senator Proxmire in response to a statement from Senator Cranston that the joint-marketing restrictions do not lock into place the specific terms or conditions of the particular grandfathered product or service, stated:

> That is correct. For example, if a nonbank bank was jointly marketing on March 5, 1987, a 3 year, $5,000 certificate of deposit, this bill would not prohibit offering in the same manner a 1 year, $2,000 certificate of deposit with a different interest rate. 133 Cong. Rec. S3959 (daily ed. March 26, 1987).

[12] In this regard, the Supreme Court in *United States* v. *Philadelphia National Bank*, noted that "the principal banking products are of course various types of credit, for example: unsecured personal and business loans, mortgage loans, loans secured by securities or accounts receivable, automobile installment and consumer goods, installment loans, tuition financing, bank credit cards, revolving credit funds." 374 U.S. 321, 326 n.5 (1963).

treatment under CEBA.

(7) *Limitations on cross-marketing to "in the same manner"*. (i) The cross-marketing restriction in section 4(f)(3) contains a grandfather provision that permits products or services that would otherwise be prohibited from being offered or marketed under the provision to continue to be offered or marketed by a particular entity if the products or services were being so offered or marketed as of March 5, 1987, but "only in the same manner in which they were being offered or marketed as of that date." Thus, to qualify for the grandfather provision, the manner of offering or marketing the otherwise prohibited product or service must remain the same as on the grandfather date.

(ii) In interpreting this provision, the Board notes that Congress designed the joint-marketing restrictions to prevent the significant risk to the public posed by the conduct of such activities by insured banks affiliated with companies engaged in general commerce, to ensure objectivity in the credit-granting process and to "minimize the unfair competitive advantage that grandfathered commercial companies owning nonbank banks might otherwise engage over regulated bank holding companies and our competing commercial companies that have no subsidiary bank." Conference Report at 125–126. The Board believes that determinations regarding the manner of cross-marketing of a particular product or service may best be accomplished by applying the limitation to the particular facts in each case consistent with the stated purpose of this provision of CEBA and the general principle that grandfather restrictions and exceptions to general prohibitions must be narrowly construed in order to prevent the exception from nullifying the rule. Essentially, as in the scope of the term "product or service" the guiding principle of Congressional intent with respect to this term is to permit only the continuation of the sepcific types of cross-marketing activity that were undertaken as of March 5, 1987.

(8) *Eligibility for cross-marketing grandfather exemption*. The Conference Report also clarifies that entitlement to an exemption to continue to cross-market products and services otherwise prohibited by the statute applies only to the specific company that was engaged in the activity as of March 5, 1987. Conference Report at 126. Thus, an affiliate that was not engaged in cross-marketing products or services as of the grandfather date may not commence these activities under the exemption even if such activities were being conducted by another affiliate. *Id.*; *see also* S. Rep. No. 100–19 at 33–34.

(e) *Eligibility for grandfathered nonbank bank status*. In reviewing the reports required by CEBA, the Board notes that a number of institutions that had not commenced business operations on August 10, 1987, the date of enactment of CEBA, claimed grandfather privileges under section 4(f)(3) of CEBA. To qualify for grandfather privileges under section 4(f)(3), the institution must have "bec[o]me a bank as a result of the enactment of [CEBA]" and must have been controlled by a nonbanking company on March 5, 1987. 12 U.S.C. 1843(f)(1)(A). An institution that did not have FDIC insurance on August 10, 1987, and that did not accept demand deposits or transaction accounts or engage in the business of commercial lending on that date, would not have become a "bank" as a result of enactment of CEBA. Thus, institutions that had not commenced operations on August 10, 1987, could not qualify for grandfather privileges under section 4(f)(3) of CEBA. This view is supported by the activity limitations of section 4(f)(3), which, as noted, limit the activities of grandfathered nonbank banks to those in which they were lawfully engaged as of March 5, 1987. A nonbank bank that had not commenced conducting business activities on March 5, 1987, could not after enactment of CEBA engage in any activities under this provision.

Board of Governors of the Federal Reserve System, September 21, 1988.

William W. Wiles,

Secretary of the Board.

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