1992

Banking and Insurance - Should Ever the Twain Meet?

Emeric Fischer
William & Mary Law School

Emeric Fischer*

Banking and Insurance—Should Ever the Twain Meet?

TABLE OF CONTENTS

* R. Hugh and Nolie A. Haynes Professor of Law, William and Mary School of Law. B.S. University of South Carolina 1951; J.D. 1963 and M.L.&T. 1964 College of William and Mary, Marshall-Wythe School of Law.

The huge amount of resource material furnished by Gary E. Hughes, Chief Counsel, Securities of the American Council of Life Insurance has made this study far more meaningful. Richard M. Whiting, Executive Director of the Association of Bank Holding Companies and John O. Alderman of the Independent Bankers Association of America have also furnished much useful material used in this paper, as have Robert M. Eubanks, III, Insurance Commissioner of Arkansas and Frederick K. Campbell, Esq. of Little Rock, Arkansas. To all my deepest gratitude. And my deepest gratitude to Betty Abele and Della Harris for their superb secretarial assistance.

I. INTRODUCTION

During the past decade, and especially since 1983, a controversial national debate has been taking place relative to the question whether banks[1] should be allowed to sell and underwrite all types of insurance.[2] This is but a segment of the debate concerning the limits of

1. Unless otherwise indicated, the term "bank(s)" includes commercial banks, and where the context permits, bank holding companies, but excludes savings banks, savings and loan institutions, investment banks and other depository or nondepository institutions.
2. At present banks are permitted very limited insurance activities. What type of activities are permissible depends on the regulatory entity exercising control over the particular bank.

financial services and products that banks and bank holding companies should be allowed to offer. This matter has been brought to a head by the Competitive Equality Banking Act of 1987 (CEBA).[3] The purpose of this study is to focus on the question of whether the consumer[4] of bank and insurance services or products would retain the protections envisioned by the regulatory schemes imposed since the 1930s if bank services and products were expanded to include the underwriting and selling of insurance of all kinds.

One of the main goals of the federal and state banking and insurance regulatory schemes[5] is the maintenance of bank and insurer solvency[6] to the end that consumers of their services and products be protected from failure of the institutions to which their money was entrusted.[7] Each financial institution carries its own particular type of

3. Pub. L. No. 100-86, 101 Stat. 552 (1987)(codified at scattered sections of 12 U.S.C.)

> It is the intent of the Congress, through the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives, to conduct a comprehensive review of our banking and financial laws and to make decisions on the need for financial restructuring legislation in the light of today's changing financial environment both domestic and international before the expiration of such moratorium.

Id. § 203(a), 101 Stat. at 584.

4. The term "consumer" refers to the bank depositor, insurance policyholder, or beneficiary of the policy.
5. "[B]anking has historically been one of the most heavily regulated industries." LASH, BANKING LAWS AND REGULATIONS 22 (1987) [hereinafter LASH].
6. *Id.* at 23; WILLIAM H. LOVETT, BANKING AND FINANCIAL INSTITUTIONS LAW IN A NUTSHELL 121-25 [hereinafter LOVETT]. Between 1920 and 1933, when there was little regulation, 16,000 banks were closed. Between 1934 and 1982, after the 1933 regulations came into existence, only 765 banks failed. *Id.* at 125. However, bank failures have started rising in recent years, due to, according to some commentators, deregulation of interest limitations on commercial banks. Geoffrey P. Miller, *Banking Regulation, The Future of the Dual Banking System*, 53 BROOK. L. REV. 1, 8 (1987). During the entire decade of the 1970s there were only 76 bank failures, but in 1985 alone 118 failed outright or received FDIC assistance. *Id.* "The assurance of the *safety of deposits*, therefore, is a basic objective that bank regulation is designed to achieve." Richard H. Whiting, *A Perspective on Financial Services Restructuring*, 37 CATH. U. L. REV. 347, 357-58 (1988)(emphasis added)[hereinafter Whiting]; "Since the primary regulatory goals of the members of the NAIC [National Association of Insurance Commissioners] are maintaining *insurer solvency* and consumer protection. . . ." Bruce W. Foundree, *Statement on Behalf of the National Association of Insurance Commissioners, submitted to the Senate Committee on Banking, Housing and Urban Affairs on the Integration of Financial Services*, 2 NAIC PROCEEDINGS 91 (1983)[hereinafter Foundree]; "Wrapped in the wonders of the new and exciting, there is a danger that even the most seasoned public policy-makers can lose sight of their basic insurance *regulatory goal-solvency*." John R. Dunne, *Risk, Reality, and Reason in Financial Services Deregulation: A State Legislative Perspective*, 2 JOURNAL OF INSURANCE REGULATION 342, 348 (1983)(emphasis added)[hereinafter Dunne].
7. Other goals of banking regulation are: (1) providing competition to prevent concentration of economic power, (2) lending for social purposes, (3) protecting the consumer (*e.g.* Truth in Lending Act, Fair Credit Reporting Act, Consumer

risk.[8] Would consolidating or concentrating several risks into a conglomerate financial entity increase those risks? When the iron curtain of institutional separation and segregation is removed, would the forces of competition exert their muscle with the potential result that efficient entities will thrive and grow, but the less efficient ones shall fail and the consumers' savings get the knockout blow?[9]

Credit Protection Act), and (4) providing an environment for monetary policy. Whiting, *supra* note 6, at 357-59 and LASH, *supra* note 5, at 22-25. Other goals of *insurance* regulation are: (1) product dependability, (2) strong insurance markets with adequate capacity and availability of coverage, (3) competition for business with fair pricing, buying opportunities and claim settlement, and (4) deconcentration of power and risks. See Dunne, *supra* note 6, at 348; *see also, Bush Task Group Report on Regulation of Financial Services: Blueprint for Reform (Part 1), Hearings Before a Subcommittee of the House Committee on Government Operations*, 99th Congress, 1st Sess. 307 (1985) [hereinafter *Bush Task Force Report*].

8. One of the primary concerns of insurance regulators is the concentration of risks which appears to be contemplated or occurring in the financial services sector. Individually, operations of insurers, securities broker-dealers, banks, savings and loans, and real estate companies involve enough hazards and difficulties in today's environment. A growing interest in offering insurance, banking and lending, securities, and real estate services under one roof carries with it the potential combination of insurance, credit, investment, and property risks not previously known or foreseen. It is this concentration, to the extent it occurs, which insurance regulators look upon with considerable apprehension. Problems of regulation are compounded by such combinations; the ability of regulators to protect consumers is affected.

   Foundree, *supra* note 6, at 92.

   In the course of their lending activities, banks take credit risks with a duration of years in many cases. Whether the borrower is an individual, a corporation or even a government entity, the bank must make a judgment whether future conditions will be such that the borrower will be able to repay the loan, and this judgment is subject to all the unforeseen events that may shape domestic or foreign economies. Regulatory controls such as lending limits, capital ratios and bad debt reserves are designed to insure that credit risks are diversified, and that the bank has adequate resources to absorb losses that may occur. Nevertheless, so long as banks lend funds to borrowers the banking business necessarily involves substantial risks that are generally greater than found in most other financial activities. Because of the degree of credit risk necessarily involved, for example, corporate lending by banks is inherently more risky than any type of strictly brokerage activity, whether involving real estate, insurance or securities, so long as the broker is not acting as a principal.

   Bush Task Force Report, supra note 7, at 330-31.

9. Several commentators have raised concern about competitive forces:

   As the number of conglomerates and holding companies has grown to be the predominant form of business, the pressure for positive financial results has increased. The recent recession, high but uncertain interest rates, and the on-again-off-again financial deregulation proposals of the federal and state governments have intensified the pressure for increased positive results.

   Managers have responded with some of the most inventive, creative and aggressive financial tactics. But some of those methods, involving

Divergent views are being expressed, sometimes with great vehemence, and numerous proposals suggesting various deregulatory modifications to present law are being submitted. To understand the nature of these proposals it is necessary to analyze the nature and structure of our dual banking system, its evolution, the jurisdictional framework of the regulating bodies, and the present statutory umbrella, all as related to the protection of the consumer. Similarly, the regulatory system of the insurance industry, as related to the protection of the policyowner and the beneficiary, needs to be reviewed. Regardless of action by Congress, it is almost certain that:

> the distinctions between different types of depository institutions, and between depository and other financial services institutions, will continue to fade. The Garn-St Germain Act greatly expanded the bank-like powers of thrift institutions, while retaining the legal distinction of these institutions as a separate industry. This Act built upon the expansion of powers initiated by the Depository Institutions Deregulation and Monetary Control Act of 1980.

> the use and abuse of holding company systems and the transactions that occur within them, have raised serious fundamental questions regarding corporate and regulatory laws insofar as adequate protection of the public interest is concerned.

John R. Dunne, *Intercompany Transactions Within Insurance Holding Companies*, 20 FORUM 445 (Spring 1985) [hereinafter Dunne, FORUM].

> We have concluded that the holding company device, when it involves affiliation with non-insurance enterprises, jeopardizes the interest of both the public and the policyholder, and especially will do so if its development is indiscriminant and without benefit of close regulatory supervision.

Id. at 446, citing Insurance Department, State of New York, *Report of the Special Committee on Insurance Holding Companies* (Feb. 15, 1968) p.7.

> Other observers believe that competitive forces rather than government agencies or laws should be allowed to structure the marketplace. In this view unrestrained entry into financial services markets will produce efficient markets, free of the distortions and inefficiencies that are usually created by government attempts to organize market activity. Many of these observers believe that the appropriate focus of government should be to promote efficient, competitive markets by prohibiting negative *practices* (such as monopolization, fraud, inadequate disclosure or capitalization, etc.). . . . These observers believe that institutions should have the maximum possible degree of flexibility to determine their own business activities in light of market conditions and competition, with government rules restricted to those necessary to prevent unfair competition and to encourage, but not require, favored types of activities.

Bush Task Force Report, supra note 7, at 319-20.

> In theory, product diversification would make it possible for banks to reduce the volatility of their earnings, thereby reducing their likelihood of failure . . . . The freedom to diversify, however, could increase instability in the banking system because of the danger that funds raised from insured depositors will be used to support unduly risky investments. This danger arises not only from the fact that managers and shareholders of some banks may be risk-seeking, but also from the "moral hazard" created by fixed-rate deposit insurance.

Robert E. Litan, *Evaluating and Controlling the Risks of Financial Product Deregulation*, 3 YALE J. ON REG. 1, 2 (1985).

> Many new state laws in recent years have also significantly expanded the permissible activities of state-chartered credit unions, thrift institutions and banks. Accordingly, many of the purely legal distinctions between the traditional categories of depository institutions have disappeared, although many individual institutions will almost certainly continue to specialize in particular products or services. In addition, depositories will increasingly enter activities traditionally limited to investment banking, brokerage and insurance firms, and vice-versa.
>
> * * *
>
> To the extent they occur the foregoing changes will tend to intensify the difficulties of the existing regulatory system in providing equitable and consistent regulatory treatment of financial institutions. They will also cause increasingly severe problems of conflicting regulatory policies and duplication, as more and more institutions become subject to multiple regulatory agencies. Without modification the current system is probably incapable of resolving the conflicts and inequities that have already occurred among financial institutions, and such problems can only be expected to worsen over time.[10]

II. EVOLUTION OF BANKING IN THE UNITED STATES

A. Banking Prior to the Civil War

1. From the Revolutionary War to 1836

The Revolutionary War was financed in a haphazard manner; both the Continental Congress and the states issued paper money which depreciated rapidly.[11] If the new republic was to survive, a more formal method of conducting financial transactions had to be developed. At the urging of Alexander Hamilton, the Bank of North America was created and chartered by the Continental Congress in 1782. Its notes[12] were redeemable in specie and its business was conducted profitably. Unfortunately, its very success brought about its demise as a "national" or "central" bank.[13] The general agrarian attitude that such a "central" bank was business oriented to the detriment of agricultural interests caused the Continental Congress to repeal its perpetual charter and issue a short term charter.[14]

---

10. *Bush Task Force Report*, *supra* note 7, at 320-21.
11. The notes issued were not freely convertible into specie. In fact the Continental notes were eventually redeemed at one cent on the dollar. *See* LASH, *supra* note 5, at 2.
12. During this period, extension of credit was by means of notes, not deposits. Borrowers from banks were given bank notes which became "money" since they were transferable from person to person.
13. Its function, aside from accepting deposits and making short term loans, was to assist in government financing. LASH, *supra* note 5, at 1. However, it was by no means a central bank.
14. This occurred a mere four years after the original charter was issued. In 1787 it obtained a charter from Pennsylvania and continued its activities as a state bank. The hostility against concentrated banking power, both private and public, has continued throughout the history of the United States and has lead to an extremely complicated dual banking system. The dual system is also at least partly responsible for the haphazard regulatory system that has evolved. Instead of cre-

Notwithstanding the opposition of Thomas Jefferson and James Madison, Hamilton, then Secretary of the Treasury, was able to convince Congress to charter the First United States Bank in 1791 for a period of twenty years. It had broader powers than the Bank of North America, but it still could not be considered a central bank since it was not a clearinghouse, a depository of banks, a creator of reserves nor the lender of last resort. The bank's charter prohibited it from owning real estate other than its place of business and from buying or selling goods and real estate.[15]

Meanwhile, many state chartered banks[16] issued notes in huge quantities.[17] The ability of these state banks to redeem the notes was rather questionable. The regulatory schemes of the states[18] were not adequate to control the volume and quality of the notes issued.[19] As a result, the First Bank of the United States, whenever it received state bank notes, would immediately present them to the issuing banks for redemption in "real" money, gold or silver coins issued by the First Bank of the United States. To a degree, this restrained state bank note issues, but it did not endear the Bank to the state banks, who added their voices to the anti Bank forces.[20] Because of the complaints of state banks, among other reasons, Congress[21] allowed the Bank's charter to expire and the Bank to cease operations in 1811. Consequently state banks proliferated,[22] issuing notes without limitation.[23] The War of 1812 proved the need for a strong national bank

---

ating a well planned regulatory system, Congress and state legislatures enacted laws in knee-jerk fashion, responding to financial crises as they arose. *See generally*, Daviel R. Fischel, et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301 (1987). The discussion and analysis in this paper will reflect the development of the banking system in the United States in light of this antibank phobia. It is for this reason that a certain portion of this paper is being devoted to the historic aspects of banking. It may be observed that when Pennsylvania issued its 1787 charter to the Bank of North America it expressly prohibited the bank from owning more real estate than needed for its place of business. Under present law national banks are similarly limited. 12 U.S.C. § 29 (1988).

15. To make sure that the Federal Government would not usurp economic power through the Bank, its stock ownership was limited to 20%, the other 80% to be owned by private stockholders.
16. By 1811 there were 88 state chartered banks.
17. In 1811 state bank notes outstanding amounted to $22.7 million, an immense sum for that time.
18. Until 1863, bank regulation was almost entirely a state matter.
19. Paradoxically, the states themselves were prohibited by the Constitution from issuing notes.
20. Jefferson, Madison and Randolph believed that the Bank was unconstitutional. However, the Supreme Court held the Second Bank of the United States to be constitutional in McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819).
21. In spite of the fact that the Bank had operated successfully, was well managed, and had accomplished the objectives sought when it was chartered.
22. By 1816 there were 246.
23. By 1816 $68 million was outstanding.

because the overissued notes of the state banks[24] depreciated quickly, giving rise to rampant inflation.

Viewing the chaotic monetary situation, Jefferson and Madison, in a complete turn-about, proposed and fervently supported the creation of the Second Bank of the United States. In 1816 Congress issued a twenty year charter to the Second Bank. Although it began its transactions during a financial crisis, the Bank worked well,[25] bringing discipline to the economy.[26] However, between 1829 and 1837 Andrew Jackson and his agrarian party campaigned to destroy the Bank. The classical fear, suspicion and resentment against concentrated power, foreign domination[27] and mercantile interests and the desire for more latitude for state banks impelled the Jacksonians to bring about the end of the Bank.[28] The response of the economy was the Panic of 1837 which started a depression that lasted until 1842.

2. *The State Free Banking System, 1837 to 1864*

After the rise and fall of the first and second national banks, it should have been apparent that without the discipline of a strong central bank, the unrestrained and unfettered practices of state banks could result only in economic chaos. Nevertheless, the anti-national bank sentiment was so strong that not only was there no new national bank charter issued by Congress, but the states made entry into the banking field easier. Until 1837 bank charters were issued only by special legislative acts, a practice which amounted to a grant of monopolistic power.[29] This did not comport with democratic ideals and lais-

24. Notes were, for the most part, the only currency available to finance the war.
25. It did not do well in its first three years under its first president, William Jones. Under his lax leadership, issuance of state bank notes were not properly restrained. The proliferation of state bank notes lead to speculation in land which culminated in the panic of 1819. Jones was then replaced.
26. Under the next two presidents, Chives and Biddle, note issues were curtailed through prompt presentation for redemption in specie. Lending practices were also tightened, and Bank notes were issued through all branches, making the currency more uniform throughout the country.
27. A large portion of the stock of the Bank was held by foreigners.
28. Jackson transferred all United States deposits from the Bank to state banks and vetoed the bill extending its charter. The Bank ceased as a national bank in 1836. It continued its existence for a short while as a Pennsylvania state bank but eventually went bankrupt in 1841.
29. The economic advantage of a bank charter was well appreciated by both the applicants and the politicians granting it. Chicanery and bribery were not excluded as a means of obtaining the license to such a fruitful tree. All parties concerned benefitted from the transaction: the legislators received meaningful gifts, the state had access to a source of low interest loans and the banker obtained the right to issue notes. *See* Thomas F. Huertas, *The Regulation of Financial Institutions: A Historical Perspective on Current Issues, in* FINANCIAL SERVICES: THE CHANGING INSTITUTIONS AND GOVERNMENT POLICY, 9 (George J. Benston ed., 1983).

sez-faire principles and thus the "free banking" method of chartering was introduced.[30]

The State of New York passed the Free Banking Act in 1838[31] which allowed anyone to obtain a charter so long as the applicant complied with minimum capital requirements and submitted to supervision and control.[32] By 1860 eighteen states adopted free banking. With the vast proliferation of bank notes which followed, the nation fell into financial chaos.

B. The National Free Banking System, 1864 to 1933

1. Prior to 1913

To finance the Civil War, Congress in 1863, and with substantial revision in 1864, passed the National Bank Act of 1864.[33] The Act's immediate goal was to bring about a system of national banks with a single uniform currency.[34] The Act established the Office of the Comptroller of Currency (OCC) to screen applicants for charters, issue charters, supervise the national banks and regulate the currency. The chartering was modeled on the New York free banking system. The dual banking system has thus been brought into existence, even though not so intended. In fact the intention was to displace the state banking system. To "encourage" state banks to switch to national charters and to cease issuing bank notes, a two percent tax on state bank notes was imposed. The response was less than spectacular; few state banks made the switch and state bank notes continued to proliferate. By hiking the tax to ten percent[35] Congress persuaded the majority of state banks to change to national charters.[36] State bank notes

30. From 1837 to 1863 banking became entirely a state matter.
31. Michigan was the first state to pass a free banking law in 1837.
32. Interestingly enough, a concomitant of free banking was the introduction of bank regulation. New York and other states, concerned about the safety of bank notes, required the posting of collateral, mainly bonds, and participation in safety funds, a precursor of today's FDIC. In case of bank failure, the sale of the collateral and monies from the safety fund would provide for the redemption of the notes. However, lax implementation of collateral requirements, the rise of "wildcat" banks and the rapid spread of free banking resulted in many failures. Many noteholders and depositors lost their money. In the early 1840s, the Treasury withdrew all its deposits from the state banks (*see supra* note 28) and established the Independent Treasury System, with "subtreasuries" throughout the country designed to transact business with the public.
33. National Bank Act of 1864, Ch. 106, 13 Stat. 99 (codified as amended in scattered sections of 12 U.S.C.). The Act squeaked through the Senate by two votes. Had the Southern states still been represented in Congress, the Act would have failed because the fear of federal centralization of power and the antibank feeling could not have been overcome.
34. It was hoped that state banks would recharter themselves as national banks.
35. Act of March 3, 1865, ch. 78, § 6, 13 Stat. 484.
36. By 1870, the ratio of national banks to state banks was five to one.

soon went out of existence. The goal of uniform currency had been achieved, but the dual bank system endured. The inclination for decentralization and the fact that checking accounts or demand deposits replaced bank notes as money motivated banks to obtain state charters.[37] By the turn of the twentieth century more than seventy percent of the nation's banks were state banks, a ratio that is still true today. Unfortunately there were many deficiencies in the structure of the national banking system[38] which resulted fairly regularly in bank runs, panics and depressions.[39] Free, decentralized banking had not proven itself; a better system was needed. It came in 1913.

2. After 1913

The most pressing need facing reformers was the need for the establishment of a banking system with a strong centralized supervisory power to provide safety and stability and an elastic currency to provide liquidity. All this was to be accomplished in the now traditional environment of decentralized banking.[40] The result was compromise legislation which gave birth to the Federal Reserve System[41] in 1913. All national banks were required to join, but state banks could elect to join.[42] The Act retained the three tier reserve requirements of the national banking system,[43] empowered the District Banks[44] to become lenders of last resort by rediscounting commercial paper of member banks,[45] thereby alleviating the liquidity crises that plagued the prior system, and authorized what is now known as "open market operations"[46] by permitting district banks to buy and sell government securities.

---

37. The more stringent regulatory aspects of national banks were also a weighty factor in the resumption and growth of state banking.
38. Typical structural deficiencies included the inelasticity of the currency, weakness in the reserve requirements and pyramiding of reserves.
39. The panics of 1873, 1893 and 1907.
40. There was general agreement as to the desirability of these goals, but little agreement on how to implement them. The bankers proposed a National Reserve Association of Banks, to be controlled by the bankers themselves. The populists wanted strong government supervision with government issue of currency, and no private control. How attitudes have changed!
41. The Federal Reserve Act, Ch. 6, 38 Stat. 251 (1913)[hereinafter "the Act"](codified as amended in scattered sections of 12 U.S.C.).
42. This attempt to bring the state banks under Federal regulation was not successful. In 1930, about 15,000 banks out of a total of 24,000 were not member banks; in 1985, about 10,000 out of a total of 15,000 banks were not member banks.
43. As provided in the National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified as a amended in scattered sections of 12 U.S.C.).
44. The United States was divided into 12 districts, each with its own District Federal Reserve Bank.
45. The so called "discount window".
46. At present, the most powerful tool to control the money supply.

As has been indicated,[47] a compelling motivation for passage of the National Bank Act was the need for a stable bank system to finance the Civil War. Similarly, during World War I the Federal Government sought the aid of the banking system to participate in the financing of the war by underwriting government bonds. Thus, the commercial banks (both state chartered and national) became accustomed to intermingling commercial and investment banking. State chartered banks had no impediment to actively engaging in securities activities since state charters did not prohibit them from so doing. However, even though the National Banking Act of 1864 did not prohibit investment banking activities, judicial[48] and administrative[49] barriers prevented national banks from participating in this lucrative post World War I business.[50] To reduce the exodus of national banks into the state chartered camps[51] and to legitimize the status of securities affiliates,[52] the McFadden Act[53] was passed in 1927, to permit, among other things,[54] the underwriting activities which the national

47. *See supra* text accompanying note 33.

48. In Logan County National Bank v. Townsend, 139 U.S. 67 (1891), the Supreme Court held that a national bank is prohibited from performing investment banking services (in this case purchasing municipal bonds) because the National Banking Act of 1864 did not *expressly confer* such power. In California National Bank v. Kennedy, 167 U.S. 362 (1897), the Court held, based on the same grounds, that a national bank may not purchase or deal in the stock of another corporation.

49. In 1902, the Comptroller of the Currency issued regulations severely restricting investment activities of national banks. *See* Robert J. Rogowski, *Commercial Banks and Municipal Revenue Bonds*, 95 BANKING L.J. 155, 157 (1978). To overcome these impediments (*see supra* note 48) many national banks pursued one of two courses; they converted to state charters or established "securities affiliates" by purchasing state chartered banks or establishing new entities. The legality of these affiliates was strongly denounced in 1911 and 1912. *See* Comment, *Securities Industry Association v. Board of Governors of the Federal Reserve System*, 31 N.Y. L. SCH. L. REV. 215, 222-23 (1986). However, due to the need of bank assistance in financing World War I, neither the Justice Department nor the Federal Reserve attempted to halt the securities activities of the commercial banks.

50. After World War I, corporations began to rely on internal financing, from their own profits or from new security issues, thus reducing their dependence on or need for bank short term loans. This put banks under pressure to find other sources of income. As a result, more and more commercial banks engaged heavily in investment bank functions, the national banks using the securities affiliate system.

51. Robert J. Rogowski, *Commercial Banks and Municipal Revenue Bonds*, 95 BANKING L.J. 155, 157 (1978).

52. *Id.*

53. Ch. 191, 44 Stat. 1224 (1927)(codified as amended in scattered sections of 12 U.S.C.)

54. The National Banking Act prohibited national banks from establishing branches. This reduced their ability to compete against state chartered banks which had no such impediment. The McFadden Act made provision to permit national banks to branch. *See infra* note 142. Several other provisions liberalized other limitations on national banks in order to make them more competitive with state chartered banks.

banks had been practicing all along. Meanwhile, in order to offset the competition of the commercial bank affiliates, investment banks entered the commercial banking field by accepting deposits and making commercial loans. By 1929 there was little left to distinguish these two classes of institutions; the separation of banking functions had practically disappeared.[55] Then came the stock market crash of 1929, followed by thousands of bank failures in the early 1930s.[56] The accusing finger (for the causes of the crash and failures) pointed at the investment activities of commercial banks. The hearings[57] Congress held to investigate the causes of the crash brought forth a long catalogue of perceived ill-deeds by the commercial banking fraternity. The stage was thus set for the Glass-Steagall Act.[58]

III. REGULATION OF BANKING

A. The Glass-Steagall Act and the FDIC

In view of the catastrophic results[59] of the 1929 stock market crash and the views expressed in the Congressional hearings[60] thereon, policymakers were compelled to reevaluate the system[61] and pass legislation to bring about the recovery and reform of banking. The immediate goals to be accomplished were:

> (1) to restore public confidence in banking following the 1929 stock market crash and the accompanying widespread bank failures; (2) to insure and maintain general economic stability by prohibiting unsound and imprudent bank investments; and (3) to forestall potential conflicts of interest between commercial and investment banking operations.[62]

To achieve these goals Congress passed the Banking Act of 1933,[63] four sections[64] of which are referred to as the Glass-Steagall Act or the Glass-Steagall wall. The "wall" alluded to is the wall between

55. *See* Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L. J. 483, 495-96 (1971).

56. By 1933 almost 9000 banks failed, ostensibly due to losses on speculative investments. See Matthew Clark & Anthony Saunders, *Judicial Interpretation of Glass-Steagall: The Need for Legislative Action*, 97 BANKING L. J. 721, 723 (1980).

57. *See Operation of the National and Federal Reserve Banking Systems: Hearings Pursuant to S. Res. No. 71 Before a Subcommittee of the Senate Comm. on Banking and Currency*, 71st Cong., 3d Session (1931).

58. The Banking Act of 1933, Ch. 89, §§ 16, 20, 21, 32, 48 Stat. 162, 184, 188, 189, 194 (codified as amended at 12 U.S.C. §§ 24, 377, 378, 78 respectively (1988)).

59. *See* Clark and Saunders, *supra* note 56, at 723.

60. *See supra* note 57 and accompanying text.

61. *See supra* text accompanying notes 52-54.

62. *See* Clark and Saunders, *supra* note 56, at 725.

63. The Banking Act of 1933, Ch. 89, §§ 16, 20, 21, 32, 48 Stat. 162, 184, 188, 189, 194 (codified as amended at 12 U.S.C. §§ 24, 377, 378, 78 respectively (1988)).

64. *Id.*

commercial and investment banking.[65] The most notable activity prohibited to commercial banks is the underwriting[66] of securities. To help restore public confidence in banking, the Banking Act of 1933 established the FDIC[67] (Federal Deposit Insurance Corporation) to insure deposits up to a specified amount,[68] guaranteed by the full faith and credit of the United States. The expectation was the restoration of public faith in the banks and prevention of future waves of panic induced bank runs. The results have been gratifying. The period following 1933 has been stable and marked by relatively few bank failures.[69]

Changes in the legislative and regulatory scheme during 1933-1986 were relatively minor[70] and largely represented a fleshing out of the themes established in and prior to 1933. The major exceptions were the Bank Holding Company Act of 1956[71] and its amendment in 1970[72] and the Garn-St Germain Depository Institutions Act of 1982.[73]

B. Policy Goals of Federal Regulation

This section delves into the broad goals of bank regulation, the pol-

---

65. Glass-Steagall:
    a) Prohibits national banks from buying or selling securities for their own account. Ch. 89 § 16, 48 Stat. 184 (1937).
    b) Restricts national banks from investing in debt securities. Ch. 89 § 20, 48 Stat. 188 (1933).
    c) Bans national banks from underwriting or issuing securities, with exceptions. Ch. 89 § 21, 48 Stat. 189 (1933).
    d) Prohibits national banks from affiliating with investment banking firms. Ch. 89 § 32, 48 Stat. 194 (1933). 12 U.S.C. § 335 (1988) imposes these prohibitions on state member banks, *i.e.* state banks which are members of the Federal Reserve System.
66. Underwriting securities is a practice whereby a financial intermediary, in effect, buys the debt or equity of its client and in turn sells it to investors. The underwriter has the potential exposure that the market will not buy the securities at or above the price paid to its client. This risk creates a potential for particular liquidity problems or abuses by banks. A bank, faced with undesirable securities, may either hold them or abuse its trust and fiduciary capacity and unload them on unsuspecting dependent customers.
67. The Banking Act of 1933, Ch. 89, § 8, 48 Stat. 168, 12 U.S.C. §§ 1811-32 (1988).
68. At present the amount is $100,000 in any insured bank.
69. During the boom years of the 1920s, an average of about 600 banks annually suspended operations. Then in the four years between 1930 and 1933, approximately 9000 commercial banks were closed. From 1934 to 1985 (52 years) there were 875 FDIC insured bank failures and 136 non insured bank failures, a total of 1011. This averages to about 20 per year. CARTER H. GOLEMBE AND DAVID S. HOLLAND, FEDERAL REGULATION OF BANKING 1986-87, 115-16 (1986).
70. *But see* sources cited *supra* note 3.
71. Ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-49 (1988)).
72. Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 (codified as amended in scattered sections of 12 U.S.C.).
73. Pub. L. No. 97-320, 96 Stat. 1469 (codified as amended in scattered sections of 12 U.S.C.).

icy tools created to pursue these goals and the constraints that limit the government in their pursuit.

1. The Broad Goals

Because of its tremendously profound role in the national economy, the Federal Government has a vital interest in regulating banking. The specific goals of federal banking policy fall into three identifiable but overlapping categories: depositor or consumer protection; credit distribution/macroeconomic goals; and monetary/cyclical economic policy.

Consumer protection includes all of those policies aimed at protecting depositors' funds, insuring competitive pricing, and insuring that banks act as relatively impartial fiduciaries for the public. Thus, the safety of deposits is a primary objective pervading banking public policy and is considered the salient point in this study.

Credit distribution entails the government's concern for suitable capital apportionment. Any distortion in the flows[74] would have the potential for powerful macroeconomic effects. Any geographic concentration of banking power or significant affiliation with a particular economic segment would have such implications. Such distortions could profoundly misshape economic growth and development.

The banking system plays a key role in the monetary system, the manipulation of which has been used as a policy tool to direct or correct economic cycles. The Federal Reserve Board ("The Fed") attempts to reach the desired results by affecting the supply of bank liquidity through open-market operations, reserve requirements and the discount rate.[75]

2. General Constraints on Federal Banking Policy

Federal banking policy is constrained by concerns for economic efficiency, the balancing of federal authority and states' rights,[76] and the fungible and global nature of capital and capital markets.

In pursuing any of the three aforementioned areas of banking policy, policy makers must be aware of the costs of their actions.[77] Bank-

74. Proper credit allocation involves the furthering of general economic growth through capital flow to its most productive use free of any systematic, geographic, industrial or other biases that would work against a healthy free market economy.

75. The Board is required under 12 U.S.C. § 225a (1982) to "maintain long run growth of the monetary and credit aggregates . . . so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."

76. *See supra* text accompanying notes 34-48.

77. As with any public policy, the makers must balance the costs and benefits associated with particular actions. For banking policy, this implies a balancing of financial safety and economic efficiency.

ing policy makers must constantly maintain the right balance of risk and efficiency. A particular policy may be to ensure deposit safety, but come only at a prohibitive cost. For example, Congress could fully guarantee the stability of deposit institutions by requiring all depositories to hold U.S. Treasury bonds exclusively. This however would not be an appropriate mix of risk and efficiency. In this case the decrease in risk does not offset the high opportunity costs of channeling money into relatively low yield and low productivity areas.

The balancing of federal and state authority over banking is a concern where such regulation affects local matters and also has national implications. Banking represents an important part of intrastate activity with interstate implications. Consequently much of the federal banking legislation reflects this concern.[78]

The business of banking is money. This creates specific concerns for the public policy maker. Money and its derivatives, debt and equity, are highly fungible and fluid and are relatively inexpensive to transfer and change form.[79] As a result banking is a regulated industry that lends itself to avoidance and evasions. A bank, by slightly modifying a particular practice, may be able to achieve substantially the same result as that which is prohibited by law or regulation.[80]

78. Under our dual banking system, the states and the federal government may charter banks. The National Bank Act of 1864, Ch. 106, 13 Stat. 99 (codified as amended in scattered sections of 12 U.S.C.), regulates federally chartered banks but not state banks, nor affiliates of national banks. Thus a national bank, through a holding company, could engage in activities that would have been forbidden to the national bank itself. This loophole became apparent in the two decades prior to the 1930s. See *supra* note 49. Congress attempted to remedy the situation through the Glass-Steagall provisions. However, the means attempted by those measures proved ineffective. To cure the problem Congress passed the Bank Holding Company Act in 1956. Ch. 240, 70 Stat. 133 (codified as amended 12 U.S.C. §§ 1841-49 (1988)). Congress was careful in its provisions not to encroach on the power of the states to regulate their state chartered banks or their bank holding companies. The present issue of the "South Dakota Loophole" is one of the manifestations of this deference to state sovereignty. *See infra* text accompanying note 295.

79. Money is simply a medium of exchange and a store of value. Debt and equity instruments all have values in present terms and are readily exchangeable.

80. An example is the sale of loans. A bank originating a loan is free to sell the loan as it would a bond or other asset. Quite often a loan is sold off in pieces corresponding to different maturity periods in the future. For example, a bank originating a five year loan may sell off the first two years to one party, the second two years to another party and keep the last year for itself. This practice is confined to very large scale loans and the periods sold are typically 30-90 days. Phillip L. Zweig, *Major New York Banks Initiate Tactic of Selling Short Term 'Strips' of Loans*, WALL ST. J., Jan. 23, 1986, at 10. This practice is, from a regulatory perspective, similar to underwriting commercial paper or very short term marketable credit which is prohibited by Glass-Steagall. *But see infra* note 219 for a decision (June 13, 1988) permitting limited underwriting activity in commercial paper.

These effects are further aggravated by the existence of integrated and global financial markets[81] which make it more difficult for regulators to contain banking within the desired limits.

C. The Policy Implementing Tools (Regulatory Mechanisms)

The foregoing concerns have produced a broad arsenal of policy regulating tools which are administered by several regulatory entities. Unfortunately these entities overlap,[82] as do the laws creating the regulatory scheme. The regulatory limitations will be examined in a functional sense rather than chronologically or by statutory classification. A *caveat* is necessary at this point: It is not the objective of this portion of this study to set forth a thorough analysis of the regulatory scheme but merely to present a simple and broad summary which focuses on the concept of safety and soundness with a view to examining the underlying question raised in the introductory portion of this paper. Thus the following generalizations do not include all the relevant substance and detail.

1. Entry Restrictions

Except during the short periods when the Bank of the United States[83] exerted some restraining influence, entry into banking was practically unregulated.[84] The threshold requirement for the promotion of safety, soundness and diminishment of risk (the first of the aforementioned policy goals) would logically impose a standard on the qualifications of persons to be permitted to enter the field and place restrictions on the environmental structure in which a bank is to be

81. The computer technology has enabled instantaneous communication of financial information on a global scale facilitating bank activity in underwriting, distributing and dealing in debt and equity securities in foreign markets such as the Euromarket. *See Hearing on Globalization of Capital Markets and the Securitization of Credit*, 100th Cong., 1st Sess. (1985). For legal authorization of such activities see 12 C.F.R. § 211.5(d)(13)(1992).

82. National banks are regulated by the Office of the Comptroller of the Currency, Act of June 3, 1864, ch. 106, § 8, 13 Stat. 99, 101 (codified in scattered sections of 12 U.S.C.), and because they are required to be members of the Federal Reserve and the FDIC, they also are regulated by the Federal Reserve Board (12 U.S.C. § 248(a) and (j)(1988)), as well as the FDIC (12 U.S.C. §§ 1811 and 1814 (1988)). State member banks (state banks may elect to join the "Fed" *or* the FDIC; but joining the "Fed" requires also joining the FDIC) are regulated by the Federal Reserve Board (12 U.S.C. § 321 (1988)) and the FDIC (12 U.S.C. § 1814 (1988)) and the appropriate state regulatory agency. State nonmember banks which elect to be insured by FDIC are regulated by the FDIC (12 U.S.C. § 1815 (1988)) and the appropriate state regulatory agency.

83. *See supra* text accompanying notes 14 and 24.

84. *See supra* text following note 31.

opened. The National Bank Act of 1864[85] did just that. It established the Office of the Comptroller of the Currency[86] charging that Office with the responsibility of determining[87] which applicants shall be permitted to "commence business."[88] The several states have similar requirements which are more or less stringent. State banks applying for Federal Reserve membership[89] are to be approved or rejected by the Federal Reserve Board[90] under criteria similar to those used by the OCC.[91] State banks, member or nonmember, applying for FDIC coverage are to be evaluated by the Board of Directors of the FDIC by a similar yardstick.[92] It appears that application of these standards has

85. National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified as amended in scattered sections of 12 U.S.C.).

86. 12 U.S.C. § 1 (1988).

87. *Id.* § 26.

88. Applicants for a bank charter must file a formal "application" with extensive supporting data. The organizers must outline their plan of operations, describe earning prospects, provide details on management capabilities (involving bank executives with appropriate experience, under contract or part of the organizing group), show adequate capitalization and soundness, and offer reasonable service to their community. In addition, the Comptroller's Office (OCC) and State Bank Departments require information on market circumstances, *i.e.*, size and growth potential, and competition from existing banks and related financial institutions. Notice of the application must be published, which allows other interested parties (normally competing institutions already in the market) to file protests and relevant data. This provides ample basis for determining whether a particular charter might meet the convenience and needs of its community, taking into account competitive circumstances.

* * *

In other words, new entrants often have to demonstrate not only financial resources and managerial competence but show also that the market in question (a city or rural area) could accommodate another banking institution. This means, in practice, that a substantial limitation on the flow of new entry may be asserted by the existing banks in an area as protestants against additional rivals. Whether or not this resistance will be effective depends on how these factors are evaluated, in the discretion of federal and state chartering authorities.

LOVETT, *supra* note 6, at 103 and 104.

89. Under 12 U.S.C. § 321 (1988).

90. Under 12 U.S.C. § 322 (1988).

91. *See* LOVETT *supra* note 6, at 103 and 104.

92. § 1816.

The factors to be enumerated in the certificate required under section 1814 of this title and to be considered by the Board of Directors under section 1815 of this title shall be the following: The financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the convenience and needs of the community to be served by the bank, and whether or not its corporate powers are consistent with the purposes of this chapter.

12 U.S.C. § 1816 (1988). The court in City National Bank v. Smith, 513 F.2d 479, 480-1, (D.C. Cir. 1975)(citing 12 C.F.R. § 4.2(b)(1974)), explained that:

The dual purpose of the chartering process is to regulate entry into the

worked well in the chartering process of banks.

2. Capitalization Requirements

Safety and soundness of any business entity, especially a banking business, requires a minimum infusion of initial capital by the organizers of the business. The National Bank Act so provides for the minimum initial capital.[93] Although present federal minimums range between $50,000 and $200,000,[94] depending on the location of the bank, as a practical matter the minimum is $1,000,000 by OCC requirements.[95] Capital adequacy requirements are measured as a percentage of total assets. The "Fed" and the OCC recently issued a single set of guidelines for capital adequacy of national banks, state member banks and bank holding companies.[96]

An adjunct to the capital adequacy requirement is the reserve requirement. The Fed is mandated[97] to prescribe by regulation the rate of reserves to be maintained by member banks against their transaction or deposit accounts. The function of the reserve is to force banks to hold enough cash as a buttress against potential bank runs. More importantly, by having the power to change reserve requirements, the Fed can, to some degree, also implement monetary policy.[98] The Fed

---

banking industry on the basis of economic considerations and to assure that national banks are competently and honestly operated. These objectives are reflected in the topics subject to investigation prior to approval of applications for charters:
(1) The adequacy of the proposed bank's structure.
(2) The earning prospects of the proposed bank.
(3) The convenience and needs of the community to be served by the proposed bank.
(4) The character and general standing in the community of the applicants, prospective directors, proposed officers, and other employees, and other persons connected with the application or to be connected with the proposed bank.
(5) The banking ability and experience of those officers and other employees.

93. 12 U.S.C. § 51 (1988). State laws have similar requirements.
94. *Id.*
95. LOVETT, *supra* note 6, at 106.
96. Acceptable ratios are: above 6.5% for multinational and regional banks, above 7% for community banks. The FDIC has a 2% total capital to total asset ratio, 12 C.F.R. § 325.4 (1992). What these ratios mean is that for every $1 of assets, $.02 (the FDIC ratio) must come from bank capital. The bank regulatory agencies have the discretion to raise these minimums for individual banks based on their financial histories or present financial conditions such as loans of questionable quality, earnings capacity and other considerations.
97. 12 U.S.C. § 461 (1988).
98. The Federal Reserve System has two additional means to manipulate the money supply. Each Federal Reserve bank (*see supra* note 44) has the power to buy and sell U.S. securities in the open market, 12 U.S.C. § 355 (1988). For every dollar of such securities sold, the money supply decreases by one dollar. The more the money supply decreases, the higher interest rates go. This is a supply and de-

can raise reserve requirements to contract lending and lower reserve requirements to expand lending. In summary, minimum capital requirements and reserve requirements are a safeguard against declines in bank asset value[99] or, in case of excessive depositor withdrawals, they provide a cushion against insolvency. Thus, these capital and reserve requirements are designed to promote liquidity and further the goal of deposit safety.

3. Limitation of and Prohibition Against Specific Activities

The most direct and powerful mechanism of implementing the policy goals which have been outlined[100] is the legislative and regulatory manifestation of permitted and prohibited activities of banks.[101] A

---

mand reaction to the increase in the scarcity of money. The second means is control over the discount rate. 12 U.S.C. § 357 (1988) empowers each Federal Reserve bank to establish discount rates. These banks lend money to commercial banks. By changing the rate of interest charged, the Fed influences the amount of money borrowed by banks, which in turn affects the money supply and interest rates. The manipulation of money supply and interest rates is in effect a control of the credit available to the national economy which in turn can be used to contain cyclical inflation and recession.

99. As witnessed by loans to third world countries and certain domestic economic sectors such as energy and agriculture, bank loans can go bad. The net present value of a bank's asset portfolio, which includes loans, is, therefore, subject to variation. A bank's capital has a subordinate claim to the assets of the bank relative to deposits. An unexpected fall in the value of a bank's loans will cause depositors to lose money only after all the bank capital has been lost.

100. *See supra* Part III.A.1.

101. 12 U.S.C. § 24 (1988 & Cum. Supp. II 1990) provides in part:

> A national banking association . . . shall have power . . . to exercise . . ., all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock; *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, except that this limitation shall not require any association to dispose of any securities lawfully held by it on August 23, 1935. As used in this section the term "investment securities" shall mean marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation

careful examination of the statute quoted *supra* note 101 shows that, in general, *national banks* are allowed to do the *business of banking* and the activities *incidental and necessary* to carry on such business.[102] These activities clearly include deposit taking, making loans, and discounting and negotiating debt.[103]

State banks derive their powers from the laws of the state of incorporation. Becoming a member of the Federal Reserve does not derogate these powers,[104] even though such banks become subject to the jurisdiction of the Fed.[105] However, the Fed may, in evaluating a state bank's application, consider "whether its corporate powers are consistent with the purposes of the Federal Reserve Act"[106] and may subject the applicant "to such conditions as it may prescribe pursuant [to the provisions of this chapter]" in order to "permit the applying bank to become a stockholder of such Federal Reserve bank."[107] However, the Glass-Steagall provisions (the bane of banking activity restrictions from the banker's point of view) do apply to state member banks.[108] Member banks are prohibited from "acting as agent for [any] nonbanking borrower in making loans on securities to [securities] dealers [or brokers]."[109] *Insured nonmember* state banks are subject to the

---

be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to [enumerated government, state and local securities].

Section 108 of CEBA, Pub. L. No. 100-86, 101 Stat. 552 (1987)(codified at scattered sections of 12 U.S.C.), added subsection "tenth" which expanded the power of national banks "[t]o invest in tangible personal property, including, without limitation, vehicles, manufactured homes, machinery, equipment, or furniture, for lease financing transactions on a net lease basis, but such investment may not exceed 10 percent of the assets of the association."

102. Because the statute does not define "banking business" nor "incidental" thereto, a great deal of litigation has resulted. Judicial and administrative rulings have identified forty-two specific activities that are considered to be within the parameters of these phrases. For the list and sources of authority of the forty-two activities see 1 HARVEY L. PITT, THE LAW OF FINANCIAL SERVICES 16-21 (Supp. 1990-92).

103. *See infra* Part III.C.5.

104. 12 U.S.C. § 330 (1988) provides that "any bank becoming a member of the Federal reserve system shall retain its full charter and statutory rights as a State bank or trust company, and may continue to exercise all corporate powers granted it by the State in which it was created."

105. *See supra* note 82.

106. 12 C.F.R. § 208.5(a)(4)(1992).

107. 12 U.S.C. § 321 (1988).

108. 12 U.S.C. §§ 78, 377 (1988) are made applicable by the terms of these sections; § 24 is applied through § 335 and § 378 is applicable to all organizations that accept deposits subject to check, thus including state member banks.

109. *Id.* § 374a.

jurisdiction of the FDIC;[110] it also imposes some prohibitions on activities it considers inconsistent with the purposes of the Federal Deposit Insurance Act.[111]

Aside from the Glass-Steagall oriented regulatory mechanism, there are other tools in the arsenal of policy implementation. To prevent funneling of money into highly nonliquid assets, national banks are limited to those real estate activities necessary for the accommodation and transaction of its business.[112] This includes real estate acquired in collecting previously contracted debts.[113] Real estate acquired in this manner may only be held for five years. The purpose of the real estate restrictions are to "keep bank capital flowing into daily channels of commerce, to deter banks from embarking on hazardous real estate speculation and to prevent accumulation of large masses of such property."[114]

Permissible insurance activities of banks are extremely limited. Interestingly, neither the National Bank Act[115] nor Glass-Steagall[116] specifically prohibit such activities. It was merely an accepted view that national banks do not have the power to sell or underwrite insurance. The "incidental powers"[117] clause was not considered broad

110. *See supra* note 82.

111. 12 C.F.R. § 332.1 (1992) Inconsistent powers.

> A State nonmember insured bank (except a District bank) which does not have any of the powers hereinafter enumerated, or which, although it has any such power, does not exercise the same, shall not hereafter exercise, take, or assume the power: (a) To do a surety business; (b) to insure the fidelity of others; (c) to engage in insuring, guaranteeing nor certifying titles to real estate; or (d) to guarantee or become surety upon the obligations of others, except as provided in § 347.3(c)(1).

The limitations prescribed in § 332.1(d) do not include acceptances, endorsements, or letters of credit made or issued in the usual course of the banking business. 12 C.F.R. § 332.1 (1992).

> § 332.2 Exercise prohibited. After the effective date of this part, any State nonmember bank (except a District bank) becoming an insured bank shall not thereafter exercise any of the powers enumerated in § 332.1.

Id. § 332.2.

Additionally, in 12 C.F.R. Part 337, entitled "Unsafe and Unsound Banking Practices", the FDIC has imposed restrictions on the following activities: (1) issuance of standby letters of credit, *Id.* § 337.2 (1988); (2) extension of credit to executive officers, directors and principal shareholders, *Id.* § 337.3; and (3) securities activities through subsidiaries or with affiliated securities companies, *Id.* § 337.4. Finally, under 12 C.F.R. § 333.2 (1992) no change in the general character of the business is permitted without prior written approval by the FDIC.

112. 12 U.S.C. § 29 (1988).

113. *Id.*

114. First Nat'l Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 681 (5th Cir. 1983).

115. *See supra* note 33.

116. *See supra* note 63.

117. *See supra* note 101.

enough to include insurance activities.[118] Apparently Congress agreed with this view. In 1916, when Congress decided that it would be in the public interest to allow national banks in towns with populations less than 5,000 to *sell* but not underwrite insurance, it added a new section[119] to the national banking laws to enable such activity.[120] However, almost fifty years later, James J. Saxon, Comptroller of the Currency decided to be contrary.[121] He ruled that:

> Incidental to the powers vested in them under 12 U.S.C. Sections 24, 84 and 371, National Banks have the authority to act as agent in the issuance of insurance *which is incident to banking transactions.* Commissions received therefrom or service charges imposed therefor may be retained by the bank.[122] (Emphasis added.)

This ruling was not limited in scope to cities of less than 5,000 population and purported to authorize every national bank, regardless of its location, to enter the insurance agency field and to compete with insurance agents.

This ruling did not go unchallenged. An association of insurance agents brought an action for declaratory judgment to declare the comptrollers ruling unlawful and to enjoin a national bank from acting as an insurance agency in places of more than 5,000 population. The agents' association was granted summary judgment on both

---

118. The Federal Reserve Board declared that "writing insurance on commission is in no sense incidental to any of the enumerated powers of a national bank." PITT, *supra* note 102 at 573, citing 2 Fed. Res. Bull. 73, 74 (1916).

119. 12 U.S.C.A. § 92 (West 1945). Section 92 was omitted when Rev. Stat. § 5202 (to which it was added by the Act of Sept. 7, 1916, ch. 461, 39 Stat. 753) was amended in 1918. *See* Act of Apr. 5, 1918, ch. 45, § 20, 40 Stat. 512. Revisers of the United States Code in 1952 accordingly omitted the section. Nevertheless, the courts have continued to treat Section 92 as if it exists, and Congress even purported to amend it as part of the Garn-St Germain Depository Institutions Act of 1982. *See e.g.* Pub. L. No. 97-320, tit. IV, § 403(b), 96 Stat. 1469, 1511 [(1982)].

PITT, *supra* note 102, at 574 n.14.

120. The apparent purpose of this legislation was expressed as follows:

> It clearly appears, then, that 12 U.S.C. § 92 was enacted not out of a belief that there was any significant connection between banking and the sale of insurance in small communities, but merely because it was believed that banks needed an additional source of income to improve their stability and profitability. Congress thus did not indicate that the sale of insurance in small towns was part of "banking", but rather that it was an unrelated business which would provide a source of income that would then be available for use in the separate banking activities of small town national banks.

Alabama Ass'n of Ins. Agents v. Board of Governors of the Fed. Reserve Sys., 533 F.2d 224, 243 (5th Cir. 1976), *vacated in part on other grounds*, 558 F.2d 729 (5th Cir. 1977), *cert. denied*, 435 U.S. 904 (1978).

121. Letter from James J. Saxon, Comptroller of the Currency, to the Presidents of all National Banks (Feb. 18, 1963).

122. O.C.C. Ruling No. 7110 (1963).

counts.[123] The OCC, however, was not overly impressed with its defeat. When the United States National Bank of Oregon (Bank), located in Portland, Oregon, requested permission to establish an operating subsidiary in Banks, Oregon, a town with a population under 5,000, so that the Bank could sell a full range of insurance products through *branches* in Banks, Oregon, the OCC ruled that:

> Based on our analysis of the relevant legal precedent, we have concluded that [our attorney, in prior correspondence] correctly determined that a national bank or its branch which is located in a place of 5,000 or under population may sell insurance to existing and potential customers located anywhere. In other words, while the bank or bank branch must be located in a small town, it can sell insurance to persons and businesses located outside that town.[124]

Naturally the insurance agents were less than enthusiastic about this decision, foreseeing vigorous entry by national banks into insurance on a national scale. The National Association of Life Underwriters (NALU) and the Independent Insurance Agents of America, Inc. (IIAA) brought declaratory and injunctive actions to challenge the ruling.[125] The Comptroller had more success with other aspects of insurance activities of national banks. In respect to credit life insurance, he ruled that "national banks, wherever located, may [*sell* as agents] individual or group credit life coverage and charge their loan customers accordingly."[126] He was upheld in *Independent Bankers Association of America v. Heimann*[127] where the court said that credit life insurance is "a limited special type of coverage written to protect loans . . . [and] is now commonplace and essential where ordinary loans on personal security are involved,"[128] that is, it is incidental to the busi-

123. Georgia Ass'n of Independent Insurance Agents v. Saxon, 268 F. Supp. 236 (N.D. Ga. 1967), *aff'd* 399 F.2d 1010 (5th Cir. 1968). The court stated:

> In interpreting the meaning of one provision of an act it is proper that all other provisions in *pari materia* should also be considered. So, in constructing the general authority contained in Section 24(7) we must give equal consideration to Section 92 as it specifically deals with the power of national banks to act as insurance agents, and when the general language in Section 24(7) dealing with "incidental" powers is construed in conjunction with the specific grant in Section 92 it is clear that application of the *expressio unius est exclusio alterius* rule requires the construction that national banks have no power to act as insurance agents in cities of *over* 5,000 population.

Id. at 1013.

124. Comptroller Staff Interpretive Letter No. 366, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,536 (Aug. 18, 1986).

125. The Court of Appeals held that section 92 had been repealed and the Comptroller's decision was, therefore, without statutory authority. Independent Ins. Agents of America v. Clarke, 955 F.2d 731 (D.C. Cir. 1992).

126. COMPTROLLER'S DIGEST OF OPINIONS § 9420 (1960)(emphasis added) *quoted in* 41 Fed. Reg. 29,846, 29,847 (1976)(codified as amended at 12 C.F.R. Part 2).

127. 613 F.2d 1164 (D.C. Cir. 1979), *cert. denied*, 449 U.S. 823 (1980).

128. *Id.* at 1170. The court's characterization of the transaction as "loans on personal security" intimates that the court was referring to the express wording of permissible activities spelled out in 12 U.S.C. § 24 (1988 & Cum. Supp. II 1990), thus

ness of banking. The expression "written to protect loans" was taken by the Comptroller as a suggestion by the court that national banks may enter into a variety of insurance activities. He ruled that a national bank or its operating subsidiary may sell[129] or underwrite[130] title insurance in connection with mortgage loans made by them, since such insurance is "incidental to banking within the meaning of 12 U.S.C. (Seventh)"[131] because "[t]here is a close connection between mortgage lending (the express banking service) and title insurance on the mortgage loan collateral (the incidental service)."[132] Meanwhile, the Comptroller also ruled that national banks may *underwrite* credit life insurance.[133]

These prohibitions, especially the ones contained in the provisions of Glass-Steagall incorporated into 12 U.S.C. § 24,[134] have a double objective: first to achieve the policy goal of consumer protection by limiting banks to safe transactions, and second to insure the policy goal of free flow of capital. The perception was that bank involvement in nonbanking activities would prejudice credit decisions in favor of affiliated businesses.[135]

4. Restrictions on Affiliations and Geographic Expansion

Although 12 U.S.C. § 24[136] prohibits national banks and state member banks (through § 335) from owning stock in *any* corporation, both the Comptroller and the Federal Reserve Board have ruled within their respective regulatory jurisdictions that banks may create subsidiaries[137] but with an absolute limitation of activities to such as permit-

---

characterizing credit life insurance as incidental to lending money on personal security.

129. Comptroller Staff Interpretive Letter No. 368 [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,538 (July 11, 1986).

130. Comptroller Staff Interpretive Letter No. 377, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,601 (Feb. 6, 1987).

131. *Id.* at 77,901.

132. *Id.* at 77,902.

133. Comptroller Staff Interpretive Letter No. 277, [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,441, at 77, 959 (Dec. 31, 1983):

> As explained below, the underwriting or reinsurance of credit life is a logical complement to a national bank's power to sell credit life. This activity is incidental to banking under even the more restrictive interpretations of 12 U.S.C. 24(Seventh) since it is "convenient or useful in connection with the performance of one of the bank's express powers under the National Bank Act," specifically the express power to lend money. *M & M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977).

Limits on BHC insurance activities discussed *infra* note 283 and accompanying text.

134. *See supra* note 101.

135. *See supra* note 74.

136. 12 U.S.C. § 24 (Seventh)(1988 & Cum. Supp. 1990).

137. 12 C.F.R. §§ 5.34 and 225.22(d)(1992) respectively.

ted their parents.[138] To prevent circumvention of the prohibited securities activities of § 24,[139] §§ 377, 378 and 78[140] prohibit any affiliation or interlocking personnel between entities considered to be banks and entities which by nature are securities dealers or investment bankers. The long and short of these sections is to keep the twain apart, each to its own turf.[141]

The fear of concentration of economic power[142] which may lead to political power impelled not only the above-mentioned product limitations but also the imposition of geographic restrictions. Sections 36 and 81 generally prohibit national banks and state member banks from establishing branches outside of the bank's home state, and permit intrastate branch banking only to the extent that state law permits the creation of branches to its own banks. Two policy goals are to be implemented by these geographic restrictions: (1) safety and soundness and (2) credit allocation. Because strong competition could cause failure of smaller or weaker banks, limiting entry of competitors would reduce such risks. As to the credit allocation aspects, the Supreme Court said that geographic restrictions "preserve a close relationship between those in the community who need credit and those who provide credit."[143] The perception existed that with free interstate banking, depositors' money would be channelled to the large money centers and local businesses would not have sources of credit.

5. *Lending and Borrowing Limitations*

To further bolster the availability of credit to large numbers of borrowers and maintain safety for depositors, the geographic restrictions are supplemented by limitations on lending power. A national bank may make unsecured loans of no more than fifteen percent of its unimpaired capital stock and surplus to any one person,[144] with an additional ten percent if the loan is secured by readily marketable collateral having a market value at least equal to the amount of funds

138. *Id.* at §§ 5.34(d)(2)(i) and 225.22(d)(2)(ii).
139. 12 U.S.C. § 24 (1988 & Cum. Supp. II 1990).
140. 12 U.S.C. §§ 377, 378, 78 (1988).
141. Indeed, this is the burning issue to which Congress is presently devoting a great deal of attention. CEBA is but one example. Pub. L. No. 100-86, 101 Stat. 552 (1987).
142. *See supra* note 28 and accompanying text. This draws attention to the fact that the Jacksonian view of keeping banks decentralized is still alive as seen in 12 U.S.C. §§ 36 and 81. Section 36 is derived from the National Bank Act of 1865, ch. 78, § 7, 13 Stat. 484 and § 81 is derived from the National Bank Act of 1864, ch. 106, § 8, 13 Stat. 101, both as amended by the McFadden Act of 1927, 44 Stat. 1224 (1927)(codified as amended in scattered sections of 12 U.S.C.). Also see Northeast Bancorp, Inc. v. Board of Governors, 472 U.S. 159, 177 (1985) where the Court said that "our country traditionally has favored widely dispersed control of banking."
143. Northeast Bancrop, Inc. v. Board of Governors, 472 U.S. 159, 178 (1985).
144. 12 U.S.C. § 84(a)(1)(1988).

outstanding.[145] The Comptroller of the Currency explains that these limitations are "intended to prevent one individual or a relatively small group, from borrowing an unduly large amount of the bank's funds. It is also intended to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different lines of business."[146]

The Garn-St Germain Act[147] repealed[148] 12 U.S.C. § 82 which limited the amount of money a national bank could borrow. Prior to the repeal of § 82, the apparent assumption of the drafters was that bank solvency would be strengthened if a bank could not be "indebted . . . to an amount exceeding the amount of its capital stock . . . plus 50 percent of the amount of its unimpaired surplus fund."[149] However the present view is that borrowing should be limited by principles of safety and soundness, which can be monitored by the regulatory agencies.

IV. REGULATION OF THE INSURANCE INDUSTRY

A. The Nature of Regulation

In contradistinction to the dual system of bank regulation, insurance is regulated almost exclusively by the states.[150] Regulation, how-

145. *Id.* at § 84(a)(2).

146. 12 C.F.R. § 32.1 (1992). The term "person" is defined at 12 U.S.C. § 84(b)(2)(1988) and "capital" is defined at 12 C.F.R. § 3.2 (1992).

147. Garn-St Germain Act, Pub. L. No. 97-320, 96 Stat. 1469 (codified as amended in scattered sections of 12 U.S.C.).

148. *Id.* at 1510, title IV, § 402.

149. 12 U.S.C. § 82 (1976).

150. Paul v. Virginia, 75 U.S. 168 (1868) held that the business of insurance is not commerce and therefore not subject to Congressional jurisdiction under the Commerce Clause. U.S. CONST., art. I, § 8 cl. 3. Thus, regulation of insurance companies was reserved to the states. However, in United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944), the Court overruled *Paul v. Virginia*. Congress quickly reacted to this decision and a year later passed the McCarran-Ferguson Act, Pub. L. No. 79-15, 59 Stat. 34 (codified at 15 U.S.C. §§ 1011-15 (1988)). Sections 1 and 2 state as follows:

> Section 1:
> Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.
> Section 2:
> (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.
> (b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Pro-*

ever, came slowly. Prior to 1865 the number of insurance companies and the assets they controlled were small. There was no pressure on legislatures to remedy abuses of insurers. However, after the Civil War, with the new American prosperity, the insurance industry began growing rapidly.[151] But with this growth came many unsound insurance practices. Unreasonably large amounts of money were being spent—and misspent—by various insurance companies on salaries, commissions, dividends, and lobbying activities. After paying premiums for years, many insureds found their companies bankrupt, undercapitalized, or non-existent. Something had to be done to regulate the insurance business and to protect the insured policyholders from many of these abuses.

The New York Armstrong Committee Investigation of 1906, under the counsel of Charles Evans Hughes, dramatically, factually, and impartially exposed various unsavory practices among life insurance companies. The investigation resulted in radical state legislation, both in New York and elsewhere, designed to regulate the life insurance industry. Today, the business of insurance is subject to regulation by the various states and their administrative agencies, due in large part to the findings of the Armstrong Committee. Since the goals of insurance regulation[152] are the same as the goals of bank regulation, solvency and protection of the consumer, there are strong similarities between insurance and bank regulatory measures.[153] However, the extensive variety of insurance policies compels additional regulation relative to standard forms (*e.g.* fire policies) and rate making procedures.

After World War II there was a tremendous surge in life insurance

---

vided, That after January 1, 1948, [the Sherman Act of 1890, the Clayton Act of 1914, and the Federal Trade Commission Act of 1914] shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

151. Whereas in 1850 there were only 48 companies with assets of $4.7 million, by 1870 there were 129 companies with assets of $2.0 billion.

152. It is the continued financial ability of the insurer to fulfill its side of the bargain that generates the value of insurance to the policyholder. Continued financial ability is . . . neither self-regulating nor within the practical power of the individual policyholder to ascertain or enforce. Its ascertainment and enforcement must be conducted by government to assure the integrity of the insurance transaction itself.

State of New York, Insurance Department, *Regulation of Financial Condition of Insurance Companies*, 3, (March 1974), *quoted in* Dunne, *supra* note 6 at 349.

[T]he fading of traditional lines between bank, insurance, securities, and real estate activities may hold benefits for consumers. On the other hand, they could have serious negative effects on consumers, including insurance policyholders, and the efficacy of existing regulation.

Bruce Fondree, *NAIC Wary on Financial Controls*, NAT'L UNDERWRITER, May 20, 1983, at 39.

153. For example, both require minimum capital requirements, reserve requirements, and licensing and both place limitations on investments.

sales[154] as well as in other insurance sales.[155] Furthermore, inflationary pressures[156] forced the creation of innovative and competitive insurance products, such as universal life policies, variable annuities, single premium annuities and other variations. These events brought about a radical change in the composition of insurance company portfolios and also compounded the difficulties of insurance regulators in the quality of their supervisory functions.

B. Items of Regulation[157]

1. Entry and Capital Requirements

Insurance companies are creatures of the state. The state insurance department issues charters subject to certain capital minimums which are required to be recorded partly as capital stock and partly as paid-in surplus.[158]

2. Reserves

a. Property and Liability Insurance

Property and liability insurance companies must maintain two types of reserves: unearned premium reserves and loss reserves. The former is the unearned portion of *gross*[159] premiums of all outstand-

154. By 1955 there were some 1100 life insurance companies with assets of 372 billion, and by 1981 there were almost 2000 life insurance companies with assets in excess of four trillion dollars! Compare these figures with those in *supra* note 151.

155. By 1982 there were almost 3000 property-liability insurance companies with assets of $212 billion.

156. The classic life insurance policy no longer was an attractive investment.

157. This section discusses only those items which are relevant to and have an impact upon the main focus of this study: the solvency of the institution and the safety of the consumer's money. *See supra* notes 4-9 and accompanying text.

158. For example, assume that state X requires $3 million initial minimum capitalization with $1 million assigned to capital stock account and $2 million to paid-in surplus. Because mutual companies have no capital stock, the full minimum capital is credited to the paid-in surplus account.

159. For example, assume a $240 semi-annual premium on an auto liability policy. The agent's commission would be $48 and other overhead expenses approximately $10. The unearned premium reserve at the inception of this policy would be the full $240. The $58 deficiency would be "drawn" from the paid-in surplus account, along with the loss reserves. The unearned premium reserve decreases with the passage of each month. Thus, the cash flow of the insurer, at the inception of a new policy, is less than the reserve requirement. As a result:

> [i]f new business increases quickly enough, it is conceivable that the insurer could become insolvent because of the exhaustion of surplus and the resultant impairment of its capital or reserve account. Of course, long before such impairment would be allowed, the insurer would stop writing more business. This point was reached in the United States immediately following World War II. Many insurers legally were "sold out" of insurance; they had written as much new business as possible without reducing their surplus accounts to dangerously low levels. Un-

ing policies at the time of valuation. The latter is the insurer's estimate of future claims and related expenses which is computed by formula or loss ratio methods. Commentators indicate that these methods are poor indicators of future liabilities. There is hardly a mathematical way to *predict* disasters or unforseen events.

b. Life Insurance

In life insurance the predictability of future losses (*i.e.* deaths) does not involve the same risk of variance from period to period. Therefore loss reserves, like the premiums charged for the policies, are based on mortality tables. Barring any external events such as large losses on investment, fraud, or embezzlement, the normal flow of premiums which are normally invested in income producing assets should provide the proper cushion for payment of claims. The premiums during the earlier years of the policy are greater than the actuarial mortality claim projection, and less in the later years.

3. Examination, Valuation of Assets and Liabilities and Investments

If the fox could be appointed to guard the chicken coop, then insurers could be relied upon to maintain adequate reserves without external supervision. However, such is not the case. State insurance departments conduct examinations to ascertain the solvency of insurers doing business within the state. An insurer is solvent when its *admitted* assets[160] exceed its liabilities. This excess is the statutory policyholders' surplus.[161] Since the largest liability of an insurer is its reserves, an examination and valuation of the assets amounts to a valuation of its reserves.

To further promote the solvency of insurance companies, the statutory provisions for allowable admitted assets places both qualitative

---

less able to attract new capital (generally not a viable solution), they were forced to discontinue writing new insurance or became overly selective in underwriting. Only the most profitable business was accepted, and the less profitable was left uninsured. This feature of the postwar insurance scene, the "capacity problem," has been one of the most widely discussed issues in property and liability insurance.

ROBERT J. MEHR AND EMERSON CAMMACK, PRINCIPLES OF INSURANCE, 687 (1976).

160. The term "admitted assets" is *sui generis* to the insurance industry. State law specifies which assets are admitted assets, the only assets counted in determining the excess of assets over liabilities. In addition, to qualify as "admitted," the assets must truly be under the control of the insurer. Thus, if an otherwise qualified admitted asset were pledged as security for the debt of a parent company, especially a non-insurer parent, the issue would arise as to whether this asset could be counted as an admitted asset in determining the statutory solvency requirements.

161. This surplus consists of the original capital (*see supra* note 158) and accumulated, undistributed profits. In the world of finance it is referred to as equity.

and quantitative restrictions on the kind of investments insurers may make. There are, of course, variations from state to state, but generally the qualitative restrictions limit the portfolio to high grade bonds, mortgages, preferred and common stock and a very limited amount of real estate investment. The quantitative limitations refer to percentages of admitted assets that may be invested in a single corporation and the percentage of the corporation's stock that may be held by the insurer.[162]

4. Rate Making

An additional tool of indirectly promoting the solvency of insurance companies is the supervision of rates charged on insurance policies. Cutthroat competition could undermine the stability and safety of insurers (especially the smaller ones) and could lead to chaotic disasters affecting numerous policyholders.[163] On the other hand, "cooperation" among insurers to set rates might lead to excessive rates leading to bilking the public. To deal with both horns of this dilemma, the New York legislature in 1911 and the National Association of Insurance Commissioners (NAIC) in 1914 investigated the problem and recommended supervised rate making. All states have now passed some form of rate legislation, though such legislation is *not* uniform throughout the United States. However, the goals of these statutes *are* uniform: to achieve rates which are adequate,[164] not excessive[165] and not discriminatory.[166]

---

162. For example, the investment in the securities of a single issue may not exceed five percent of the insurer's total admitted assets *and* may not exceed two percent of the issuer's security. Generally there are no quantitative limitations as to investments in Government and state securities.

163. During the latter half of the 19th century large cyclical losses caused the collapse of many insurers.

164. To yield a reasonable profit in light of past and future (projected) losses.

165. To prevent premiums which are too high.

166. Reasonable classification is permitted and, therefore, certain preferred risks might be insured at lower rates than standard risks. The Virginia statute, VA. CODE ANN. § 38.2-1900 (Michie 1990 Repl. Vol.), expresses the public policy behind its rate making provisions as follows:

> PURPOSES OF CHAPTER. [Ch. 19] A. This chapter shall be liberally construed to achieve the purposes stated in subsection B of this section.
> B. The purposes of this chapter are to:
> 1. Protect policyholders and the public against the adverse effects of excessive, inadequate or unfairly discriminatory rates;
> 2. Encourage independent action by insurers and reasonable price competition among insurers as the most effective way to produce rates that conform to the standards of subdivision 1;
> 3. Provide formal regulatory controls for use if independent action and price competition fail;
> 4. Authorize cooperative action among insurers in the rate making process, and regulate such cooperation in order to prevent practices that tend to create monopoly or to lessen or destroy competition;

Rate making is an extremely complex and beyond the scope of this paper.[167] Suffice it to say that life insurance is not subject to rate making since the reserve requirements necessarily set the premium requirements.[168] The rates of property and liability insurance and workman's compensation, however, are frequently regulated.[169]

C. Insurance Holding Companies

The 1960s witnessed a sharp decline in the profits of insurance companies creating an impetus to seek additional ways to employ large pools of liquid funds. Life insurers experienced a drop in earnings because of long term inflation which became acute in 1963. Inflation made investment in life insurance less attractive and quickened public investment in higher yielding equity instruments. Furthermore, the conservative investments of life insurers required by law produced a lower return than portfolios of non-insurers. Property and liability insurers faced a rapid rise of replacement costs and rising damage judgments which could not be matched by increases in premium rates. As a result, their loss ratios rose steadily.[170]

Finally, the emergence of "one stop" financial service entities[171]

---

5. Provide rates that are responsive to competitive market conditions and improve the availability of insurance in this Commonwealth; and
6. Regulate the business of insurance in a manner that will preclude application of federal antitrust laws.

167. Some states require property and liability insurers to belong to rating bureaus and file rates based on the bureaus' published rates; other states, although permitting bureaus, allow insurers to file independently of the bureaus. Some states follow the "prior approval" method (the rates filed become effective after 15 days of the filing date, unless disapproved within that period), other states follow the "file and use" approach, wherein the filed rates become effective immediately, subject to disapproval within a statutory period. Some states have "use and file" statutes, permitting the use of new rates with filing later (within a statutory period). Still other states have no filing requirements at all (pure *laissez-faire*), whereas others prohibit rating bureaus. For a more complete discussion of rate regulation, see 19 JOHN APPLEMAN, INSURANCE LAW AND PRACTICE §§ 10491-96 (1982) and ROBERT E. KEETON, INSURANCE LAW 557-567 (1971). *See generally* JOHN G. DAY, ECONOMIC REGULATION OF INSURANCE IN THE UNITED STATES 20-30 (1970) and Spencer L. Kimball & Ronald N. Boyce, *The Adequacy of State Insurance Rate Regulation: The McCarran-Ferguson Act in Historical Perspective*, 56 MICH. L. REV. 545 (1957).

168. *See supra* part IV.B.2b.

169. Regulation and licensing of insurance agents and brokers, financial reporting requirements, requirements of standard contracts (or standard clauses in contracts) or forms and classification regulations are not discussed herein.

170. To add to their woes they incurred heavy losses during the civil disturbances and riots of the 1960s.

171. For example, Sears Roebuck owns Allstate Insurance, Dean Witter Securities, Allstate Savings and Loan Association and Greenwood Trust and Bank which handles the Discover credit card; American Express owned Firemans Fund Insurance Company and Shearson-Lehman; Merrill Lynch created the CMA account, has a major interest in Insurance Systems Unlimited and owns the Family

worsened the competitive status of insurers and impelled the search for activities that would more fully and profitably utilize

> "[t]he management expertise and specialized knowledge required for effective insurer operation in such fields of investments, engineering, and electronic data processing as are needed in related financial businesses . . . . It seems apparent that the prospect of higher earnings through diversification would secure better access to the capital markets by insurers and would help to insulate them against 'take overs,' while facilitating insurer acquisition of other businesses.[172]

However, most states prohibit insurers from pursuing other business activities and place strict limitations on their investment portfolios.[173] Additionally insurers may issue only a single class of common stock and no senior securities. To overcome these regulatory handicaps, insurance company management looked to the holding company structure to supplement underwriting and investment income by diversifying activities and gaining better access to capital markets. Many insurers formed "upstream"[174] holding companies transferring surplus funds[175] to the newly created parent. The parent then invested these funds in a variety of businesses and avoided the regulatory prohibition against diversification. Since the holding company was not an insurance company it, was beyond the jurisdiction of the regulators.[176] Similarly, the limitations on an insurer's portfolio in-

---

Life Insurance Company; Bank America owned discount broker Charles Schwab and Company; Prudential Insurance Company owns the Capital City Bank of Hapeville, Georgia and Bache Securities. The list could continue.

172. *Report of the Industry Advisory Committee to the (D1) Subcommittee of the NAIC on Holding Company Legislation*, 1 PROCEEDINGS OF THE NAIC, 177 (1969), (hereinafter 1969 Advisory Committee).

173. *See supra* part IV.B.3.

174. The normal procedure would be for the insurer to organize a subsidiary holding company. The stock of the insurer is then exchanged for the stock of the holding company and the holding company becomes the parent of the insurer. It is then necessary for the insurer to declare a substantial dividend to the holding company to finance the expansion into new fields.

Milton S. Wolke, Jr., *Insurance Companies as Parents and Subsidiaries*, SECTION OF INSURANCE, NEGLIGENCE AND COMPENSATION LAW, 167, 168 (1970).

175. Funds in excess of reserve requirements referred to as "surplus surplus." Many large insurance companies accumulated assets, generally liquid assets, well in excess of minimum reserve requirements.

176. Since 1965 the movement toward formation of holding companies has been an outstanding feature in insurance company history. Over half of the major property and casualty companies as well as the bulk of the larger life insurance companies have restructured their corporate form of organization to place their operating companies under holding company ownership. In conjunction with these moves or shortly after the formation of the holding companies, steps have been taken to bring in other subsidiaries in the field of financial services related to or ancillary to the insurance business. For example, both Life Insurance Company of Virginia and St. Paul Fire and Marine Insurance Company brought title insurance companies under their newly formed holding companies.

vestment[177] were bypassed because the holding company could invest in common stocks without restriction. Again, the non-insurer parent could issue a variety of securities (different classes of common stock, preferred stock, debt, convertible or nonconvertible, etc.) with distinct advantages over the restricted types[178] that the operating insurance company was permitted to issue.

Other insurers formed "downstream" holding companies:

> An alternative to the exchange approach is to have the insurance operations of the insurer transferred to a subsidiary and to convert the insurer into a general business corporation. This way, no dividend is necessary, and the stockholders do not have to approve a plan of exchange with a newly organized (and usually thinly capitalized) holding company. However, it will be necessary, of course, to obtain stockholder approval of the conversion.[179]

The holding company movement was not restricted to these upstream and downstream devices. The large liquid asset holdings of the insurance industry suddenly drew the attention of the conglomerate fraternity. Rapid takeovers of insurers resulted.[180] One commentator cites the following reasons for the rash of insurance company takeovers by the conglomerates:

> 1. The subnormal underwriting results of the property and casualty insurance companies as a group during recent years caused the stocks of most of these companies to sink to record lows early this year. Prices were depressed both in relation to earnings and in relation to estimated liquidating values. Even such highly regarded companies as Hartford Fire Insurance Company, Insurance Company of North America and United States Fidelity and Guaranty sank below the value of their capital and surplus, let alone their total liquidating values which would attribute some extra amount for the value of unearned premium reserves.
>
> 2. At the same time the stocks of many of the conglomerates had risen to exceptionally high levels in relation to their earnings and book values.
>
> 3. With this set of valuations—extremely low for the insurance companies and fantastically high for the conglomerates—it was possible for the latter to try to acquire the sound investment values of the insurance companies, using

---

> And it didn't take the CNA Financial Corporation long to add the Tsai Management Corporation and General Finance Corporation to its principal subsidiaries which include Continental Casualty Company, Continental Assurance Company and National Fire Insurance Company of Hartford.

William W. Amos, *The Merger Movement in the Insurance Industry*, FEDERATION OF INS. COUNSEL Q., Winter 1968-69, 11, 12.

177. *See supra* note 162 and accompanying text.

178. Generally only common stock of one class.

179. Wolke, *supra* note 174, at 167-68. Additional advantages afforded by the holding company structure include more liberal accounting methods, repurchase of capital stock in the open market and merchandising superiority. *See* Amos, *supra* note 176.

180. Although conglomerate *general* take-over activity reached feverish heights by the early 1960s, it was not till 1968 that take over bids were made to large *insurer* groups, such as Reliance Insurance, Fund American Companies, Great American Holding Corporation and Home Insurance. *See* Amos, *supra* note 176, at 14.

the cheap money of the conglomerates' stock.[181]

The acquiring conglomerate could then sell off the portfolio of the acquired insurer (which was carried on the books of the insurer at low original acquisition cost) at current high market prices, realizing huge profits. These profits would be included in the overall earnings of the conglomerate which, when applied to the high price earnings multiple of the conglomerate, would further increase the market price of the conglomerate stock.[182] Thus, insurance holding companies[183] emerged in large numbers placing great strain on the insurance regulatory system. State insurance laws were designed to control and regulate insurance companies, not holding companies whose members could be—and often were—non-insurers. The regulators needed statutory means to protect policyholders by supervising the financial conditions of the insurance companies, despite the layers of ownership and the diversification of activities. The National Association of Insurance Commissioners (NAIC) reacted to these new conditions by establishing a committee[184] to "propose to the NAIC such legislation as the states should enact and such regulatory procedures as the Insurance Commissioners should adopt in order to assure adequate and proper supervision of insurers in their relationships with holding companies."[185] After many discussions, reports, drafts and debates, the NAIC adopted the Model Insurance Holding Company Systems Regulatory Act of 1969 (the Model Act), the goals and policies of which are:

(1) to maintain the solvency of insurance companies by policing takeovers of

181. Amos, *supra* note 176, at 14.

182. For a humorous and instructive description of the "pooling" method of accounting for mergers and acquisitions, see JAMES D. COX, FINANCIAL INFORMATION, ACCOUNTING AND THE LAW, 744-47 (1986).

183. An "insurance holding company" is defined as "consist[ing] of two (2) or more affiliated persons, one or more of which is an insurer." NAIC, *Insurance Holding Company System Regulatory Act*, in 2 NAIC MODEL INSURANCE LAWS, REGULATIONS AND GUIDELINES § 1D (1992)[hereafter MODEL ACT].

184. *See supra* note 172.

185. 1969 Advisory Committee, *supra* note 172, at 175. The Committee, after lengthy study, submitted the following conclusions and objectives:

> 1. Holding companies serve a beneficial, valid and legitimate function in the insurance industry.
> 2. There should be an effective and comprehensive state supervision of insurers in their relationship with holding companies in order to protect their financial integrity.
> 3. The most effective regulatory system is one premised on disclosure and regulation of significant intra-system transactions involving the insurer, and verification by examination when necessary.
> 4. To prevent shifting of assets from an insurer to other affiliates (whether parent, subsidiary or other) disclosure of dividends and distributions need be required.
> 5. The domiciliary state should bear the primary responsibility for regulation of the insurer in its relationship and transactions with insurance holding company systems.

Id. at 181-83.

> insurers and extraordinary distributions by insurers to the holding company parent or to noninsurance affiliates; (2) to protect policyholders by continuing intensive supervision of the adequacy of insurance companies' surplus; (3) to provide standards to assure that intrasystem transactions involving insurers are fair and reasonable; (4) to encourage domiciliary states to continue their established role as the primary regulators of the insurance industry by giving them full responsibility for regulation of insurers within an insurance holding company system; and (5) to predicate regulatory activities on the principles of registration, disclosure, and prior approval of certain transactions (*e.g.* extraordinary dividends and distributions) and relationships impacting an insurer.[186]

Underlying the provisions of the Act was the belief that although the potential for "milking" of insurance company assets by affiliates (especially parent holding companies) was a valid concern, the problem could be effectively regulated.[187] Furthermore, to protect policyholders[188] and maintain insurer solvency the NAIC placed its reliance on the effectiveness of domiciliary states to adequately regulate its insurers.[189] A reading of the Model Act would seem to indicate that the safety of the insurer and policyholder could be achieved through its provisions.[190] A comprehensive analysis of the Model Act is not within the scope of this paper, however, a description of its structure is necessary, along with the foregoing explanation of banking regulatory law, in order to understand some of the problems inherent in the questions posed by this study.[191]

---

186. *Report of the Industry Advisory Committee on Model Insurance Holding Company Legislation to the Insurance Holding Companies (B1) Subcommittee*, 1 NAIC PROCEEDINGS 213, 221 (1978).

187. *Id.* at 222.

188. Protection of insurance company stockholders was not a concern of the Model Act.

189. *See supra* note 186, at 222.

190. The error of this conclusion surfaced years later when Baldwin-United collapsed. *See infra* note 198 and accompanying text.

191. The act is divided into several sections, each of which focuses on a particular aspect of the relationship between the insurer and other members of the insurance holding company system and specifies how that particular aspect will be regulated.

After defining key terms, such as "affiliate" and "insurance holding company system," in Section 1, the act goes on in Section 2 to deal with downstream diversification by insurers. Section 2(a) enumerates types of businesses in which subsidiaries of insurers may engage, including investment management, data processing, and accounting. The ultimate determination as to the scope of the activities in which an insurers' subsidiaries may permissibly engage is left to each domiciliary state.

Section 2(b) allows a domestic insurer additional investment authority beyond that permitted under the insurance code, so that it can, for example, invest in the stock, debt obligations, and other securities of its subsidiaries up to certain percentage limits. However, an individual state can modify the liberalized investment approach so that insurers' investment activity continues to conform to that state's public policy. . . .

Section 3 of the act provides protections against detrimental takeovers of insurance companies by regulating mergers with, and acquisi-

In response to the Model Act, the vast majority of states have passed comparable legislation. Most have adopted crucial registration requirements and prior approval requirements for certain transactions such as dividend payments to affiliates and prior approval requirement of mergers, acquisitions and takeovers. A few states imposed only part of the regulation proposed by the Model Act. Portions of the statutes did not go unchallenged,[192] but, in the main, the statutes were

---

tions of, domestic insurers. Persons who propose to acquire or merge with a domestic insurer are required, under subsections (a), (b), and (c), to file a statement with the commissioner, disclosing the principal acquiring parties; giving certain financial and other information about them; describing their plans, agreements, and activities concerning the proposed takeover; and including any other information the commissioner may request. Section 3(d) provides that all takeovers are subject to prior approval by the commissioner, after a public hearing, which hearing is optional with the commissioner. Section 3(d)(1) lists the several grounds upon which any denial of such approval must be based, *e.g.* a finding by the commissioner that the proposed takeover might lead to the insurer's insolvency or undercut policyholders' interests. . . .

Registration requirements for insurers are delineated in Section 4. Under subsection (a), all authorized insurers that are members of insurance holding company systems must register with the commissioner, unless they are foreign insurers that are subject to substantially similar requirements in their domiciliary states. Section 1 of the act indicates, through its definitions of "affiliate," "control," "person," and "insurance holding company system," that 10% stock ownership of an insurer by another person (or 10% stock ownership of another person by an insurer) creates a rebuttable presumption of the insurer's membership in an insurance holding company system. Section 4(b) states that the registration statement shall contain current information about the financial condition of the insurer, and about certain specified relationships and transactions between the insurer and its affiliates. . . .

Section 5 contains the provisions applicable to material transactions, dividends and distributions. There are standards provided in Section 5(a) for evaluation of material transactions between insurers and their affiliates and, in Section 5(b), for evaluation of adequacy of surplus. Section 5(c) provides a prior approval procedure for extraordinary dividends and other distributions. . . .

Sections 6(a) and (b) confer upon the domestic commissioner the power to conduct an examination of any insurer where it is necessary to ascertain the financial condition or legality of conduct of that insurer in order to protect the interests of policyholders.

Report of the Industry Advisory Committee on Model Insurance Holding Company Legislation to the Insurance Holding Companies (B1) Subcommittees, *supra* note 186, at 222-23.

192. Some courts held takeover provisions in violation of the Commerce Clause and the Williams Act, 15 U.S.C. § 78m(d), (e) & 78n(d)(t)(1982); *e.g.*, Edgar v. Mite 457 U.S. 624 (1982), (examining the Illinois Business Take-Over Act); Terry v. Yamashita, 643 F. Supp. 161 (D. Hawaii 1986), (examining the Hawaii Control Share Acquisition statute). Other courts found violations of the Commerce Clause: *e.g.*, Martin-Marietta Corp. v. Bendix Corp., 690 F.2d 558 (6th Cir. 1982)(examining the Michigan Take-Over Offers Act); Icahn v. Blunt, 612 F. Supp. 1400 (W.D. Mo. 1985)(examining the Missouri Control Share Acquisition Act); Sharon Steel Corp. v. Whaland, 466 A.2d 919 (N.H. 1983)(examining the New Hampshire Security Takeover Disclosure Act). Other courts held the take-

accepted by the industry. The statutes were made applicable to any affiliate[193] that was in control of or controlled by another insurer, a corporation, a partnership, any other entity or an individual. However, the realization that changing events and conditions require adjustment and modification to current laws persuaded the NAIC to undertake a thorough review of the Model Act.

The first review was prompted by the Equity Funding Corporation of America fiasco.[194] The frightening and dismaying aspect of this scandal is that apparently a large financial organization was able to

---

over statute in violation of the Williams Act: *e.g.*, Gunter v. AGO Int'l B.V., 533 F. Supp. 86 (N.D. Fla. 1981)(examining the Florida Insurance Holding Company Act). However, some courts upheld takeover statutes: *e.g.*, John Alden Life Ins. Co. v. Woods, Fed. Sec. L. Rep. (CCH) ¶ 98,617 (D. Idaho 1981), (examining the Idaho Acquisitions of Control and Insurance Holding Company Systems Act); Professional Investors Life Ins. Co. v. Rousall, 528 F. Supp. 391 (D. Kansas 1981), (examining the Kansas Insurance Holding Company Act); L. P. Acquisition Co. v. Tyson, 772 F.2d 201 (6th Cir. 1985)(examining the Michigan Take-Over Offers Act).

193. Defined in Section 1(A) of the Model Act (*see supra* note 183) as follows: "[a]n 'affiliate' of, or person 'affiliated' with, a specific person, is a person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified."

194. Equity Funding was a holding company with several life insurance company subsidiaries. Early in 1973 Equity Funding was linked to rumors about its financial condition and questions concerning "certain" operations. Based on these rumors the Illinois Insurance Department conducted a surprise audit on Equity Funding Life Insurance Company and discovered that 60,000 fake life insurance policies were issued, then sold for cash to other insurance companies that do a reinsurance business, and that $24 million in bonds that were supposed to be on deposit at American National Bank & Trust Company were nonexistent. These discoveries triggered investigations by the insurance departments of California, Massachusetts, Mississippi, Ohio, Pennsylvania and New York. Eventually the FBI also entered the picture and uncovered a massive counterfeit securities operation involving as much as $100 million in bogus securities printed by printing subsidiaries of Equity Funding. These bogus securities were then counted as part of Equity assets (inflating the net worth of Equity Funding and consequently inflating its stock market price). An officer of Bankers National Life Insurance Company (another life insurance subsidiary of Equity Funding) stated that he was repeatedly asked by Equity Funding officials to illegally transfer Bankers National assets to the parent company. The California insurance department charged that two-thirds of insurance in force, $2 billion out of $3 billion, claimed by Equity Life was bogus and that bogus loans were issued to the phantom policyholders. The Massachusetts Commissioner stated that out of 4200 life insurance policies claimed to have been sold in the state his department could account for only 700. The California commissioner's office strongly criticized the First National City Bank for relinquishing stock certificates of Northern Life Insurance Company, another Equity subsidiary, held as loan collateral, during the week prior to disclosure of the scandal, upon the urging of an Equity Funding officer. The scandal triggered dozens of civil and criminal lawsuits involving major brokerage firms, banks, other financial institutions, national accounting firms, security analysts and executives of various Equity affiliates. For the sake of completeness, I might add that Equity Funding Corporation was reorganized in

deceive the Securities Exchange Commission, the New York Stock Exchange, the banking regulatory entities, state insurance authorities, accounting firms and security analysts. Such a spectre exposes the weaknesses inherent in regulating the types of computer operations which had played a substantial role[195] in perpetrating the fraud.

After lengthy deliberations, the NAIC (B1) Task Force to Consider Insurance Holding Company Legislation submitted its report to the Insurance Holding Companies (B1) Subcommittee, with the recommendation that eight key provisions[196] in the Model Act be amended. Notwithstanding the Equity Funding scandal, the Committee came to the conclusion that no amendments were needed.[197] It took another

---

bankruptcy proceedings and several of the insurance company affiliates were rehabilitated under state insurance regulatory proceedings.

195. A system of computer codes was programmed to manufacture $120 million of fictitious assets and to create about 60,000 bogus life insurance policies for nonexistent persons and to handle phantom death benefits and nonexistent policy lapses. The California and Illinois insurance commissioners stated that it is impossible to protect the public with the antiquated methods of audit available to state insurance regulatory bodies and that the fraudulent practices of Equity Funding would not have been detected except for rumored irregularities and the resulting surprise audits ordered by both states. The information in notes 194 and 195 was obtained from numerous articles in the *New York Times* and *Wall Street Journal* which appeared during 1973.

196. The eight items concerned dividends and distributions, the surplus test, the materiality test (for disclosure of "material" transactions), the solvency test, independent directorships, and several matters relating to investigations and state reciprocity. *Report of the NAIC Task Force on Model Insurance Holding Company Legislation*, 1 NAIC PROCEEDINGS 215 (1978).

197. As to the committee's objectives, the committee was appointed to comment on the report of the NAIC (B1) Task Force to Consider Insurance Holding Company Legislation. The task force reviewed the Model Insurance Company System Regulatory Act first issued in 1969 by the NAIC, under cover of a letter from the then Director of the Nebraska Department of Insurance, Mr. E. Benjamin Nelson, the task force issued its report on October 26, 1976. The task force considered several proposals to amend the act, which are the eight specific areas covered in our committee paper.

The advisory committee took a new look at the Holding Company Act. Essentially, the committee decided that after nearly ten years of experience it was time to see whether a major overhaul of the act and the regulatory principles affecting insurance holding companies were in order. The committee considered the 1968 report of the industry advisory committee on this same subject. As the committee deliberated, it was mindful that in 1977, even more than in 1967-68, the insurance industry has a very direct interest in the enhancement of the regulatory system in view of the guarantee laws almost universally applicable to casualty property companies, and rapidly becoming so for the life companies.

As to the committee's conclusions, the essential conclusion was that the act does not require a major change. It provides the commissioners with the regulatory powers they need and the insurance industry with the flexibility it needs.

The committee endorsed the NAIC's 1967-69 positive attitude to-

disaster, the Baldwin-United collapse,[198] to motivate the regulators to

> wards insurance holding companies and again concluded that insurance holding companies can be effectively regulated. The committee believes the act does promote effective state regulation of the insurance holding company system through extensive registration, disclosure and prior approval mechanisms.

Id. at 216.

198. Baldwin-United began as the Baldwin Piano Co. in 1862. One hundred years later it was transformed into a financial conglomerate. This metamorphosis was born out of the economic changes then occurring in the United States. The high inflation of the 1960s and 1970s caused the public to feel that savings were being diluted. Additionally, the income tax "bracket creep" pushed people into higher and higher tax brackets motivating them to seek havens where their money would receive the highest returns and simultaneously shelter their income from the ravenous tax collector. New, high yielding financial instruments were being created by various investment industries resulting in a flood of disintermediation of bank deposits into these new vehicles of wealth accumulation. Not to be left out in the cold, insurance companies devised new products in order to garner some of this "hot money". Universal Life and variable life products such as variable annuities were among the new creations. However, a product which had been in existence for some time, but not previously "pushed", developed into the greatest tap to the ocean of tax shelter seeking funds—the Single Premium Deferred Annuity (SPDA). Enter Morley P. Thompson, president and chief executive officer of D.H. Baldwin Co., a subsidiary of Baldwin-United, a brilliant innovator and corporations intermingler par excellence who masterminded the most complicated conglomerate that ever bedazzled (and then duped and confused) the moneyed tycoons of Wall Street. Prior to its collapse Baldwin-United consisted of almost 500 separate business entities, including banks, savings and loans, mortgage bankers, real estate firms, twenty-two property and casualty insurers, fifteen life and annuity underwriters as well as numerous non-financial entities.

> In terms of surface complexity the events that have come under the [bankruptcy examiner's] scrutiny could hardly be matched. Any devotee of baroque puzzles could find no happier pastime than losing himself for hours, days, or weeks in the endless mazes of intercorporate transactions and transfers among [Baldin-United's] myriad subsidiaries that have been the constant activities [for the three fiscal years preceding the commencement of the bankruptcy proceedings, September 26, 1983].

Examiner's Statement of Investigation in Re: Baldwin-United Corporation and D.H. Baldwin Company, United States Bankruptcy Court, Southern District of Ohio, Western Division, 5 (1985)(on file with author).

An SPDA is a product purchased with a lump sum premium. When the SPDA matures years later periodic payments are made to the annuitant either for life or a definite period of time. Between the time of the original premium payment and the maturity date, interest is credited to the account, but is not taxable until the time for payout, creating tax shelter feature which made SPDAs so attractive).

Between 1970 (the time of Thompson's ascendancy to the presidency of Baldwin) and 1982, numerous financial entities were acquired including National Investors Life Insurance Company (NILIC) which became the main issuer of Baldwin's SPDA.

> The SPDA was the right product at the right time, and Baldwin made the most of it by a marketing concept of promoting the product primarily through major national brokerage firms such as Merrill Lynch instead of through established insurance agents. During a period when most of its other business activities were showing losses or minimal growth, Bald-

question whether the 1969 Model Act sufficiently protected the sol-

---

> win was reporting awesome increases in revenues in its SPDA insurance subsidiaries. In 1979 revenues from SPDAs were $9 million. In 1980 they jumped to $233 million. In 1981 they exploded to over $1.5 billion. The company's stock was soaring, and its president was acclaimed as one of the great financial wizards of the decade.

Id. at 20.

The profits shown by this astounding growth were illusory. In the industry the premiums received by the insurer were invested with the goal that the income therefrom should cover expenses, a profit and the interest to be credited. Even when interest rates are stable, matching assets to liabilities is a difficult task. But when interest rates fluctuate (as they did during the 1970s the early 1980s) the task is almost impossible. The Baldwin SPDAs carried interest rates higher than those of competitors, but the assets (*i.e.*, the investments) did not produce income sufficient to cover the aforementioned elements, resulting in a negative spread between the net earnings and crediting rates. How then did Baldwin show profits? Answer: By creating them from thin air through clever manipulation of tax laws. At the time it acquired NILIC, it also formed National Investors Pension Insurance Company (NIPIC) which was a *non*-life insurance company designed to act as reinsurer of NILIC.

> Upon sale of a SPDA policy NILIC would, for income tax purposes, record the initial premium as revenue and expense an identical figure as initial reserve. It would also expense all acquisition costs such as commissions at the time of sale. It would reinsure the policy with NIPIC which would pay it a 12% ceding commission. The difference the acquisition expenses of approximately 6% and the receipt of the 12% ceding commission would be income to NILIC and taxed at the rates applicable to life insurance companies, generally approximately 23%. The expenses reflected in the payment of the ceding commission were thus incurred by NIPIC which was not a life insurance company for tax purposes. This created for tax purposes significant losses. Since NIPIC was consolidated with the rest of Baldwin-United non-life insurance affiliates, those affiliates could offset what would otherwise be taxable income, taxed at the general corporate rate of 46%, against the NIPIC losses. This plan served to shift income from the 46% general corporate rate to the 23% life insurance company rate. In 1981 this *tax arbitrage contributed $40.7 million* to Baldwin's net income.

Id. at 20-21 (emphasis added).

To illustrate this sleight-of-hand income creation, assume the sale of a $100,000 SPDA: NILIC would pay $6000 in commissions and overhead expenses. Upon reinsurance with NIPIC it would receive $12,000 of ceding commissions, resulting in a $6000 profit upon which it would pay taxes of $1380, at the life insurer rate of 23%, by filing separately from the Baldwin consolidated return. Thus a $4620 after tax profit was realized, instead of a loss of $6000. NIPIC, on the other hand, would incur a loss of $12,000, and by filing as part of the Baldwin consolidated return, it would reduce total consolidated income by $12,000 giving a tax benefit (to the consolidated group) of $5520. A total of $10,140 profit out of thin air! In addition, reinsuring within the holding company attributes a healthy appearance to the insurer when in fact it may be deficient. This is so because the ceded insurance is no longer the liability of the original insurer but the premium money from the policy flows to the reinsurer who invests it in various assets.

> Baldwin, by having NILIC reinsure with NIPIC, did just that. With its liabilities reduced, NILIC looked healthy on paper. NIPIC, in turn, invested the ceded premiums heavily in Baldwin's affiliated securities, thereby funneling the premium dollars up to the parent. The result: the

vency of an insurer in a holding company system in an era of rapidly expanding financial services giants.

> security of the policyholder was actually dependent on the strength of the parent holding company.

John R. Dunne, *Intercompany Transactions Within Insurance Holding Company*, 20 FORUM 445, 449-450 (1985).

However, there are several flaws in this kind of financial legerdemain. First, NIPIC's constant operational losses required frequent infusions of new capital since its investments of premium money into Baldwin affiliates generated very little income. Secondly, the generation of tax losses is senseless unless there are income producing companies to take advantage of the losses, which gave rise to additional pressure for expansion by acquisition. At the same time that this feverish expansion activity was going on, the explosive sale of SPDAs created a tension between two capital requirements: during a growth period insurance reserve requirements dictate the holding of capital at the insurance company level and may even require additional infusions of new capital (see *supra* note 159 and accompanying text) whereas aggressive expansion through new acquisitions requires capital at the parent level. By the end of 1981 the cash needs of this conglomerate were far beyond the cash flows generated by the insurance companies and myriad other subsidiaries of Baldwin-United. The house of cards was about to collapse, when wizard Thompson came to the rescue in March of 1982 with the final and biggest acquisition of all: MGIC Investment Corporation. Unfortunately this rescue turned into Baldwin's fiasco. MGIC was a mortgage guarantee insurance company from which Baldwin expected heavy cash flows. Thompson expected to finance the $1.17 billion purchase price by internally generated cash and borrowing $584 million from a bank consortium for one year. The internal raising of cash was accomplished by a series of complicated intercompany transfers among Baldwin subsidiaries designed to draw the cash from the operating level to the level. NILIC, NIPIC and other insurance company subsidiaries were among the entities being depleted of cash. In March 1980 and again in March 1981 the NAIC (National Association of Insurance Commissioners) examiner team detected a need for regulatory attention of NIPIC. However, Arkansas, the primary domiciliary regulator, proceeded cautiously, not wanting to becloud the reputation of an insurer. It was not till early 1982 that a special examination was begun in conjunction with Missouri, Texas, Indiana and Arizona, also domiciliary regulatory states. By the time the audits were completed in late 1982, the financial community became aware that Baldwin had problems and their stock price began to plummet. Since a large portion of NILIC's and NIPIC's assets consisted of stock in Baldwin subsidiaries, these assets had to be revalued downward, resulting in NIPIC becoming statutorily insolvent unless new capital was infused immediately. This was done, but it left Baldwin so bereft that it was unable to meet the payment of the loan due on the MGIC purchase. The house of cards fell; Chapter 11 followed.

To summarize, Baldwin tried to accomplish its huge expansion program by trading assets, funding loans, providing collateral and purchasing equity interests among affiliated companies. The insurance companies were caused to transfer liquid assets to other affiliates to fund other acquisitions and received, in return, equity or debt securities in those affiliates. The goal of the Baldwin policy was to aggregate its assets in the regulated affiliates and to assemble the liabilities in the unregulated companies. But:

> [t]he same dollar cannot be used to pay debts incurred in acquisitions at one corporate level while meeting capital requirements at another corporate level. Baldwin became increasingly caught in a bind between the demand for adequate capital for regulatory purposes at the level of its

As indicated by the report of the 1969 Advisory committee, the 1969 Model Act relied on regulation by disclosure. The amended Model Act of 1985 relies on *prior regulatory approval* of acquisitions of or mergers with domestic insurers, and any interaffiliate transac-

---

insurance subsidiaries and the demand for adequate cash to service debt at the holding company level.

Examiner's Statement, *supra* at 23.

The NAIC issued a paper in February 1985 entitled The Baldwin-United Corporation Bankruptcy: Its Significance for Insurance Regulation. Its conclusion on page 13 is reproduced below:

CONCLUSIONS

> Baldwin's accomplishments occurred with the cooperation of virtually all of the country's major retail stockbrokers, with state insurance department approvals, the silent acquiescence of federal agencies, as well as the active participation of dozens of the country's most sophisticated banks, plus a legion of lawyers, accountants and actuaries who had actively or passively approved the various stages of Baldwin's evolution.
>
> Most of the transactions and acquisitions received the approval of the appropriate regulatory agency—state or federal. Based on hindsight it is easy to observe that some of the acquisitions and/or transactions should not have been approved, but this raises larger issues for those in the business of financial regulation. How can regulators detect a pattern detrimental to the viability of a corporate structure when each part appears sound? How can the group of affiliated companies be gauged if its structure is changing almost daily? How can regulators detect problems soon enough when management obscures the facts or engages in activity that is detrimental to its own health? How can the cumulative or synergistic effect of a series of permissible, but risky, transactions be measured? Most important, if the regulator's role is defined as that of oversight and supervision and not management of an insurer's operations, how can the regulator respond when management has charted a determined and dangerous course.
>
> The normal difficulties plaguing financial regulators were exacerbated by the incredible complexities of Baldwin. This, added to an atmosphere of deregulation and new hybrid products, made life difficult for regulators and, unfortunately, the various publics they serve. While the situation is far from hopeless for Baldwin SPDA-holders due to the Rehabilitation Plan we, as regulators, should waste no time in attempting to prevent future Baldwins.

Author's note: The material in this note is but a brief description of the activities and transactions of Baldwin-United. This information was gleaned from the following sources: Examiner's Statement of Investigation in Re: Baldwin-United Corporation and D.H. Baldwin Company, United States Bankruptcy Court, Southern District of Ohio, Western Division (1985); NAIC, THE BALDWIN-UNITED CORPORATION BANKRUPTCY: ITS SIGNIFICANCE FOR INSURANCE REGULATION (1985); John R. Dunne, *Intercompany Transactions Within Insurance Holding Companies*, 20 FORUM 445 (1985); Complaint for Plaintiff, In the Matter of the Rehabilitation of National Investors Pension Insurance Company, National Investors Life Insurance Company and Mt. Hood Pension Insurance Company, Linda N. Garner Rehabilitator/Receiver of National Investors Life Insurance Company, National Investors Pension Insurance Company and Mt. Hood Pension Insurance Company v. Morley P. Thompson, Circuit Court of Pulaski County, Arkansas, Cause No. 84-5517 (1984); ARKANSAS INSURANCE DEPARTMENT REPORT OF EXAMINATION OF NATIONAL INVESTORS PENSION INSURANCE COMPANY AS OF DECEMBER 31, 1982 AND JUNE 30, 1983 (1984).

tions such as reinsurance, service contracts, management agreements and expense allocations including taxes. Section 2 of the new Model Act enumerates permissible activities of an insurer's subsidiaries and sets out the limits of investment in them. Section 3 sets forth the "big stick" procedures governing acquisitions of or mergers with insurers. The requirements include submission of detailed information to the commissioner, including specific data about the acquiring entity, source and amount of funds to be used for effecting the merger or acquisition, nature of the acquirer's business, future plans for the acquired insurer, audited financial statements and many additional matters. It authorizes the commissioner to employ, at the acquirer's expense, attorneys, accountants, actuaries and other experts to assist in determining whether to approve or disapprove the application.

The new philosophy of prior regulatory approval embodied in the 1985 Model Act is clearly manifested in amended section 5, under which interaffiliate transactions[199] or reinsurance agreements and

199. (2) The following transactions involving a domestic insurer and any person in its holding company system may not be entered into unless the insurer has notified the Commissioner in writing of its intention to enter into such transaction at least thirty (30) days prior thereto, or such shorter period as the Commissioner may permit, and the Commissioner has not disapproved it within that period.

(a) sales, purchases, exchanges, loans or extensions of credit, guarantees, or investments provided such transactions are equal to or exceed: (i) With respect to nonlife insurers, the lesser of three percent (3%) of the insurer's admitted assets or twenty-five percent (25%) of surplus as regards policyholders as of the 31st day of December next proceeding; (ii) With respect to life insurers, three percent (3%) of the insurer's admitted assets; as of the 31st day of December next preceding;

(b) Loans or extensions of credit to any person who is not an affiliate, where the insurer makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the insurer making the loans or extensions of credit provided such transactions are equal to or exceed: (i) With respect to nonlife insurers, the lesser of three percent of the insurer's admitted assets or twenty-five percent (25%) of surplus as regards policyholders as of the 31st day of December next preceding; b) with respect to life insurers, three percent (3%) of the insurer's admitted assets, as of the 31st day of December next preceding;

(c) Reinsurance agreements or modifications thereto in which the reinsurance premium or a change in the insurer's liabilities equals or exceeds five percent (5%) of the insurer's surplus as regards policyholders, as of the 31st day of December next preceding, including those agreements which may require as consideration the transfer of assets from an insurer to a non-affiliate, if an agreement or understanding exists between the insurer and non-affiliate that any portion of such assets will be transferred to one or more affiliates of the insurer;

(d) All management agreements, service contracts and all cost-sharing arrangements; and

dividend payments[200] require thirty days prior notice. One of the lessons of the Baldwin-United collapse was that after-the-fact reporting

(e) Any material transactions, specified by regulation, which the Commissioner determines may adversely affect the interests of the insurer's policyholders. Nothing herein contained shall be deemed to authorize or permit any transactions which, in the case of an insurer not a member of the same holding company system, would be otherwise contrary to law.

(3) A domestic insurer may not enter into transactions which are part of a plan or series of like transactions with persons within the holding company system if the purpose of those separate transactions is to avoid the statutory threshold amount and thus avoid the review that would occur otherwise. If the Commissioner determines that such separate transactions were entered into over any twelve month period for such purpose, he may exercise his authority under Section 10.

(4) The Commissioner, in reviewing transactions pursuant to Subsection A (2), shall consider whether the transactions comply with the standards set forth in Subsection A (1) and whether they may adversely affect the interests of policyholders.

(5) The Commissioner shall be notified within thirty (30) days of any investment of the domestic insurer in any one corporation if the total investment in such corporation by the insurance holding company system exceeds ten percent (10%) of such corporation's voting securities.

MODEL ACT, *supra* note 183, § 5(A)(2)-(5).

200. (B) *Dividends and other Distributions.* No domestic insurer shall pay any extraordinary dividend or make any other extraordinary distribution to its shareholders until (1) thirty days after the Commissioner has received notice of the declaration thereof and has not within such period disapproved such payment, or (2) the Commissioner shall have approved such payment within such thirty-day period.

For purposes of this section, an extraordinary dividend or distribution includes any dividend or distribution of cash or other property, whose fair market value together with that of other dividends or distributions made within the preceding twelve (12) months exceeds the lesser of (1) ten percent (10%) of the insurer's surplus as regards policyholders as of the 31st day of December next preceding, or (2) the net gain from operations of such insurer, if such insurer is a life insurer, or the net income, if such insurer is not a life insurer, not including realized capital gains, for the 12-month period ending the 31st day of December next preceding, but shall not include pro rata distributions of any class of the insurer's own securities. In determining whether a dividend or distribution is extraordinary, an insurer other than a life insurer may carry forward net income from the previous two (2) calendar years that has not already been paid out as dividends. This carry-forward shall be computed by taking the net income from the second and third preceding calendar years, not including realized capital gains, less dividends paid in the second and immediate preceding calendar years.

Notwithstanding any other provisions of law, an insurer may declare an extraordinary dividend or distribution which is conditional upon the Commissioner's approval and the declaration shall confer no rights upon shareholders until (1) the Commissioner has approved the payment of the dividend or distribution or (2) the Commissioner has not disapproved such payment within the thirty (30) day period referred to above.

Id. § 5(b).

was too late to prevent debilitating interaffiliate transactions.[201]

Although the section 5 requirements should achieve control over potentially precarious activities of insurers within a holding company system, the information reaching the regulators even under this prior approval scheme would be fragmented or isolated and not easily correlated. To ensure that the regulators obtain inclusive information about the total picture of a company's interaffiliate transactions, section 4 of the Model Act sets up provisions for a comprehensive reporting format under a mandatory registration requirement. Every domestic insurer must register[202] in its state of domicile and every for-

201. Baldwin-United was not the only holding company that milked its insurance subsidiaries. During the late 1960s $1.5 billion was extracted from property-liability insurers by their parent holding companies in the form of dividends and other distributions. Richard de R. Kip, *How to Get Capital Out of the Property-Liability Insurance Business*, 23 CPCU ANNALS 235, 236 (1970).

202. The registration statement shall include the following information:

> (B) Information and Form Required. Every insurer subject to registration shall file the registration statement on a form prescribed by the NAIC, which shall contain the following current information:
>
> (1) The capital structure, general financial condition, ownership and management of the insurer and any person controlling the insurer;
>
> (2) The identity and relationship of every member of the insurance holding company system;
>
> (3) The following agreements in force, and transactions currently outstanding or which have occurred during the last calendar year between the insurer and its affiliates:
>
> (a) Loans, other investments, or purchases, sales or exchanges of securities of the affiliates by the insurer or of the insurer by its affiliates;
>
> (b) Purchases, sales or exchange of assets;
>
> (c) Transactions not in the ordinary course of business;
>
> (d) Guarantees or undertakings for the benefit of an affiliate which result in an actual contingent exposure of the insurer's assets to liability, other than insurance contracts entered into in the ordinary course of the insurer's business;
>
> (e) All management agreements, service contracts and all cost-sharing arrangements;
>
> (f) Reinsurance agreements;
>
> (g) Dividends and other distributions to shareholders; and
>
> (h) Consolidated tax allocation agreements;
>
> (4) Any pledge of the insurer's stock, including stock of any subsidiary or controlling affiliate, for a loan made to any member of the insurance holding company system;
>
> (5) Other matters concerning transactions between registered insurers and any affiliates as may be included from time to time in any registration forms adopted or approved by the Commissioner.
>
> (C) Summary of Registration Statement. All registration statements shall contain a summary outlining all items in the current registration statement representing changes from the prior registration statement.
>
> * * *
>
> (E) *Reporting of Dividends to Shareholders.* Subject to Subsection 5B each registered insurer shall report to the Commissioner all dividends and other distributions to shareholders within fifteen (15) business days following the declaration thereof.

eign insurer doing business in the state must also do so, unless it is subject to registration in its domiciliary state under standards similar to those set forth in certain parts of section 5 of the Model Act. An examination of the listed items of information required by the provisions evidences the attempt of the NAIC to correct the Baldwin-United problems and forestall recurrences of similar fiascos.[203]

V. PRESSURES ON BANKS TO EXPAND THEIR ACTIVITIES

A. The Changes in the Financial Services Industry

The skeletal discussion of bank regulation and insurance regulation in the foregoing portions of this study was not intended to examine or express in detail the substance of the regulatory schemes governing the two industries, but merely to highlight the emphasis that such legislation places on the preservation of safety of the consumer's investment. As long as banking, securities, insurance and real estate were kept apart, the banking industry was not aggressive in attempting to diversify into financial areas *verboten* by the respective laws. However, during the past three decades the financial services industry has undergone revolutionary changes at a galloping pace. Unregulated entities have entered the field to perform services and offer products similar to those formerly available only through banks.[204] More recently, thrift institutions were authorized to make certain consumer loans[205] and provide NOW accounts.[206] Addition-

---

(F) Information of Insurers. Any person within an insurance holding company system subject to registration shall be required to provide complete and accurate information to an insurer, where such information is reasonably necessary to enable the insurer to comply with the provisions of this Act.

MODEL ACT, *supra* note 183, § 4B, C, D, E, F.

203. The remaining portion of the MODEL ACT (Sections 6 through 17) are not analyzed herein.

204. For example, Sears opened financial centers offering insurance, securities, real estate services, check cashing facilities and credit card availability; American Express, aside from credit card services, offered insurance, investment banking and banking services through a Swiss bank.

> The nation's largest stock insurer, Aetna Life and Casualty, now owns 40 percent of the Samuel Montagu and Company group, a leading British investment bank and 87 percent of Federated Investors Incorporated, this nation's second largest money market and mutual fund management firm.
>
> Security Pacific Corporation, one of the fastest growing and most diversified securities firms, now has among its $37 billion of assets the country's tenth largest bank. Its growing empire includes fifteen retail stockbroker offices, three wholesale bond houses, an investment banking group, a private Swiss bank, a group of sixteen common trust funds, a New York state chartered trust company, and a wholesale discount securities brokerage firm.

Dunne, *supra* note 6, at 345.

205. Depository Institutions Deregulation and Monetary Control Act (DIDMCA),

ally, new financial products, such as money market mutual funds (MMMFs) and Cash Management Accounts (CMAs) were introduced to compete with traditional bank accounts. Because Regulation Q[207] imposed ceilings on the interest rates that banks could pay, there was an outflow or disintermediation of deposits into MMMFs, which paid higher rates. Although not a demand deposit account, an MMMF is similar to a traditional checking account in that it permits a depositor check writing privileges. Introduced in the 1970s, the CMA combined a securities brokerage account, a money market fund, a checking account with a bank and a debit card issued by the same bank.[208] Through the use of computers and toll free telephone numbers instantaneous transfers of funds can be accomplished through the CMA account.[209]

Not only have innovative products replaced traditional banking services, "old fashioned" nonbank entities have carved out thick slices of a highly profitable banking activity—consumer loans. Finance companies and automobile finance companies have displaced commercial banks as the major providers of installment credit.[210] Furthermore, the global aspects of the financial world have reduced the need for domestic bank services:

> The technology revolution has opened up twenty-four hour worldwide financial markets linked by instantaneously communicated financial information on a global scale. This development has made it possible for financial customers to bypass banks and meet their credit and investment needs directly and less expensively in the securities markets. By enhancing investor ability to

---

Pub. L. No. 96-221, §§ 204-05, 94 Stat. 132, 143 (codified at 12 U.S.C. §§ 3503-04 (1988)).

206. *Id.* § 303. NOW (negotiable order of withdrawal) accounts are interest bearing checking accounts. Prior to 1980 interest was not permitted to be paid on demand deposits. Naturally many members of the public transferred their money from demand deposits to the NOW accounts of thrift institutions.

207. 12 C.F.R. pt. 217 (1992). The Glass-Steagall Act prohibited payment of interest on demand deposits and authorized the Fed to impose interest rate ceilings on savings accounts or time deposits, such as certificates of deposit. The Banking Act of 1933, Ch. 89, § 11, 48 Stat. 162, 181. The Fed implemented this authority through Regulation Q. But by the 1980s it became apparent that banks had been losing their deposits since the 1960s to other liquid investments due to higher market rates. In 1980 DIDMCA called for a phase-out of the ceilings with total elimination by March 31, 1986. Depository Institutions Deregulation and Monetary Control Act, Pub. L. No. 96-221, §§ 204-05, 94 Stat. 143 (codified at 12 U.S.C. §§ 3503-04 (1982)).

208. The CMA is the "invention" of Merrill Lynch and is now offered by many securities firms.

209. When the owner of the CMA account purchases securities, writes a check against the account, or uses his debit card, the needed funds are automatically withdrawn and credited to the seller's or payee's account. The CMA account has become a powerful substitute for traditional deposit accounts. AMERICAN BANKER (October 8, 1987 p. 1) reported that by 1987 the Merrill Lynch CMAs alone had $160 billion in deposits. PITT *supra* note 102, at 712 n.21.

210. Whiting, *supra* note 6, at 361.

assess credits and diversify risk without the need for banking expertise or FDIC protection, computer technology has dramatically altered the credit evaluation and diversification role of banks that once made them essential intermediaries.[211]

The vast proliferation of retirement plans has also had its impact:

Moreover, increased institutionalization of savings in the form of pension and retirement plans and the management of these funds by professional nonbank money managers has diverted vast pools of funds away from banks to the securities markets.[212]

Worst of all, banks began to lose their large corporate customers:

Glass-Steagall's constraining effects have dramatically inhibited the ability of banks to respond to the evolving financial needs of large corporate customers, traditionally the strongest source of profitable banking activity. Prime corporate customers increasingly are sidestepping banks and satisfying their short-term and intermediate credit needs by issuing commercial paper and securitizing their assets.[213] Fifteen years ago, commercial banks controlled some 90% of the short-term loan market. Today, roughly half of this market is satisfied through the use of commercial paper.[214] The securitization of assets has reduced the need for bank loans even further.[215]

---

211. William M. Isaac and Melanie L. Fein, *Facing the Future—Life Without Glass-Steagall*, 37 CATHOLIC U. L. REV. 281, 292-3 (1988)(footnotes omitted).

212. *Id.* at 293 (footnote omitted).

213. The Securities Industry Association boasts that securities firms' distribution of commercial paper enabled corporate borrowers to raise funds at costs well below the 250 to 300 basis point spread over costs of funds typically demanded in bank loans. *Reform of the Nation's Banking and Financial Services: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 100th Cong., 2d Sess. 122 (1988)(statement of John Bachmann, Chairman, Securities Industry Assoc.).

214. *See Structure and Regulation [of Financial Firms and Holding Companies: Hearings Before the Subcomm. of the House Comm. on Government Operations*, 99th Cong., 2d Sess., pt. 1, 124 (1986)]. (statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System); FEDERAL RESERVE BANK OF NEW YORK, RECENT TRENDS IN COMMERCIAL BANK PROFITABILITY: A STAFF STUDY, 159-77, (1986)(*hereinafter* COMMERCIAL BANK PROFITABILITY STUDY)]. The commercial paper market has more than doubled since 1980, from $31 billion to $78 billion in mid-1987. *Structure and Role of United States Financial Institutions: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 100th Cong., 2d Sess. 5 (1987)(statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System).

215. For example, mortgage pass-through securities accounted for approximately one-third of all residential mortgage credit in 1987. The President of the Federal Reserve Bank of New York has stated that, "if securitization were to continue to spread rapidly to other types of credit, the historic role of the deposit-based credit intermediation process could be seriously jeopardized." COMMERCIAL BANK PROFITABILITY STUDY, *supra* note [214], at xvi (foreword by E. Corrigan). [A primary function of financial intermediaries is to facilitate the flow of capital from savers to borrowers. Financial institutions exist because they can do this at a lower cost than would be possible through direct financing arrangements. Banks and other depository institutions perform this intermediary function by making loans and accepting deposits. Sometimes, however, a financial intermediary's de-

By packaging automobile loans, leases, consumer loan receivables, and portfolios of other assets into pools, a company can fund its operating costs by selling interests in the pool directly to investors.[216]Bank loans are being used increasingly as a source of back-up liquidity rather than a primary funding source for many commercial customers.[217] These customers need underwriting and distribution services to facilitate the sale of their own securities directly in the market. Glass-Steagall precludes banks from providing these services. While banks have gained limited authority to assist corporate customers in privately placing commercial paper after a decade-long battle,[218] their ability to underwrite commercial paper and securitized assets has been narrowly circumscribed and is entangled in ongoing litigation initiated by the securities industry.[219/220]

---

mand for loans at a given rate is greater than its supply of deposits, in which case it may purchase the Fed's funds or other uninsured deposits, sell securities under repurchase agreements, sell short-term securities such as commercial paper or bankers acceptances, or sell assets such as government securities or loans. When an institution sells loans, it can sell whole loans or loan participations, or it can "securitize" a portfolio of similar loans.

Securitization is a recent innovation in asset sales. It involves the pooling and repackaging of loans into securities, which are then sold to investors. Like whole loan sales and participations, securitization provides an additional funding source and eliminates assets from a bank's balance sheet. Unlike whole loan sales and participations, securitization is often used to market small loans that would be difficult to sell on a stand-alone basis. Most importantly, securitization can increase the liquidity and diversification of a loan portfolio. The ability to package and sell these otherwise illiquid assets in an established secondary market increases their liquidity. Christine Pavel, *Securitization*, 10 ECONOMIC PERSPECTIVE 16 (1986)].

216. The securitization of assets allows a company to eliminate intermediary expenses in obtaining funding, transfer credit and interest rate risks, enhance balance sheet liquidity, improve asset management, and diversify credit risk. The asset-backed securities market is expected to grow to $100 billion in the next five years. Standard & Poor's, *Dramatic Growth Expected, in* ASSET BACKED SECURITIZATION CREDIT REV., Mar. 16, 1987, at 1. *See generally* Christine Pavel, *Securitization*, 10 ECONOMIC PERSPECTIVE 16 (1986); AMERICAN BANKER ASSET SALES REP., Jan. 11, 1988, at 5.

217. *See* sources cited *supra* note [216]. Although the October 1987 stock market plunge temporarily boosted the demand for commercial loans as major borrowers fled from the volatile securities markets, the long-term downturn in the commercial loan sector has not changed. *Stock Crisis Could Boost Demand for Loans*, AMERICAN BANKER, Oct. 30, 1987, at 22, col. 2.

218. *See* Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137 (1984); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 486 U.S. 1059 (1987); Bankers Trust New York Corp., 73 Fed. Res. Bull. 138 (1987). *See generally* FEDERAL RESERVE BOARD STAFF, COMMERCIAL PAPER PRIVATE PLACEMENT ACTIVITIES (1977). Although banks may participate in the commercial paper market as issuers of standby letters of credit providing back-up liquidity to issuers whose commercial paper fails to sell in the market, they may not do so with respect to commercial paper they place under restrictions imposed by the Federal Reserve Board. Moreover, this activity is not a substitute for commercial loans. *Id.*

219. In 1987, under the BHCA, the Federal Reserve Board approved for the first time major banking holding companies' applications to engage, through subsidiaries, in underwriting, and dealing in commercial paper, mortgage backed securities, mu-

In summary, as banks lost their hold on the intermediation of financial activities, they began losing their profitability and viability. The integrity and stability of the national monetary system was threatened. The banking industry had to respond to what appeared to be a calamitous environment.

B. The Banking Response

1. Bank Holding Companies

Banks sought to overcome the statutory limitations on their activities by forming bank holding companies (BHCs).[221] In an effort to evade geographic restraints,[222] a bank would create a BHC that would

---

nicipal revenue bonds, and consumer receivable backed securities. The Chase Manhattan Corp., 73 Fed. Res. Bull. 367 (1987); Citicorp, 73 Fed. Res. Bull. 473 (1987) [hereinafter Board Order of April 30, 1987]; The Chase Manhattan Corp., 73 Fed. Res. Bull. 607 (1987); Chemical New York Corp., 73 Fed. Res. Bull. 616 (1987); Citicorp, 73 Fed. Res. Bull. 618 (1987); Manufacturers Hanover Corp., 73 Fed. Res. Bull. 620 (1987); Security Pacific Corp., 73 Fed. Res. Bull. 622 (1987); The Chase Manhattan Corp., 73 Fed. Res. Bull. 729 (1987); Chemical New York Corp., 73 Fed. Res. Bull. 731 (1987)(CRRs); Marine Midland Banks, Inc., 73 Fed. Res. Bull. 738 (1987); PNC Financial Corp., 73 Fed. Res. Bull. 742 (1987); J.P. Morgan & Co., 73 Fed. Res. Bull. 875 (1987); First Interstate Bancorp, 73 Fed. Res. Bull. 928 (1987); Bank of New England Corp., 73 Fed. Res. Bull. 133 (1988). The Board limited such activities to no more than 5% of each underwriting subsidiary's total gross revenues and limited each to no more than a 5% share of the market in each type of security. The Board also imposed numerous operating restrictions on such underwriting subsidiaries, including a prohibition on management interlocks with affiliated banks, restrictions on extensions of credit to issuers and purchasers of securities underwritten by the holding company's subsidiary, and capital adequacy requirements. The Board's orders approving the applications have been challenged in court by both the Securities Industry Association as well as the bank holding company applicants and are the subject of a judicial stay. *See* The Chase Manhattan Corp. v. Board of Governors of the Fed. Reserve Sys., No. 87-1333 (D.C. Cir. filed July 20, 1987); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., Nos. 87-4091, 87-4093, 87-4095 (2d Cir. filed July 1 and July 15, 1987); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., No. 87-4041 (2d Cir. filed May 1, 1987); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., No. 87-1169 (D.C. Cir. filed April 17, 1987); Bankers Trust N.Y. Corp. v. Board of Governors of the Fed. Reserve Sys., No. 87-1035 (D.C. Cir. filed Jan. 23, 1987); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., No. 87-1030 (D.C. Cir. filed Jan. 20, 1987). On Feb. 8, 1988, the Board's Order of April 30, 1987, was upheld by the United States Court of Appeals for the Second Circuit, with the exception of the 5% market limit which the court struck down. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., No. 87-4041 (2d Cir.Feb. 8, 1988). The Securities Industry Association has filed a petition for certiorari seeking Supreme Court review of the court's opinion. [*cert. denied*, 486 U.S. 1059 (U.S. June 14, 1988).]

220. Isaac and Fein, *supra* note 211 at 293-94. Original footnote numbers 61 through 67 were renumbered 213 through 219.

221. A bank holding company is any entity that controls one or more banks.

222. Branch banking was strictly circumscribed. *See supra* text accompanying note 142.

own it and also acquire other banks both in the home state and other states where state law permitted. Branch banking restrictions could be sidestepped because subsidiaries of BHCs were not considered branch offices but corporations with their own charters. Because the use of BHCs was fairly limited prior to the 1930s, Congress enacted no special legislation to curb their activities. The Banking Act of 1933, motivated by the 1929 crash, contained some controls on BHCs. Under the act all BHCs which were members of the Federal Reserve were placed under federal supervision.[223] Like the Glass-Steagall provisions,[224] the goal of this *ineffective* provision was to separate banking from affiliates engaged in investment banking. Because of the slow but steady acquisition of nonbanking affiliates by BHCs,[225] by the early 1950s concerns arose about the concentration of banking resources in other financial fields.

Congress reacted to these concerns by enacting the Bank Holding Company Act of 1956.[226] However, since Congress was primarily concerned with the anticompetitive factors of large BHCs, the 1956 Act applied only to BHCs controlling two or more banks.[227] The 1956 Act placed BHCs under the regulating power of the Fed and prohibited BHCs and their nonbank subsidiaries from activities of a nonbank nature, except those "of a financial, fiduciary or insurance nature . . . which the Board . . . has determined to be so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto."[228] Since one-bank BHCs were not covered by the 1956 act they were free to engage in nonbanking activities. As a result, the post 1956 period saw a surge in one-bank BHCs conducting interstate banking and nonbanking activities.[229] Congress reacted to

223. The provision was triggered only if at least one bank in the holding company entity was a member of the Federal Reserve System *and* the holding company voted its stock in the member bank. By refraining from voting (or simply not owning a *member* bank) the BHC did not come under the jurisdiction of the Fed and could engage in activities prohibited by Glass-Steagall. Thus the provision was a complete failure. Act of June 16, 1933, ch. 89, § 191(e), 48 Stat. 162, 188 (codified at 12 U.S.C. § 61), *repealed in relevant part by* Act of July 1, 1966, Pub. L. No. 89-485, § 13(c), 80 Stat. 236, 242.

224. The Banking Act of 1933, Ch. 89 §§ 16, 20, 21, 32, 48 Stat. 162, 184, 188, 189, 194 (codified as amended at 12 U.S.C. §§ 24, 377, 378, 78 respectively (1988)); *see also supra* note 65.

225. The National Bank Act regulates national banks and their operating subsidiaries, but does not regulate their affiliates or parents.

226. Ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-49 (1988)).

227. Congress expressly rejected regulation of one-bank holding companies because such companies were few in number and controlled only small banks.

228. Bank Holding Company Act of 1956, ch. 240, § 4(c)(6), 70 Stat. 133, 137 (codified as amended at 12 U.S.C. § 1843(c)(8)(1988)).

229. By 1968 $100 billion of deposits (approximately 25% of total deposits) of insured commercial banks were held in this form. CORPORATE LAW AND PRACTICE, PRACTICING LAW INSTITUTE, ONE-BANK HOLDING COMPANIES 13 (1969). During

the surge by passing the 1970 amendments to the Bank Holding Company Act (BHCA),[230] which redefined the term "bank holding company" to include one-bank holding companies. This did not, however, deter the continued expansion in the number of BHCs. At present there are over 9,000 BHCs registered with the Fed.

2. Nonbank Banks

The nonbank bank phenomenon added to the arsenal of tools to be used to escape the pincers of the BHCA. After 1970 and prior to 1987 the BHCA defined a bank as any institution "which (1) accepts deposits that the depositor has a legal right to withdraw on demand and (2) engages in the business of making commercial loans."[231] Under this definition commercial banks that accepted demand deposits but made no commercial loans (or vice-versa) would not be banks for BHCA purposes. Such institutions are referred to as "nonbank banks."

Soon this loophole was discovered by financial institutions and there was a rush by securities entities, insurance companies, investment banks and other firms to buy or establish nonbank banks not subject to the BHCA geographic and product limitations. Thus, banks and BHCs came under additional competition from a multitude of firms[232] offering financial services previously the exclusive domain of banks. Organizations that were not regulated under the BHCA were able to enter the banking industry by acquiring FDIC-insured nonbank banks. To offset this disadvantage, BHCs also acquired nonbank banks for use in interstate banking activities[233] such as acceptance of deposits and consumer but not commercial lending.

Through the BHCs and nonbank banks, the banking industry has attempted to expand its product and geographic activities. These vari-

---

1968 several major banks announced their intention to form one-bank holding companies. By 1970 there were 1100 companies in control of banks covering 40 percent of total deposits. Richard M. Whiting, *Bank Holding Companies: A Regulatory Primer*, 2 BANKING L. REP. 190 (1986). These one-bank holding companies were engaged in about 100 different activities, including agriculture, mining, manufacturing, transportation, and retail trade. LASH, *supra* note 5, at 49.

230. Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 (codified in scattered sections of 12 U.S.C.).

231. 12 U.S.C. § 1841(c)(1982)(amended 1987).

232. Some of these firms were: Merrill-Lynch, Prudential Insurance Company, American Express, Fidelity Investments, Drexel Burnham Lambert Group, Dreyfus Corp., Sears, J.C. Penney Co., and many others.

233. BHCs were prohibited from acquiring any interest in banks outside the state in which the principal operations of such BHC's banking subsidiaries were conducted unless a state positively permitted such branching. This provision is known as the "Douglas Amendment." Bank Holding Company Act of 1956, ch. 240, § 3(d), 70 Stat. 133, (codified as amended at 12 U.S.C. § 1842(d)(1988)). This provision supplements the interstate branching limitations of the McFadden Act. 44 Stat. 1224 (1927)(codified as amended in scattered sections of 12 U.S.C.).

ous undertakings will be discussed in connection with the legislative, judicial, and administrative curbs that were being challenged.

VI. REGULATORY PROHIBITIONS

A. The Bank Holding Company Act

The Bank Holding Company Act[234] (BHCA) regulates the activities of BHCs and their affiliates in nonbanking functions (either directly or through investments) and prohibits the undertaking of business unrelated to banking. Germane to this paper are controversies arising under section 3[235] and section 4[236] of the BHCA. Generally, section 3 prohibits any company, without the Fed's prior approval, from taking any action that would result in the creation of a bank holding company. Section 3 also prohibits any BHC from acquiring control[237] of any bank or merging with another BHC without prior Fed approval. The Fed is prohibited from approving an application for an acquisition or a merger that would result in a substantial lessening of competition, unless the anticompetitive effect would be clearly outweighed by the beneficial effects in meeting the convenience and needs of the local public. Furthermore, the Fed may not approve an application for an out of state acquisition or merger unless the laws of the target state expressly authorize the entry of the BHC. In contradistinction to section 3, which governs *bank* acquisitions, section 4 governs *nonbanking* acquisitions and activities of BHCs and their nonbanking affiliates. Section 4 opens with a broad prohibition on ownership or control by BHCs of "any company which is not a bank."[238] Then follows a list of exemptions;[239] the most important of which is section 4(c)(8). This exemption applies to:

> shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices. In orders and regulations under this subsection, the Board may differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or

234. 12 U.S.C. §§ 1841-1850 (1988).
235. 12 U.S.C. § 1842 (1988).
236. 12 U.S.C. § 1843 (1988).
237. For this purpose control is more than 5% of the stock of the bank. 12 U.S.C. § 1842(a)(1988).
238. 12 U.S.C. § 1843(a)(1)(1988).
239. *Id.* §§ 1843(c)(1)-(13).

in part, of a going concern.[240]

Several elements of this provision bear closer examination. The parenthetical phrase indicates that the Board may make its determinations either by regulation or by order. The former is generally made at the initiative of the Board; the latter in response to an application. The Board has promulgated regulations[241] in which there are listed twenty-five activities[242] which are permissible under section 4(c)(8) as meeting the requirement that they be "so closely related to banking . . . as to be a proper incident thereto." In addition, the Board, has also approved by order more than twenty activities which are "incident" to the business of banking. The applicant for a nonbanking activity must pass the "closely related" test and the "benefits for the public" test in order to receive a favorable determination.

In *National Courier Association v. Board of Governors of the Federal Reserve System*, the D.C. Circuit Court considered the meaning of "closely related" and concluded that the intention of Congress was to ensure that banks would not undertake activities "which are so clearly of a purely commercial nature that the predominantly adverse effects of a bank's engaging in them may be presumed."[243] The test for the requirement that the activity "be a proper incident [to banking]"[244] is referred to as the "public benefits" test because section 4(c)(8) specifically requires the Board to consider whether the activity will produce benefits to the public "that outweigh possible adverse effects."[245] *National Courier*[246] held that this test must be applied on a case-by-case basis using the factors enumerated in section 4(c)(8), that is, the potential public benefits of greater convenience, increased competition, and gains in efficiency versus potential the adverse effects of concentration of resources, decrease in competition, conflicts of interest, and unsound banking practices.[247]

B. Tiptoeing Through the Tulips of Restraints

This section will briefly review the more significant attempts of the banking industry to overcome limitations on their financial activities in face of increased competition by entities not regulated by federal or state banking laws.

---

240. *Id.* § 1843(c)(8)(1976). The quoted version contains the wording used prior to the 1982 Amendment discussed *infra* note 283.
241. Regulation Y, 12 C.F.R. pt. 225 (1992).
242. 12 C.F.R. §§ 225.22(a), (b), and 225.25(b)(1)-(24).
243. National Courier Ass'n v. Board of Governors of the Fed. Reserve Sys., 516 F.2d 1229, 1237 (D.C. Cir. 1975).
244. *See supra* quotation accompanying note 239.
245. *Id.*
246. National Courier Ass'n v. Board of Governors of the Fed. Reserve Sys., 516 F.2d 1229, 1237 (D.C. Cir. 1975).
247. *See supra* quotation accompanying note 240.

Until 1963 it was commonly recognized that a mutual fund would be considered an "affiliate" of its sponsor. Thus, under section 20 of the Glass-Steagall Act[248] neither a member bank nor a BHC[249] could sponsor a mutual fund. In 1963 Comptroller Saxon promulgated a regulation[250] permitting national banks to sponsor (establish and operate) mutual funds. The Investment Company Institute (ICI) challenged the validity of the regulation. The Supreme Court in *ICI v. Camp*[251] rejected the Comptroller's position, holding that under sections 16[252] and 21[253] of the Glass-Steagall Act a national bank is prohibited from sponsoring an open-end investment company (a mutual fund). The Court reasoned that shares of a mutual fund are securities and, therefore, the sponsoring bank would be underwriting and distributing securities in violation of section 16 because the sponsor is in control of the fund. Even though section 20 was not in issue, the Court implied that an *open-end* mutual fund sponsored by a BHC would be considered an affiliate of that BHC.

The Board interpreted the holding to mean that a BHC could sponsor a *open-end* mutual fund as well as a *closed-end* investment company.[254] The ICI challenged this regulation but lost. In *Board of Governors of the Federal Reserve System v. ICI*[255] the Court held that a BHC could sponsor a closed-end investment company without violating section 20 because neither the fund nor the sponsor would be "engaged principally"[256] in the issuance of securities.

The complexity of the meaning of the phrase "engaged principally"

248. 12 U.S.C. § 377 (1988) prohibits any affiliation between banks and securities organizations. *See supra* text accompanying note 140.

249. For definition of "affiliate" see 12 U.S.C. § 221a(b)(1988).

250. 12 C.F.R. § 9.18(a)(3)(1970)(current version at 12 C.F.R. § 9.18(a)(1)(1992)).

251. 401 U.S. 617 (1971).

252. For the contents of Section 16 (12 U.S.C. § 24 (1988 & Supp. II 1990)) see *supra* note 101.

253. 12 U.S.C. § 378 (1982). It forbids any entity in the securities business to receive deposits.

254. 12 C.F.R. § 225.125(f)(1992). The regulation explains the difference between open-end or mutual funds and closed-end investment companies as follows:

> Briefly, a mutual fund is an investment company which, typically, is continuously engaged in the issuance of its shares and stands ready at any time to redeem the securities as to which it is the issuer; a closed-end investment company typically does not issue shares after its initial organization except at infrequent intervals and does not stand ready to redeem its shares.

12 C.F.R. § 225.125(c)(1992).

255. 450 U.S. 46 (1981).

256. Section 20 states:

> [N]o member bank shall be affiliated . . . with any corporation, association, business trust, or other similar organization *engaged principally* in the issue, flotation, underwriting, public sales, or distribution . . . of stocks, bonds, debentures, notes, or other securities.

12 U.S.C. § 377 (1988)(emphasis added).

arose again when in 1984 and 1985 several BHCs applied to the Board for permission to engage, through affiliates, in underwriting and dealing in bank-ineligible securities[257] such as municipal revenue bonds, commercial paper, mortgage-related securities and other debt securities. The BHC applicants were Citicorp[258] (the largest bank organization in the country), Bankers Trust and J.P. Morgan & Co. The most crucial issue involved in the matter was a determination of the quantitative limits of activity to be permitted in ineligible securities under section 20.[259] The applicants contended that "engaged principally" meant that the volume of activity in ineligible securities would have to exceed fifty percent of the total business of the affiliate.[260] After two years of deliberation, the Board, in a lengthy order,[261] rejected this interpretation and held that five to ten percent of the affiliate's total gross revenue on average over any two year period would be the proper measure and also added a market share test. The order limited the applicants to the lower end of the scale, five percent. As required by the BHCA[262] the Board found that the activities in which the applicant intended to engage met the two required tests;[263] *i.e.*, the activities were so closely related to banking as to be an incident thereto and that the public benefits outweighed possible adverse effects. Thus, the Board granted approval for underwriting and dealing in commercial paper, municipal revenue bonds and mortgage related securities, subject to the five percent limitation and subject to a long list of conditions and terms.[264]

While the Board engaged in lengthy deliberation, Congress passed CEBA,[265] which, *inter alia*, contained moratorium provisions which prohibited federal banking regulatory agencies to approve any BHC or affiliate thereof to engage

> in the flotation, underwriting, public sale, dealing in, or distribution of securities if that approval would require the agency to determine that the entity which would conduct such activities would not be engaged principally in such

257. Section 16 of the Glass-Steagall Act permits national banks to underwrite or deal in eligible securities such as federal government and general obligation municipal securities. All other securities (*i.e.*, those not listed in Section 16) are ineligible securities. 12 U.S.C. § 24 (1988).

258. This was Citicorp's revised application. It withdrew its earlier application when it became apparent that it would not be granted.

259. 12 U.S.C. § 377 (1988).

260. The applications, however, voluntarily limited the activities to a much lower percentage.

261. Citicorp, 73 Fed. Res. Bull. 473 (1987).

262. *See supra* quotation accompanying note 240.

263. *See supra* text following note 242.

264. *See supra* note 261. The Board thereafter approved several applications from other banks, including Chase Manhattan, Chemical New York Corp., Security Pacific, Manufacturers Hanover and others.

265. Pub. L. No. 100-86, 101 Stat. 552 (1987)(codified at scattered sections of 12 U.S.C.).

activities.[266]

The foregoing decisions of the Board were rendered after the effective date of the above provision, March 6, 1987. Immediately after the *Citicorp* decision, the Securities Industry Association (SIA) filed suit in the Second Circuit Court of Appeals challenging the Board's construction of the term "engaged principally" and asking the court to stay the Board's orders in light of CEBA's moratorium.[267] Several BHCs also filed suit in the same court challenging the Board's quantitative and market limitations. The court imposed a stay on the orders until March 1, 1988, but proceeded to decide the substantive issues raised by the opposing parties and consolidated all the cases into one.[268] It denied SIA's challenges and affirmed the bank holding companies' arguments as to the market limitation imposed by the Board. However, the court upheld the Board's quantitative limitation of five percent.[269]

The *Citicorp* decision represents a foot in the door of securities activities for BHCs. The result could be the dismantling of Glass-Steagall. The subtle beginnings of such dismantling are already perceptible in *Chemical New York Corporation*[270] in which the Board approved underwriting and dealing in consumer receivable-related securities.[271] A giant step in this incursionary process was the recent decision of the Board[272] to permit BHCs, through nonbank subsidiar-

266. Competitive Equality Banking Act § 201(b)(2), 101 Stat. 552, 582 (1987).

267. The moratorium was effective until March 1, 1988. *Id.* § 201(a).

268. The citations to the court's orders staying all orders and its order of consolidation are omitted.

269. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059, (1988). This decision again points out (by implication) that Glass-Steagall treats affiliates of banks (section 20) differently from banks (section 16). Thus a less stringent standard may be applied to activities of an affiliate than to a bank. *See* Board of Governors of the Fed. Reserve Sys. v. ICI, 450 U.S. 46, 60, 71 (1981).

270. 73 Fed. Res. Bull. 731 (1987).

271. An exhaustive exposition of the numerous securities related activities that banks or BHCs are now permitted to engage in would be too cumbersome and not essential to this paper. However, a sampling is worth mentioning. An acquisition of a discount brokerage house (Schwab) was approved by the Board in BankAmerica, 69 Fed. Res. Bull. 105 (1983), upheld by the Supreme Court in Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve System, 468 U.S. 207 (1984). Investment advisory services to investment companies is permitted under Regulation Y, 12 C.F.R. § 225.25(b)(4)(ii)-(iii)(1992). Full service brokerage was approved in Bank of New England Corp., 74 Fed. Res. Bull. 700 (1988). Full service brokerage to retail customers was allowed in respect to ineligible securities *held as principal* in connection with authorized underwritings and dealing activities in PNC Financial Corp., 75 Fed. Res. Bull. 396 (1989).

272. J.P. Morgan & Co. Inc., 75 Fed. Res. Bull. 192 (1989). The SIA challenged this order and filed a petition in the U.S. Court of Appeals, D.C. Circuit which was denied. Securities Indus. Ass'n v. Board of Governors of the Fed. Res. Sys., 900 F.2d 360 (D.C. Cir. 1990).

ies, to underwrite and deal in all types of debt and equity securities within certain quantitative limits.[273] Congressional reaction to this decision was immediate and vehement. Rep. John Dingell (D. Mich.), chairman of the House committee that oversees securities regulation, said through a spokesman, "The Fed is on its way to giving banks an invitation to shoot craps with the taxpayer's money. This is the kind of irresponsible behavior that gave us the savings and loan crisis and brought about the 1929 crash."[274] House Banking Committee Chairman Henry B. Gonzalez (D. Tex.) said, "Some may argue that the Congress has moved too slowly to resolve the issue. But this indicates the divisiveness and complexity of the issue and does not cloak the Federal Reserve with the authority to supplant congressional action."[275]

In summary, BHCs may engage in discount brokerage; full-service brokerage; limited underwriting and dealing in commercial paper, municipal revenue bonds, mortgage-backed securities, consumer-receivable-backed securities, corporate debt and equity securities, securities of affiliates; sponsoring closed-end mutual funds and numerous other securities activities. The Office of the Comptroller of Currency has authorized similar (and more expansive) activities for national banks and the FDIC has given permission to state nonmember banks subject to state law to engage through affiliates in even broader securities transactions.

Banks have attempted to enter other financial spheres. The pressure to expand products and services impelled the banking industry to cast an eye towards the lucrative insurance domain which had historically been closed to such competition. The legal separation which had existed between banking and insurance did not come about through any one particular piece of legislation as with the Glass-Steagall Act separating the banking and securities industries. Rather, the separa-

273. The revenue from securities trading cannot exceed five percent of the subsidiary's revenue. The Board required that underwriting and dealing in equity securities be delayed for at least one year, pending a review of the track record established in bonds. These subsidiaries are referred to as section 20 subsidiaries. *See supra* note 256 and text accompanying notes 258-260.

274. Kathleen Day, *Fed Grants New Powers to 5 Banks*, WASH. POST, Jan. 19, 1989, at F1, F2.

275. *Id.* But all this bluster and saber rattling did not cow the Board. As if to further challenge Congress, in its Modifications to Section 20 Orders, 75 Fed. Res. Bull. 751 (1989), the Board raised from 5 to 10 percent the revenue limit on the amount of total revenues a section 20 subsidiary may derive from ineligible securities underwriting and dealing activities. *See supra* note 273. In addition the modifications permit, with certain conditions, underwriting and dealing in securities of affiliates. Furthermore, in Bankers Trust New York Corporation, 75 Fed. Res. Bull. 829 (1989) and J.P. Morgan & Co. Inc., 76 Fed. Res. Bull. 26 (1990), the Board authorized the private placement of all types of securities, permitted the provision of related advisory services, and permitted the buying and selling of all types of securities on the order of investors as a "riskless principal." The Board also held that on such transactions the 10 percent limitation does not apply.

tion resulted from the generally accepted view that banks should not be allowed to engage in nonbanking activities.[276] This perception was reflected by Congress's decision to permit banks to engage in minimal insurance activity embodied in section 92 of the national bank laws.[277]

When the Comptroller, a half century later, attempted to enlarge this power of national banks,[278] he was overruled in *Georgia Association of Independent Insurance Agents, Inc. v. Saxon*.[279] The Comptroller had more success in empowering national banks to sell and underwrite credit life insurance and title insurance in connection with loans.[280] As can be seen from the foregoing decisions, the Comptroller's Office has taken a fairly permissive attitude towards bank activity in the insurance field.

A more significant matter was the right of national banks to engage through their subsidiaries in underwriting of municipal bond guaranty insurance. Such underwriting not only raised the substantive issue of banking and insurance but also raised a controversial jurisdictional issue between the Comptroller and the Board. In January 1985, Citibank, a *national bank* and subsidiary of the BHC Citicorp, in a letter to the OCC proposed the establishment of a new operating subsidiary,[281] American Municipal Bond Assurance Corporation (AMBAC) for the purpose of issuing "standby letters of credit" for municipal bonds. Municipalities issuing bonds would apply for AMBAC insurance and, if there were a default thereon, the bondholders would apply to AMBAC for payment of interest and principal due. The Citibank reasoned in its proposal that this activity was not insurance but standby letters of credit, a long standing permissible banking activity. In May 1985, the Comptroller approved Citibank's proposal, agreeing that this was not insurance.[282]

In immediate response to this bombshell, the American Insurance

276. *See* Saxon v. Georgia Ass'n of Independent Insurance Agents, Inc., 399 F.2d 1010 (5th Cir. 1968). *See supra* text accompanying notes 115 through 118. Because of the lack of comprehensive legislation, each banking authority developed its own interpretations as to the sphere of insurance activity to be permitted. Thus, the Fed, the Comptroller, the FDIC and the state authorities made independent and conflicting decisions.

277. 12 U.S.C. § 92 (1988). For subsequent history of § 92 see *supra* note 125. For provision of § 92, *see supra* text accompanying note 119.

278. *See supra* note 122 and accompanying text.

279. 268 F. Supp. 236 (N.D. Ga. 1967), *aff'd*, 399 F.2d 1010 (5th Cir. 1968). For discussion of this case, see *supra* note 123 and accompanying text.

280. *See supra* notes 126-33 and accompanying text.

281. Although section 16 of Glass-Steagall (12 U.S.C. § 24 (1982)) prohibits national and member banks from owning stock in a corporation, both the OCC and the Fed ruled that such banks may establish operating subsidiaries with the restriction that such subsidiaries may engage only in activities permitted their parents, 12 C.F.R. §§ 5.34, 225.22(d)(1988).

282. Comptroller Staff Interpretive Letter No. 338, *reprinted in* [1985-1987 Transfer Binder], Fed. Banking L. Rep. (CCH) ¶ 85,508 (May 2, 1982).

Association (AIA) filed suit in the D.C. District Court. The AIA raised several issues including the contention that the proposed activity *was* insurance and, furthermore, that this activity was prohibited under the BHCA as amended by the Garn-St Germain Act.[283] The

283. Under the 1956 BHCA, Ch. 240, 70 Stat. 133, (codified as amended at 12 U.S.C. §§ 1841-49 (1988), and prior to the 1970 amendments thereto, Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 (codified as amended in scattered sections of 12 U.S.C.), the Fed permitted BHCs to engage in insurance activities which were far broader than what is considered permissible today. The language of the 1956 Act led to this latitude. This language prohibited BHCs and their nonbank subsidiaries from engaging in activities of a nonbank nature, except those "of a financial, fiduciary or insurance nature . . . which the Board . . . has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." Bank Holding Company Act of 1956, ch. 240, § 4(c)(6), 70 Stat. 133, 137 (codified as amended at 12 U.S.C. § 1843(c)(8)(1988)). In the 1970 Amendment, Congress, *inter alia*, deleted the "of a financial, fiduciary, or insurance nature" language and substituted the language containing the two tests mentioned in the quoted text accompanying *supra* note 240; *see also supra* text accompanying notes 243-245. On the basis of this new language the Fed adopted regulations and interpretations which were more definitive and somewhat more restrictive by promulgating § 225.4(a) of Regulation Y (now § 225.25), of which § 225.4(a)(9)(now § 225.25(b)(8)) related to insurance activities. Section 225.4(a)(a) stated: [Permissible activities which the Board determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto are]:

> (9) acting as insurance agent or broker in offices at which the holding company or its subsidiaries are otherwise engaged in business (or in an office adjacent thereto) with respect to the following types of insurance:
> (i) Any insurance for the holding company and its subsidiaries;
> (ii) Any insurance that (a) is directly related to an extension of credit by a bank or a bank-related firm of the kind described in this regulation, or (b) is directly related to the provision of other financial services by a bank or such a bank-related firm, or (c) is otherwise sold as a matter of convenience to the purchaser, so long as the premium income from sales within this subdivision (ii)(c) does not constitute a significant portion of the aggregate insurance premium income of the holding company from insurance sold pursuant to this subdivision (ii);
> (iii) Any insurance sold in a community that (a) has a population not exceeding 5,000, or (b) the holding company demonstrates has adequate insurance agency facilities.

12 C.F.R. § 225.4(a)(9)(1976). (Now 12 C.F.R. § 225.25(b)(8)(1988)).

The Alabama Association of Insurance Agents brought suit against the Board, contending that the activities listed in § 225.4(a)(9) violated § 4(c)(8) of the BHCA in that they were not sufficiently "closely related to banking". *Alabama Ass'n, Ins. v. Board of Governors of Fed. Reserve Sys.*, 553 F.2d 224 (5th Cir. 1976), *vacated in part on rehearing*, 558 F.2d 729 (1977), *cert. denied*, 435 U.S. 904 (1978). As a result of this litigation BHCs could continue to engage in the following insurance activities:

> 1. Credit life and credit accident and health insurance sold in connection with extensions of credit by a bank holding company or its nonbank subsidiary. This type of insurance may also be underwritten by bank holding companies.
>
> 2. Property and casualty insurance sold, on an agency basis, in connection with extensions of credit or the provision of a financial service

court granted summary judgment in favor of the Comptroller, holding

---

(such as mortgage servicing). Bank holding companies may not underwrite this type of insurance.

3. Insurance (liability, employee health, etc.) sold to banking subsidiaries of the bank holding company. This insurance cannot be underwritten by the holding company.

4. General insurance to the public in towns with under 5,000 citizens, so long as the parent bank holding company's principal place of banking is located in a town of less than 5,000.

but are prohibited from the following activities:

1. "Convenience insurance" (whole life or other types of insurance products not necessarily connected to any specific loan) usually sold to customers of a bank holding company or its nonbank subsidiaries;

2. The sale of property and casualty insurance, fidelity insurance, or group life or health insurance for a bank holding company, any of its nonbanking subsidiaries, or employees thereof;

3. The sale of renewal insurance after a loan from a bank holding company nonbank subsidiary has been repaid.

4. The combined sale of mutual funds and insurance, that is, insurance premium funding; and

5. Underwriting life insurance not sold in connection with a credit transaction by a bank holding company or a nonbank subsidiary.

S. REP. NO. 97-536, 97th Cong., 2d Sess. (1982).

This brings us to the Garn-St Germain Act, Pub. L. No. 97-320, 96 Stat. 1469 (codified as amended in scattered sections of 12 U.S.C.). Congress, reflecting the traditional public view against concentration of economic power (*see supra* text accompanying note 27), became concerned with the growing penetration of banks into the insurance industry. For several years prior to 1982, Congress held hearings on legislation designed to restrict the insurance activities of BHCs. The result was a provision in the Garn-St Germain Act which divested the Fed of its duty and power under § 4(c)(8) to determine whether an insurance activity is "so closely related to banking . . . as to be a proper incident thereto." Section 601 of the Act, incorporated into § 4(c)(8), 12 U.S.C. § 1843(c)(8), has been modified as follows:

[The prohibition that a BHC shall not acquire a company which is not a bank shall not apply to]

(8) shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order of regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto, but for purposes of this subsection it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent, or broker except . . . .

There follow seven exemptions to this general prohibition. Exemption A permits BHCs to act as underwriters, agents or brokers with respect to credit life, disability and involuntary unemployment insurance if the insurance is limited to paying off loan balances in case of the borrower's death, disability or involuntary unemployment. Exemption B permits finance company subsidiaries of BHCs to sell (*not* underwrite) property insurance on loan collateral on loans of $10,000 or less (as adjusted annually by the Consumer Price Index). Exemption C permits BHCs and their nonbank subsidiaries to engage in general insurance agency activities in towns of 5,000 or less population. Exemptions D and G are grandfathering provisions. Exemption E authorizes BHCs to supervise retail insurance agents who sell insurance to the BHC or its subsidiaries. Exemption F permits small BHCs (assets of $50 million or less) to engage in any insurance agency activ-

that the guarantee insurance offered by AMBAC was not insurance but the functional equivalent to providing standby letters of credit.[284] The court made short shrift of the AIA's argument that the proposed activity violated the BCHA by saying that it was unnecessary to address this contention. The court noted that under section 4(c)(5) and the Board's own regulation a BHC bank subsidiary may own any operating subsidiary whose activities are deemed permissible under the National Bank Act by the Comptroller. The court further stated that the Board will defer to the Comptroller's judgment,[285] in effect holding that the BHCA does not apply and the Board had no jurisdiction in the matter.

In *American Insurance Association v. Clarke*,[286] in which the AIA appealed the decision, the D.C. Circuit Court in effect overturned the Comptroller and the district court. The court did agree with the OCC that the guarantee insurance was analogous to standby letters of credit and, as such, permissible under the National Bank Act. However, it noted that the OCC's 1985 decision that Board approval is unnecessary because the BHCA covers only the nonbank subsidiaries of the BHCs and not their banking subsidiaries, was incorrect. The BHCA does limit the activities of a BHC bank subsidiary's subsidiary. Section 1843(a)(1)[287] bars a BHC from acquiring "direct or *indirect* ownership or control of any voting shares of any company which is not a bank," unless an exception applies.[288]

The court concluded that ultimate control of AMBAC by Citicorp, a BHC, triggered the section 4(c)(8) prohibition of a BHC engaging directly or indirectly through a subsidiary's subsidiary, here Citibank, in insurance activities. The decision that standby credits were not insurance activities was not a judgment that the Comptroller was to make, but was to be left to the Board. Finally, the court held that that district court's reliance on section 1843(c)(5)[289] in its conclusion that the BHCA does not apply to any OCC approved investments by a national bank was also misplaced. Section 24 applies only to securities held for investment, but not to shares of an operating subsidiary such as AMBAC, which is neither a security nor an investment as contem-

---

ity, *provided* that sales of life insurance and annuities is limited to activities permitted under exemptions A, B or C.

284. American Ins. Ass'n v. Clarke, 656 F. Supp. 404 (D.D.C. 1987), *aff'd on reh'g*, 865 F.2d 278 (D.C. Cir. 1989).

285. *Id.* at 413-14 (*citing* 12 U.S.C. § 1843(c)(5)(1982) and 12 C.F.R. § 225.22(d)(1)(1985)).

286. 854 F.2d 1405 (D.C. Cir. 1988), *vacated in part*, 865 F.2d 278 (D.C. Cir. 1989).

287. 12 U.S.C. § 1843(a)(1)(1982).

288. 854 F.2d 1405, 1411 (D.C. Cir. 1988).

289. 12 U.S.C. § 1843(c)(5)(1988). This section provides that national banks and their subsidiaries may only own stock explicitly authorized by statute for investment by national banks under the provisions of 12 U.S.C. § 24 (1988).

plated in section 24. To summarize, the D.C. Circuit held that Citibank must obtain Board approval before issuing "standby credits" (*i.e.*, municipal bond insurance) through AMBAC, even though the OCC granted it permission to do so. This decision caused great concern to the Comptroller and the banking industry as it was viewed as a shift of jurisdiction from the deregulation oriented OCC to the more conservative Board. This motivated the Justice Department, OCC, and Citibank, to petition the court to reconsider whether it had been appropriate for the court to consider the OCC's interpretation of the BHCA and whether the acquisition of an insurance subsidiary by a national bank subsidiary of a bank holding company required prior approval by the Board. The court granted a rehearing on October 24, 1988. On January 6, 1989, the court vacated the portion of its decision relating to the BHCA issue, holding that, because the Board and not the OCC had exclusive jurisdiction in interpreting the BHCA the court would not review the OCC's interpretation.[290]

The Justice Department took the position that the Board does not have jurisdiction over the operating subsidiaries of holding company banks and refused to permit the Board to file its own brief in the rehearing.[291] The Board, on November 21, 1988, decided to issue for comment proposed amendments to Regulation Y[292] that would rescind its existing regulation[293] which permits BHCs to acquire, *without the Board's approval*, through their subsidiary *state banks*, companies engaged in activities that the bank is permitted to conduct under *state* law (the so called "South Dakota loophole").[294] If the existing rule were rescinded, BHCs would be required to obtain approval under section 4(c)(8) prior to acquiring or creating an operating subsidiary through a state bank. Until the AMBAC matter is resolved (at the date of this writing it still is in limbo) the Board will probably not extend its rulemaking proposal to national bank operating subsidiaries. To understand the meaning of the issues involved as well as their implications, it is necessary to review two additional matters involving insurance, the "South Dakota loophole" and the *Merchants National* case.

290. American Ins. Ass'n v. Clarke, 865 F.2d 278 (D.C. Cir. 1989). The court did not say that Citibank cannot continue ownership of AMBAC and, therefore Citibank, at the time of this writing, is continuing with this activity.

291. The Justice Department represents federal agencies in litigation and has the power to prevent individual agency self-representation.

292. 53 Fed. Reg. 48915 (December 5, 1988).

293. 12 C.F.R. § 225.22(d)(2)(ii)(1988). This rule is referred to as the "operating subsidiary" rule.

294. This rulemaking is not directed at the operating subsidiary rule at issue in AMBAC (where BHC ownership of the operating subsidiary was through a *national bank*) but it does address the *same* legal issues. The national bank operating subsidiary rule is found in 12 C.F.R. § 225.22(d)(1)(1992).

Late in 1982 when the Garn-St Germain Act was passed, the insurance industry had cause for celebration: it hoped that Congress had finally passed a law that would separate banking and insurance once and for all, and thus thwart Citicorp's (and other banks') longstanding desire to enter the insurance business. Citicorp, however, began lobbying several states to allow state banks to engage in insurance activities. By March 2, 1983, the South Dakota legislature took the bait and passed a law allowing state banks and their subsidiaries to engage in "all facets of the insurance industry."[295] *At the same time*, legislation was passed to permit out of state BHCs to acquire South Dakota banks.[296] Thus the insurers' celebration did not last long. In April of 1983, Citicorp filed an application with the Board to obtain permission to acquire American State Bank of Rapid City, a South Dakota state bank, and thus to enter into *any* insurance activity *nationwide*.[297] Citicorp's application was filed under section 3 of the BHCA (which governs the acquisition of banks)[298] in an attempt to avoid the prohibition of section 4 which governs the acquisition of nonbanks.[299] Citicorp relied on section 4(a)(2),[300] section 225.4(e) of Regulation Y[301] and two

295. S.D. CODIFIED LAWS ANN. § 51-18-30 (Supp. 1983).

296. S.D. CODIFIED LAWS ANN. § 51-16-40 to -42 (Supp. 1983).

297. Soon thereafter, BankAmerica Corp., First Interstate Bancorp and Security Pacific Corp announced plans to buy state banks in South Dakota for the purpose of entering the insurance business. Note, *Paving the Way in the Financial Services Industry: South Dakota Opens the Insurance Industry to Banks*, 29 S.D.L. REV. 172, n.36 (1983). They all filed applications with the Board, but later withdrew them (including Citicorp) when the Board issued a statement in January 1984 which concluded with the following paragraph:

> Taking account of the important and fundamental legal and policy issues raised by these applications, and their pending consideration before the Congress, the Board reached the tentative judgment that it could not approve the proposed bank acquisitions in view of present law and expressions of Congressional intent, subject to any further consideration by the Congress. However, the Board has, in the past, taken the position that the processing of an application may be suspended where the issues raised are the subject of pending litigation, legislation or rulemaking. Accordingly, the Board staff has informed the Applicants of the Board's views on these matters and the Applicants have requested the Board to suspend the processing of their applications. Similarly, because of the pending legislation, the Board decided to defer further action on the rulemaking now in progress on section 225.4(e) of Regulation Y, which permits subsidiaries of state banks that are owned by bank holding companies to acquire or form an operating subsidiary to engage in any activity that the Bank itself may engage in directly.

Board Statement on Applications to Acquire State-Chartered Banks in South Dakota, January 5, 1984, [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,820. Citicorp requested the Board to reactivate its application in February 1985.

298. 12 U.S.C. § 1842 (1988).

299. 12 U.S.C. § 1843 (1988). *See also* text accompanying notes 238-240.

300. 12 U.S.C. § 1843(a)(2)(1988).

301. Now 12 C.F.R. § 225.22(d)(2)(1988).

old Board orders.[302] Citicorp argued that the language of section 4(a)(2) covers only the BHC itself and its *non*banking subsidiaries, but does not relate to its *banking* subsidiaries.[303] Under section 225.4(e) the Board declared in 1971 that

> So far as federal law is concerned, a state chartered bank or a subsidiary thereof may . . . acquire or retain all . . . of the shares of a company that engages solely in activities in which the parent bank may engage, at locations in which the bank may engage in the activity, and subject to the same limitations as if the bank were engaging in the activity directly.[304]

Citicorp contended that this language clearly exempted state banks owned by BHCs from the constraints of the "closely related to banking" standards of section 4(c)(8);[305] the scope of their nonbanking activities being subject only to the limitations of state law. In relation to the *Piedmont* and *American Bancorp* orders,[306] Citicorp maintained that the Board had held that BHC insurance activities through state bank subsidiaries are consistent with the BHCA. These cases involved applications under section 3 for the formation of new BHCs by the existing banks, and under section 4 for the acquisition by the new BHCs of several finance companies. The existing banks were already engaged through subsidiaries in general insurance agency activities permitted by state law. Pursuant to section 4(c)(5) of the BHCA and section 225.4(e) of Regulation Y, the Board approved the applications and stated that Board approval was not required.[307]

The Board nevertheless denied Citicorp's application without specifically addressing Citicorp's contentions.[308] The Board approached the matter from a wholly different point of view; it concluded that the proposed acquisition was an attempted *evasion* of the requirements of section 4.[309] It analyzed the South Dakota statute as follows:

> South Dakota law specifically provides that an out-of-state bank holding

---

302. Piedmont Carolina Fin. Servs., Inc., 59 Fed. Res. Bull. 766 (1973); American Bancorp, Inc., 39 Fed. Reg. 22,468 (1974).

303. The language referred to is as follows: "No bank holding company shall . . . retain direct or indirect ownership or control . . . of any company *which is not a bank or bank holding company* or engage in any activities other than . . . banking or of managing or controlling banks . . . and . . . those [activities] permitted under [Section 4(c)(8)]." 12 U.S.C. § 1843(a)(2)(1982)(emphasis added).

304. 12 C.F.R. § 225.4(e)(1983). In 1984 the Board replaced this provision with § 225.22(d)(2), *supra* note 301, in which there was added the italicized phrase: "A state chartered bank or its subsidiary may, insofar as federal law is concerned *and without the Board's prior approval* . . . acquire or retain all . . . of the securities of a company." 12 C.F.R. § 225.22(d)(2)(1988)(emphasis added). This additional language seems to strengthen the argument set forth by Citicorp.

305. 12 U.S.C. § 1843(c)(8)(1988).

306. *See supra* note 302.

307. Piedmont Fin. Servs., Inc., 59 Fed. Res. Bull. 766, 768 (1973).

308. Citicorp, 71 Fed. Res. Bull. 789 (1985).

309. Thus leaving the South Dakota loophole issue still an open question. In fact the Fed specifically refused to decide that point:

> company may acquire a single existing state chartered bank in South Dakota. S.D. CODIFIED LAWS ANN. § 51-16-40(b)(1984). South Dakota law also permits all banks chartered under the laws of South Dakota to engage, either directly or through subsidiaries, in all facets of the insurance business. S.D. CODIFIED LAWS ANN. § 51-18-30 (1984). Under South Dakota law, however, a South Dakota bank acquired by an out-of-state bank holding company is prohibited from expanding or acquiring new banking offices or remote service units by merger, acquisition or *de novo* and is required to conduct its insurance activities in South Dakota in a manner and at a location that is not likely to attract customers from the general public in South Dakota to the substantial detriment of existing insurance companies, brokers and agents in the state. S.D. CODIFIED LAWS ANN. § 51-16-41 (1984). In addition, a *de novo* South Dakota bank acquired by an out-of-state bank holding company is limited to operating a single banking office in South Dakota and is required to conduct its banking business in South Dakota at a location and in a manner so that it is not likely to attract customers from the general public in South Dakota to the substantial detriment of existing banks in the state. *Id. South Dakota banks owned by South Dakota bank holding companies are not subject to the same limitations or restrictions as apply to state banks owned by out-of-state bank holding companies, and may, for example, establish branches statewide.*[310]

The Board concluded that the primary, if not sole, purpose of the proposed acquisition is to enable Citicorp to engage in nationwide insurance activities prohibited under section 4. It further found that the acquisition of the South Dakota bank would amount to the acquisition of a nonbank and an attempt to bypass the strictures of section 4(c)(8) because the acquired "bank" would be predominantly an insurance agency engaged in little, if any, banking business. The Board noted that it is authorized under section 5(b)[311] to deny applications that manifest an *evasion* of the purposes of the BHCA, even if the proposal technically meets the letter of the law.[312] This decision raised fears in

---

> In light of this conclusion, the Board finds it necessary to make a determination regarding Protestants' contention that the nonbanking and insurance provisions of the Act apply to holding company banks.
>
> The Board has, however, previously determined that the nonbanking provisions of the Act apply to acquisitions by holding company banks of voting shares of a company. 12 C.F.R. 225.101. The Board has adopted a regulatory exemption from this prohibition, found in section 225.22(d)(2) of Regulation Y, for acquisitions by holding company state banks of all of the voting shares of a nonbanking company engaged only in activities that the bank may conduct directly. This exemption was adopted in order to promote competitive equity between holding company banks and independent banks in the absence of evidence of use by bank holding companies of holding company banks to evade the nonbanking provisions of the Act. Because Citicorp proposes to utilize Bank to evade the nonbanking provisions of the Act, the Board concludes that the proposal is not consistent with regulation.

Citicorp, 71 Fed. Res. Bull. 789, 791, n.6. The Board is now in the process of resolving the matter through the rulemaking process. *See supra* text accompanying notes 291-294.

310. Citicorp, 71 Fed. Res. Bull. 789 (1985)(emphasis added).

311. 12 U.S.C. § 1844(b)(1980).

312. Citicorp, 71 Fed. Res. Bull 789, 790, n.3. Although the Board did not stress Citicorp's § 225.4(e) argument, in its rulemaking notice for amending

the insurance industry that, absent an evasionary motive, the Board would approve BHC applications of the South Dakota-type loophole.

The decision motivated Congress to hold hearings on the matter.[313] The main issue was whether the insurance prohibition provision of section 4(c)(8) of the BHCA[314] should be applied to bank subsidiaries of BHCs. Under the present wording of that section and section 4(c)(5) the Board has held that it only applies to the BHCs themselves and their nonbank subsidiaries.[315] Unfortunately, Congress did not follow through and act on this matter[316] and the fears of the insurance industry were realized when the Board made its decision in the *Merchants National Corporation* case.[317]

In 1986 the Board approved applications by Merchants, a BHC, to acquire two Indiana state banks, Anderson Bank and Mid State Bank.[318] Both banks had been engaged in selling insurance of all kinds, except life insurance, as authorized by Indiana law.[319] The Board approval included permission to continue the insurance business, *directly* by the *banks* themselves and not through subsidiaries of the banks, reiterating the Board view that section 4(c)(8) does not apply to subsidiary banks of BHCs. The response of the insurance indus-

---

§ 225.22(d)(2)(the successor provision), *see supra* text accompanying notes 292-294, the Board, in its introductory remarks stated:

> In adopting these rules in 1971, the Board noted that it did so based upon notions of competitive banks and in the absence of evidence that acquisitions by holding company banks were resulting in evasions of the Act. 36 Fed. Reg. 9292 (1971) .... The Board, however, recognized that over time these rules could become the focus for evasion of section 4(c)(8) of the Act and cautioned that *it would review the merits of its decision not to apply the Act to these subsidiaries from time to time based upon its experience in administering the Act.*
>
> At year-end 1971, bank holding companies controlled 2,420 banks, or approximately 18 percent of the total banks in the United States. These banks held approximately 57 percent of the total assets in commercial banks in the country. By year-end 1987, bank holding companies controlled 9,316 banks with 92 percent of assets in commercial banks.

Citicorp, 71 Fed. Res. Bull. 789, n.3 (emphasis added). Thus it appears that the Board has in fact, *sub silentio*, applied the above quoted *caveat* in the Citicorp case, and therefore did not need to address the *Piedmont* and *American Bancorp* contentions, nor the other contentions of Citicorp. Piedmont Fin. Servs., Inc., 59 Fed. Res. Bull. 766 (1973); American Bancorp, Inc. 39 Fed. Reg. 22, 468 (1974).

313. *The South Dakota Loophole: Hearing Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 99th Cong., 1st Sess. (1985).
314. *See supra* note 283.
315. 12 C.F.R. § 225.22(d)(1988).
316. Since 1982, Congress has repeatedly considered legislation that would restrict insurance activities of banks, but has not done so, notwithstanding numerous and extensive hearings on the subject.
317. 73 Fed. Res. Bull. 876 (1987).
318. 72 Fed. Res. Bull. 838 (1986).
319. IND. CODE ANN. § 28-1-11-2 (Burns 1986).

try was immediate and vehement. A large number of trade groups protested the Board's order on the grounds that it violated section 4 of the BHCA. Merchants did not want to get involved in long litigation and, therefore, made a commitment that it would cause the two banks to divest themselves of their insurance agency activities within two years unless, within that time, the Board approved the banks to retain their insurance activities. During this period, Merchants agreed to sell *only* renewal policies. Subsequently, Merchants requested the Board to release it from its commitment on grounds not relevant to this discussion. The Board granted the release on the grounds that the insurance prohibitions of section 4 of the BHCA do not in any way limit the direct activities of subsidiary banks of BHCs, except where the record demonstrates that the type of evasion described in the *Citicorp/South Dakota* case is present.[320] In the instant case, the Board concluded that:

> the record does not show that the banks would be operated by Merchants predominantly as insurance agencies or that the acquisition of the banks is a device to enable the applicant to engage in insurance activities. Rather, the record shows that the insurance activities of the banks are incidental and small relative to their banking operations.[321]

Thus, the Board apparently legitimized the South Dakota loophole. The Board went further; even though the *Merchants* case did not involve nonbank subsidiaries of state banks in a BHC system, the Board used this case as a vehicle to clarify its view as to applicability of section 4 of the BHCA including the Garn-St Germain amendment. The Board stated that it draws a distinction between direct activities and those conducted through a subsidiary of a bank. As to the latter, the restrictions of section 4 of the BHCA do apply.[322] Thus, if the *Merchants* order is permitted to stand, bank holding companies will be free to enter the insurance business through the acquisition of state chartered banks provided that all insurance activities not expressly permitted by section 4(c)(8) are conducted directly by the state bank and not through a subsidiary.

The insurance industry was very upset, especially since this precedent could be expanded to permit BHC bank subsidiaries not only to sell insurance but also to underwrite insurance and engage in any nonbanking activity authorized by the particular state. The Independent Insurance Agents of America (IIAA) immediately filed a motion to stay the Board's order pending judicial review in the Court of Appeals for the Second Circuit. The suit was grounded on several substantive

320. Merchants Nat'l Corp., 73 Fed. Res. Bull. 876, 878 (1987). The Board also noted that the insurance prohibitions of the Garn-St Germain Act do not apply. "Thus, the provisions of the Garn-St Germain Act have no applicability where the nonbanking provisions of section 4 of the Act do not apply." *Id.* at 878 n.7 (1987).

321. 73 Fed. Res. Bull. 876, 878 n.9 (1987).

322. *Id.* at 888.

issues and on the CEBA[323] moratorium[324] which bars the Board from issuing orders of the type issued here.[325] The Second Circuit vacated the Board's order,[326] holding that it fell within the CEBA moratorium provisions but did not address the substantive issues involved.[327] After the expiration of the moratorium, Merchants requested that the Board reissue the order. On March 3, 1989 the Board granted the relief prayed for,[328] reiterating its view that section 4 of the BHCA does not regulate the direct activities of bank subsidiaries of BHCs.[329] The

323. Pub. L. No. 100-86, 101 Stat. 552 (1987)(codified as amended at scattered sections of 12 U.S.C.).

324. *Id.* at § 201(b)(4).

> The provision reads as follows:
> [The Board] may not approve the acquisition of a bank holding company . . . of . . . a State chartered bank, unless the bank holding company, . . ., has agreed to limit the insurance activities in the United States of the company to be acquired to those permissible under section 4(c)(8). . . .

12 U.S.C. § 1841 (1988).

325. The Fed in its order stated that the moratorium provision did not apply in *Merchants* because "[t]he Board's decision to grant relief from the commitments, . . ., does not constitute the *authorization* of any activity under the BHC Act." 73 Fed. Res. Bull. 876, 893 (1987)(emphasis added). In other words, the Fed felt that the relief granted "would not increase the banks' insurance powers since the banks already had the powers by virtue of state law and those powers were not and never had been limited by the BHC Act." Merchants National Corp., 75 Fed. Res. Bull. 388, at 389 (1989).

326. Independent Ins. Agents v. Board of Governors of the Fed. Reserve Sys., 838 F.2d 627 (2d Cir. 1988).

327.

> We have no authority to predict that the Board, now advised that the moratorium applies to the approval of Merchants National's application, will choose to reissue its order with an effective date of March 1, 1988. The proper course is to vacate the order and permit the Board to proceed as it sees fit in a manner consistent with our decision and applicable law.
>
> In view of our disposition, *it is both unnecessary and inappropriate for us to review that portion of the Board's order that concerns the scope of the nonbanking prohibitions of section 4 of the Bank Holding Company Act.*
>
> The petition for review is granted, and the order of the Board is vacated.

Id. at 635 (emphasis added).

328. Merchants Nat'l Corp., 75 Fed. Res. Bull. 388 (1989).

329. The Board carefully analyzed §§ 1843(a)(1) and (a)(2)(12 U.S.C. § 1843(a)(1982)(*see supra* note 303), and concluded that:

> By its terms, this restriction in section 4 does not apply to shares of a company that is itself a bank. Thus, a bank holding company that controls an institution that qualifies as a "bank" under the definition in the Act is not required, in order to acquire or retain the shares of the institution, to limit the institution's activities to those permitted under the closely related to banking standard of section 4 (or one of the other limited exceptions in the Act), except where the record demonstrates an evasion of the Act, such as presented in the *Citicorp (South Dakota)* case. It is only companies that do not qualify as "banks" under the Act that must limit their nonbanking activities to those permitted under the closely related to banking standard in section 4(c)(8) of the Act (or qual-

IIAA immediately appealed to the Second Circuit,[330] which handed down a shattering decision in November of 1989. Unless the Supreme Court reverses or Congress takes some action to limit the effect of the holding, the Second Circuit's decision may have an enormous impact on financial institutions.

The Court of Appeals for the Second Circuit analyzed sections 3 and 4 of the BHCA.[331] It found that section 3 sets forth factors governing Board approval of bank acquisitions by BHCs. Section 4 sets forth two sets of prohibitions, characterized as the "ownership clause" and the "activities clause." The former provides that a BHC may not "retain direct or indirect ownership or control of any voting shares of any company which is not a bank or bank holding company."[332] The latter forbids a BHC to "engage in any activities other than (A) those of banking or managing or controlling banks . . . and (B) those permitted under [section 4(c)(8) of the Act]. . . ."[333] Section 4(c)(8)[334] sets forth the "closely related to banking" exception to the nonbanking provision.[335]

The court then reviewed the Board's decision which held that the provisions of section 4 limiting the nonbanking activities of the BHCs do not apply to bank subsidiaries of a BHC. The Board held that the limitations of section 4(a)(2)[336] apply in express terms only to BHCs, not to banks. Furthermore, the "ownership clause" of section 4 restricts the entities a BHC may acquire or retain while the "activities clause" restricts the activities the BHC itself may engage in. If the restriction on activities were to apply to subsidiaries of the BHC, the Board determined, the restriction on acquisition of nonbank entities would be superfluous. The inclusion of the phrase "direct or indirect" in the "ownership clause" and its omission in the "activities clause" further compelled the Board's decision that the restrictions of section 4 do not apply to BHC subsidiaries. Finally, relying on section 2(g)(1)[337] of the BCHA, the Board held that the insulation of bank subsidiaries of BHCs from section 4 limitations does not apply to the banks' own subsidiaries. Section 2(g)(1) provides that stock of such third generation entities are deemed to be held indirectly by the BHC

---

ify under some other exception in section 4) in order to be acquired or retained directly or indirectly by a bank holding company.

Merchants Nat'l Corp., 75 Fed. Res. Bull. 388, 391 (1989)(footnote omitted).

330. Independent Ins. Agents v. Board of Governors of Fed. Reserve Sys., 890 F.2d 1275 (2d Cir. 1989).

331. 12 U.S.C. §§ 1842, 1843 (1988).

332. 12 U.S.C. § 1843(a)(2)(1988).

333. *Id.*

334. *Id.* at § 1843(c)(8).

335. See *supra* note 283 for the wording of this provision.

336. 12 U.S.C. § 1843(a)(2)(1988).

337. 12 U.S.C. § 1841(g)(1)(1988).

and, therefore, in the Board's view, the question of the ownership of such entities and the scope of activities of such entities are governed by section 4. The Board further noted that the legislative history of the BHCA and its amendments shows Congress's purpose to maintain the power of state and national chartering authorities to determine the scope of permissible activities of a BHC's bank subsidiaries regardless of whether the BHC is subject to the jurisdiction of the Board.[338]

The court initially noted that the BHCA did not speak precisely to the question at hand:

> We find no provision that says, in substance, 'The Board may not regulate the activities of bank subsidiaries of bank holding companies' or 'Bank subsidiaries of bank holding companies may engage in nonbank activities to the extent permitted by their chartering authorities.' The Board reads the Act as if it contained such language. On the other hand we find no provision that says, in substance, 'Bank subsidiaries of bank holding companies may not engage in nonbank activities.' The IIAA reads the Act as if it contained this wording. The question for us is whether the Board's interpretation of the language that does appear in the Act is reasonable. . . .[339]

Although the court found some of the Board's arguments fallacious, it found somewhat more persuasive textual arguments arising from comparisons of the "activities clause" with certain other provisions of section 4(a)(2). The grandfather clause of section 4(a)(2) permits a BHC to conduct those activities "in which directly or through a subsidiary" it was engaged in at the designated times and conditions. No similar clause modifies the "activities clause." Additionally the "ownership clause" prohibits retention of "direct or indirect" ownership of nonbanks, but no such phrase modifies the "activities clause." The court found stronger support for the Board's interpretation in the structure of the Act. The Board argued that if the "activities clause" did apply to subsidiaries of a BHC, then the "ownership clause" would be superfluous, since under that reading, the "activities clause" alone would preclude a BHC from owning a nonbank. The court agreed with this view, but found perplexing the Board's contention that it had no authority to regulate bank subsidiaries of BHCs in their nonbank activities but did have the authority to regulate the subsidiaries of the bank subsidiary. It found the IIAA's interpretation of the BHCA more consistent.

The IIAA pointed out that the section 4(c)(8) exemptions including those of the "activities clause," use the term "company" to describe

338. The view of the Board as to the congressional intent in the BHCA in respect to limitations on permissible activities of subsidiary banks of BHCs is again a manifestation of the traditional national concern of balancing of federal and state authority over banking. *See supra* note 78. *See also supra* text accompanying notes 11 - 28.

339. Independent Ins. Agents v. Board of Governors of Federal Reserve Sys., 890 F.2d 1275, 1281 (2d Cir. 1989).

those entities. "Company" is defined in section 2(b)[340] to include a bank. Further, section 4(c)(8) requires of the Board, in determining whether a particular activity is a "proper incident to banking", to assess whether the performance of that activity "by an affiliate of a holding company" will produce public benefits. Section 2(b)[341] defines "affiliate" to include "company", and thus a bank. Therefore, the IIAA argued, subsidiary banks should be subject to the "activities clause" because they are within the class exempted from that clause by section 4(c)(8). The IIAA maintained that, it is more logical to hold that the Board has regulatory power over the nonbanking activities of all three tiers (the BHC, the bank subsidiary of the BHC and the bank's subsidiary) rather than permit the generation-skipping effect, which would result from the Board's interpretation.[342]

Although the court seemed to indicate that the IIAA had espoused a more justifiable position, it ultimately held for the Board. The court seemed to ignore the force of the IIAA's contentions regarding section 4(c)(8) and relied on legislative history to reach its conclusion:

> Plainly, as the ownership clause commands, Congress did not want bank holding companies to own nonbanks. The legislative history, however, is remarkably free of clear statements indicating disapproval of nonbanking activities engaged in directly by bank subsidiaries. If such were the intent of Congress, one would expect to find a clear statement of such purpose in the key House and Senate reports. Finally, during the hearings the attention of Congress was specifically called to the range of activities that state chartering authorities were permitting for bank subsidiaries of bank holding companies, . . ., and some Congressmen expressed the view that the holding company still would not modify the state regulatory authority. . . .[343]

In connection with the 1970 amendments to the Act, the court quoted the following portion of the Banking Committee report:

> It should be emphasized that these two prohibitions [insurance activities and sale of mutual funds] apply only to the bank holding company and its nonbanking subsidiaries and not to the bank subsidiaries of bank holding companies whose insurance agency and mutual fund operations are governed by other Federal and State laws. *This is in keeping with the original concept of the 1956 act, which was to regulate bank holding companies and not subsidiary banks.* [Emphasis added][344]

The IIAA's petition for certiorari was denied.[345]

---

340. 12 U.S.C. § 1841(b)(1988).
341. *Id.* at § 1841(k)
342. The IIAA points out that under the Board's interpretation the prohibition of the "ownership clause" can be avoided by merging the "grandchild" into the bank subsidiary and then conducting the nonbank activities itself.
343. *Control and Regulation of Bank Holding Companies: Hearings on H.R. 2674 Before the House Comm. on Banking and Currency*, 84th Cong., 1st Sess. 536, 553 (1955).
344. H.R. REP. NO. 387, 91st Cong., 1st Sess. 9 (1969)(emphasis added). The bill on which the quoted portion of the report was made did not pass.
345. Independent Ins. Agent of America v. Board of Governors of the Fed. Reserve Sys., 111 S.Ct. 44 (1990).

To summarize the present situation it may be stated that the position of banks with respect to insurance is in a state of obfuscated limbo. The Board's interpretation of section 4 of the BHCA supports the view that direct activities of bank subsidiaries of BHCs are not regulated by the nonbank activities regulatory provisions of the BHCA, and, therefore, such bank subsidiaries may engage in such activities to the extent permitted by the applicable state laws or the National Bank Act. The Second Circuit agreed with this view.

Nonbank subsidiaries of state banks in a BHC system are considered by the Board to be under its jurisdiction, but under its present regulation they are subject to the liberal "operating subsidiary" rule,[346] now under review by the Board.[347] For nonbank subsidiaries of national banks in a BHC system the "operating subsidiary" rule[348] seems to give all jurisdiction to the Comptroller. *Clark*,[349] however, draws this matter into question and the Board does not seem to wish to clear it up.[350] It appears that the Board, the Comptroller and the courts are all waiting for Congress to stabilize the matter legislatively.

C. Congressional Activity and Lack Thereof

Since the early 1980s Congress has sought solutions to the problems raised by the new financial environment.[351] Extensive hearings have been held[352] and many bills have been introduced, but virtu-

346. *See supra* text accompanying note 294.
347. *See supra* text accompanying note 293.
348. 12 C.F.R. § 225.22 (d)(1)(1992).
349. American Ins. Ass'n v. Clarke, 854 F.2d 1405 (D.C. Cir. 1988) *vacated in part* 865 F.2d 278 (D.C. Cir. 1989).
350. *See supra* text following note 294. On the other hand, the banking industry contends that not only are subsidiary banks of a holding company free from section 4 BHCA regulation (as per the Fed) but that their nonbanking subsidiaries are likewise so. The insurance industry argues that *all* subsidiaries of BHCs are subject to section 4 of the Act. The courts are divided.
351. *See supra* part V. A.
352. A sampling (chronologically listed) is as follows:
Bank Holding Company Legislation and Related Issues: Hearings Before the Subcomm. on Financial Institutions Supervision, and Insurance of the House Comm. on Banking, Finance, and Urban Affairs, 96th Cong., 1st Sess. (1980); *Competition and Conditions in the Financial System: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 97th Cong., 1st Sess. (1981); *Financial Institutions Restructuring and Services Act of 1981: Hearings on S.1720 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 1st Sess. (1981); *Financial Institutions Restructuring and Services Act: Hearings on S.1686, S.1703, S.1720, and S.1721 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. (1981); *Depository Institutions Amendments of 1982: Hearings on S.2879 Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance, and Urban Affairs*, 97th Cong., 2d Sess. (1982); *Competition in Financial Services: Hearing on H.R. 3537 Before the Subcomm. on Commerce, Transportation and Tourism of the*

ally no remedial legislation has emerged from this feverish activity.

House Comm. on Energy and Commerce, 98th Cong., 1st Sess. (1983); *Financial Services Industry: Oversight: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. (1983); *Competitive Equity in the Financial Services Industry: Hearings on S.2181 and S.2134 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. (1984); *Financial Restructuring: The Road Ahead: Hearings Before the Subcomm. on Telecommunications, Consumer Protection and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 2d Sess. (1984); *How the Financial System can Best Be Shaped to Meet the Needs of the American People: Hearings Before the House Comm. on Banking, Finance, and Urban Affairs*, 98th Cong., 2d Sess. (1984); *The South Dakota Loophole: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 99th Cong., 1st Sess. (1985); *Bush Task Group Report on Regulation of Financial Services: Blue Print for Reform: Hearings Before a Subcomm. of the House Comm. on Government Operations*, 99th Cong., 1st Sess. (1985); *Comprehensive Reform in the Financial Services Industry: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 99th Cong., 1st Sess. (1985); *Structure and Regulation of Financial Firms and Holding Companies: Hearings Before the Subcomm. of the House Comm. on Government Operations*, 99th Cong., 2d Sess. (1986); *Structure and Regulation of Financial Firms and Holding Companies: Hearings Before a Subcomm. of the Comm. on Government Operations*, 99th Cong., 2d Sess. (1986); *Financial Condition of Federally Insured Depository Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. (1987); *The Financial Modernization Act of 1987 and the Financial Services Oversight Act: Hearings on S.1886 and S.1891 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. (1987); *Reform of the Nation's Banking and Financial Systems: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance, and Urban Affairs*, 100th Cong., 1st Sess. (1987); *The Structure of the Financial Services Industry: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 100th Cong., 1st Sess. (1987); *Modernization of the Glass-Steagall Act: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. (1987); *New Securities Powers for Bank Holding Companies: Hearings Before the Senate Comm. on Banking, and Housing, and Urban Affairs*, 100th Cong., 1st Sess. (1987); *Implications of New Technology for Banking Regulation: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. (1987); *Role of Financial Institutions: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 100th Cong., 2d Sess. (1987); *Changes in Our Financial System: Globalization of Capital Markets and Securitization of Credit: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. (1987); *Legislative Proposals to Restructure our Financial System: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. (1987); *Financial Restructuring Proposals: Hearings on H.R. 3063 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. (1987); *Interrelationships of the Banking and Insurance Industries: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. (1987); *Reform of the Nation's Banking and Financial Systems: Hear-*

For example, a bill proposed by Senator Garn[353] in 1981 would have permitted increased flexibility in lending transactions between a bank and its affiliates, allow all depository institutions to sponsor and sell shares in mutual funds, *restrict bank holding company insurance activities* and authorize commercial banks to underwrite municipal revenue bonds. It would have broadened the powers of savings and loan associations allowing them to offer checking accounts, make commercial loans and invest in nonresidential real estate and corporate debt instruments.[354] However, the thrust of S.1720 was directed toward facilitating, under extraordinary circumstances, interstate and cross country mergers and acquisitions of troubled S & Ls.[355] The Regulators' Bill,[356] another 1981 bill that focused the ailing thrift industry, offered only short-term relief as distinguished from the long-term outlook of S.1720.[357] However, the Senate Banking Committee submitted an alternative bill, the Deposit Insurance Flexibility Act[358] which also offered solutions to the endangered thrift institutions but with a broader panoply than the Regulators' Bill.

Having witnessed the failure of these proposed bills, Senator Garn introduced a new bill, the Depository Institutions Amendments of 1982.[359] The bill would have amended Glass-Steagall to permit banks to establish "bank securities affiliates," which could underwrite and deal in municipal revenue bonds and also organize, sponsor, underwrite and distribute shares of mutual funds. However, the Senate Banking Committee amended the bill and substituted it for the House-passed H.R.6267, which then required a joint conference committee to resolve the differences between the two bills. The result was the Garn-St Germain Depository Institutions Act of 1982.[360]

This was a massive piece of legislation focused mainly on relieving the growing crisis in the thrift industry.[361] A number of provisions

---

ings Before the House Comm. on Banking, Finance, and Urban Affairs, 100th Cong., 2d Sess. (1988); *Financial Modernization Act of 1988: Hearings on S.1886 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 2d Sess. (1988).

353. The Financial Institutions Restructuring and Services Act of 1981, S.1720, 97th Cong., 1st Sess. (1981).

354. The very items that eventually became permitted activities of S & Ls and brought about the calamitous disaster in that industry.

355. It was already obvious at the beginning of the 1980s that disaster would hit the S & L industry, yet Congress waited to the end of the decade to come to the rescue, at a projected cost to the taxpayer of $300 billion.

356. H.R. 4603, 97th Cong., 1st Sess. (1981).

357. *See supra* note 353.

358. S.2532, 97th Cong., 2d Sess., (1982). Other bail-out bills were the Capital Assistance Act of 1982, S.2531, 97th Cong., 2d Sess. (1982) and the Net Worth Guarantee Act, H.R.6267, 97th Cong., 2d Sess (1982).

359. S.2879, 87th Cong., 2d Sess. (1982).

360. Pub. L. No. 97-320, 96 Stat. 1469 (1982)(codified in scattered sections of 12 U.S.C.).

361. The problem of the thrift industry did not develop overnight; Congress had con-

did, however, deal with the problems of insurance and banking. Title VI of the Act[362] restricted BHCs from engaging in insurance activities except certain specific enumerated types.[363]

In 1983 the Isaac Bill, sponsored by the FDIC, was introduced in the House and Senate.[364] This bill not only failed to address restructuring the financial services industry, but reinforced then existing laws and eliminated the loopholes created by the courts and regulatory agencies.[365] In contrast to the Isaac Bill, Senator Garn and Representative St Germain introduced the Financial Institutions Deregulation Act of 1983,[366] (FIDA). FIDA was designed to revamp, deregulate and reorganize the financial services industry. It provided for partial repeal of sections 20 and 32[367] of the Glass-Steagall Act, to allow banks to be affiliated with securities affiliates and permit cross employment of directors, officers, and employees between banks and their securities affiliates. FIDA would have enabled banks to indirectly involve themselves in securities underwriting and dealing and also sponsoring mutual funds. These activities would have been effected through Depository Institution Holding Companies,[368] (DIHCs), and Depository Institution Securities Affiliates, (DISAs). BHC formation would have been simplified and the creation of nonbank banks[369] would have been eliminated. One significant provision of FIDA would have been the expansion of BHC permitted activities to include "activities of a financial nature," *insurance underwriting* and other risky ventures, such as real estate investment and development.[370] The provision "activities of a financial nature" was to be interpreted broadly by the Board so as to include such services as are

---

sidered many relief bills prior to the 1982 Act, but passed none of them. Among the relief measures were provisions authorizing the FDIC and FSLIC to arrange acquisitions of financially troubled entities, to make loans to or deposits in, or purchase the assets or assume the liabilities of, such institutions. Another provision gave thrifts the power to make nonresidential real estate loans and consumer loans. This led to speculative investments by the more venturesome S & Ls and accelerated the fiscal calamity that followed. *See supra* note 355.

362. Pub. L. No. 97-320, tit. VI, § 601, 96 Stat. 1536-38 (1982)(codified at 12 U.S.C. § 1843(c)(8)).

363. See the latter portion of *supra* note 283 for a more detailed discussion of this provision.

364. S.1682, 98th Cong., 1st Sess. (1983); H.R.3768, 98th Cong., 1st Sess. (1983).

365. For example, the nonbank banks.

366. S.1609, 98th Cong., 1st Sess. (1983); H.R. 3537, 98th Cong., 1st Sess. (1983).

367. 12 U.S.C. §§ 377, 378 (1982); *see also supra* note 256.

368. In order to permit the creation of the DIHCs, nine federal statutes would have required amendment: The Glass-Steagall Act, The Securities Act of 1933, The Securities Exchange Act of 1934, The BHCA, The SLHCA (Savings & Loan Holding Company Act), The Bank Service Corporation Act, The Investment Company Act, the Home Owners Loan Act and the Federal Reserve Act.

369. *See supra* text accompanying notes 231-33.

370. If S & Ls can, why not commercial banks?

offered by companies not regulated as BHCs.[371] Additional bills[372] were introduced in 1983, but no law came forth that year.

The Financial Services Competitive Equity Act of 1984[373] was a watered down version of FIDA.[374] Introduced in the Senate, this bill would have eliminated the nonbank bank loophole, would have prohibited insurance activities for BHCs and *all* their subsidiaries, but would have exempted certain instruments from the coverage of Glass-Steagall. It would have also permitted the creation of DISAs through which banks and BHCs could deal in and underwrite certain securities.[375] The House Banking Committee reported out the Financial Institutions Equity Act of 1984,[376] which provided for the closing of the nonbank bank and South Dakota loopholes and also for tightening certain provisions of Glass-Steagall, a much more conservative approach than the Senate's. With such divergent views in the House and Senate no banking legislation came out of Congress in 1984.[377] In 1985, the one bill that would have dealt with bank regulation, H.R.20,[378] submitted by Representative St Germain, never made it to the House floor.[379]

The year 1986 was an extremely active insofar as bills being introduced, but no fruit was harvested from any of them. The most encompassing bill was the omnibus bill introduced by Senator Garn, the Deposit Insurance Reform and Competitive Enhancement Act

371. *See supra* text accompanying notes 204-220.

372. The Financial Services Competitive Equity Act of 1983, S.2181, 98th Cong., 1st Sess. (1983), a massive bill similar to FIDA with some additional provisions. The Depository Institutions Holding Company Act of 1983, S.2134, 98th Cong., 1st Sess. (1983), introduced by Sen. Proxmire, provided for the elimination of nonbank banks and closing the South Dakota loophole. S.2072, 98th Cong., 1st Sess. (1983) would have closed the loophole now opened wide by the *Merchants National* decision, 75 Fed. Res. Bull. 388 (1989), by prohibiting *bank* subsidiaries of a BHC from engaging in activities prohibited to a BHC or *any* subsidiary thereof. This bill would have prevented the decision in the aforementioned case as well as the Fed's incipient order in this case and its view and interpretation of § 4(c)(8)(*see supra* note 329). Had S.2072 become law in 1983, a great deal of litigation would have been eliminated in the latter part of the '80s.

373. S.2851, 98th Cong., 2d Sess. (1984).

374. *Supra* note 366.

375. By 1990 court decisions and Fed orders had not only empowered BHCs to engage through subsidiaries in such activities but in additional ones, too. *See supra* text following note 275.

376. H.R. 5916, 98th Cong., 2d Sess. (1984).

377. With one exception: The Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (1984)(codified in scattered sections of 15 U.S.C.). But this act is not germane to this paper.

378. H.R.20, 99th Cong., 1st Sess. (1985).

379. Although it was reported out of the House Banking Committee, it was blocked in the House Rules Committee, because its chairman, Claude Pepper, opposed the nonbank bank loophole closing provisions therein.

(DIRCEA).[380] This was a massive comprehensive bill which included provisions for expansionary (*i.e.*, deregulatory) powers for banks that were included in the 1984 FSCEA[381] as well as provisions for interstate purchases of banks (failing or about to fail) which would have given great impetus to interstate banking, and provisions to close the nonbank bank and South Dakota loopholes and many provisions of earlier bills which addressed narrow separate issues only. But opposition from the House and from those who did not want the nonbank bank loophole closed forced Senator Garn to abandon efforts to pass the bill. On the House side Representative St Germain introduced an omnibus bill[382] with restrictive measures rather than expansionary ones. Many other bills were introduced during 1986,[383] but none came to fruition.

The year 1987, however, did bring forth CEBA, a massive piece of legislation.[384] Before discussing CEBA it would be instructive to briefly review two of the many other bills that were introduced during 1987. One of the earliest ones was The Financial Service Holding Company bill, introduced as H.R. 3360.[385] It was proposed by the Association of Bank Holding Companies and endorsed by four other banking associations (including the American Bankers Association, the largest national banking association) and introduced by Republican Representatives Dreier of California and Roth of Wisconsin. This bill would have, in effect, repealed most of the Glass-Stegall limitations and the BHCA limitations on bank activities or BHC activities and would have permitted:

> (1) the control of a savings and loan association; (2) underwriting and distributing securities; (3) operating, sponsoring, and selling securities of an investment company; (4) acting as an investment advisor; (5) engaging in the business of selling and underwriting insurance; (6) engaging in real estate development and brokerage; and (7) engaging in any activity permissible for a multiple savings and loan association or a bank holding company.[386]

These activities would be carried out through financial services holding company (FSHC) subsidiaries, a FSHC being "defined by ownership of a BHC and any other subsidiary engaged in 'financially re-

380. S.2592, 100th Cong., 2d Sess (1986).
381. *See supra* note 373 and accompanying text.
382. H.R. 5565, 99th Cong., 2d Sess. (1986).
383. The 1986 Regulators' Bill, S.2372, 99th Cong., 2d Sess. (1986), H.R. 4701, 99th Cong., 2d Sess. (1986); The Federal Deposit Insurance Improvements Act of 1986, H.R. 4997, 99th Cong., 2d Sess. (1986); The Federal Savings and Loan Insurance and Financial Regulations Act, S.2752, 99th Cong., 2d Sess. (1986); The Banking Stability, Housing Improvement and Consumer Protection Act of 1986, H.R. 5565, 99th Cong. 2d Sess. (1986).
384. Pub. L. No. 100-86, 101 Stat. 552 (1987)(codified at scattered sections of 12 U.S.C.).
385. H.R. 3360, 100th Cong., 1st Sess. (1987).
386. Richard W. Whiting, *A Perspective on Financial Services Restructuring*, 37 CATH. U. L. REV. 347, 366 (1988).

lated' activities."[387] "Financially related" is defined to encompass the activities mentioned in the above quotation. It may be noted that many of the above quoted activities are now permitted to banks or BHCs through judicial and administrative decisions.[388] Time does not wait for Congress' indecisiveness.

Senators Wirth (D-Colo.) and Graham (D-Fla.) introduced the Financial Services Oversight Act,[389] a complex bill, conceived by Gerald Corrigan, President of the Federal Reserve Bank of New York. It proposed three different types of holding companies, most germane to this paper being the bank holding company. This entity could engage (through subsidiaries) in all sorts of financial activities including securities and insurance as well as normal banking business. It would also have access to the payments system and discount window through its depository subsidiaries. The subsidiaries would be regulated by existing regulators, the parent being subject to Board supervision. The second type would be called a financial holding company. It could engage in financial services but could not own depository institutions. It would have limited access to the discount window, but full access to the payments system. The third type would be the commercial financial holding company. Such a company could pursue both commercial and financial activities except for banking (*i.e.*, ownership of a bank or thrift) and it would have no access to the payments system or discount window. While this third type holding company could be owned by a nonfinancial entity, the other two types could not be so owned.

Notwithstanding the fact that the two aforementioned bills (as well as some others) were broadly deregulatory in orientation, CEBA did not address the issues of expanded or continued limited bank (or BHC) activities in securities, insurance, real estate, mutual funds, revenue bonds, mortgage-backed securities and other financial products. CEBA did close the nonbank bank loophole (with a March 5, 1987 grandfather clause), apply §§ 20 and 32 of Glass-Steagall[390] to nonmember banks (*i.e.* tighten rather than deregulate), and provide a moratorium until March 1, 1988, during which period no federal banking agency was permitted to expand the real estate and insurance powers of banks and bank holding companies within their respective jurisdictions.[391] However, it further provided that state chartered

387. *Id.*
388. *See supra* text following notes 273 and 322.
389. S.1891, 100th Cong., 1st Sess. (1987).
390. 12 U.S.C. §§ 377, 378 (1988); *see also supra* note 256.
391. Note that the statute specifically prohibited the Fed from approving (during the moratorium) the acquisition of state chartered banks that engage in insurance activities, yet the Fed approved such in *Merchants National*. *See supra* text accompanying notes 323-327. The statute also specifically prohibited the Comptroller from permitting national banks to expand their geographic limits of insurance activities. *See supra* text accompanying notes 119-123.

banks that are not under BHC control are not subject to the moratorium and may engage in any insurance activity that state law permits.[392] The bulk of CEBA, however, was focused on repairing the badly ailing thrift industry, and is not germane to this paper. In addition, CEBA included a provision which mandated a comprehensive review of the nation's banking and financial laws with a view of legislating a restructuring thereof.[393]

Since CEBA did not address the restructuring issues that have plagued Congress for several years, several bills were introduced after its passage to bring about some resolution of the matter. Senators Proxmire and Garn introduced the Proxmire Financial Modernization Act of 1987[394] which would have in effect repealed most of the Glass-Steagall limitations, permitting commercial banks to affiliate with securities firms. The bill did not provide for expanded insurance or real estate activities for BHCs, as did the Corrigan proposal.[395] A bill different from the others was H.R.3063[396] introduced by Representative Thomas Casper (R-Del.). This bill provided that, subject to disapproval by the Comptroller, a national bank may engage (through a subsidiary) in the same activities that state banks are permitted in the state in which the national bank is located. This would be a South Dakota loophole with a vengeance! The most "radical" bill (as a backlash to CEBA) was introduced by Senators Cranston (D-Cal.) and D'Amato (R-N.Y.), called the Depository Institution Affiliation Act.[397] This bill would have eliminated the distinction between investment and commercial banking and would have permitted "depository institutions holding companies", through subsidiaries, to engage in virtually every kind of financial activities (including selling and underwriting insurance) *as well as* commercial activities. Functional regulation of the subsidiaries would continue under present regulatory agencies. Inter-affiliate transactions would be strictly limited to preserve safety of the depository affiliates.[398]

The Proxmire bill[399] having failed to pass in 1987, was again taken up in 1988, and, after many amendments in the Senate Banking Committee, was passed by the Senate as the Proxmire Financial Moderni-

392. *Cf. supra* text accompanying notes 295, 296.

393. 12 U.S.C. § 203(a)(1988).

394. S.1886, 100th Cong., 1st Sess. (1987).

395. *See supra* text accompanying note 389.

396. H.R. 3063, 100th Cong., 1st Sess. (1987).

397. S.1905, 100th Cong., 1st Sess. (1987).

398. Among other bills proposed in 1987 were: The Barnard bill, H.R. 3799, 100th Cong., 1st Sess. (1987), a broad deregulatory proposal; the American Bankers Association pressed for the passage of S.60, 100th Cong., 1st Sess. (1987) and H.R. 50, 100th Cong., 1st Sess. (1987), also a proposal for expanded bank powers.

399. *Supra* note 394.

zation Act of 1988.[400] The House passed its own bill, H.R. 5094,[401] a much less expansionary bill than the Senate bill. Unfortunately, the two chambers were unable to reconcile the differences and the 100th Congress closed without any law coming forth, leaving it to the judiciary and regulatory agencies to determine what banks may do.

During 1989 Congress was deeply concerned with the crisis in the savings and loan industry and concentrated on passing a law to solve it. It did pass the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA),[402] not germane to this study. However, there were two bills submitted, proposing expanded powers to banks and BHCs. The first, the Proxmire Financial Modernization Act of 1989,[403] would have repealed §§ 20 and 32 of the Glass-Stegall Act,[404] permitting BHCS to acquire securities affiliates and also would have amended the BHCA to permit limited insurance activities to state banks owned by BHCs. The second bill was the Depository Institution Affiliation Act,[405] a broad deregulatory bill which would have permitted affiliates of a DIHC (Depository Institution Holding Company) to engage in activities of a financial nature, including securities, insurance and real estate. Banking and other insured affiliates would be prohibited from direct involvement in the foregoing activities and would be insulated from the other affiliates of the DIHC by being extensively prohibited from interaffiliate transactions.

From the foregoing skeletal discussion it can be seen that Congress was not idle in 1980s in regard to banking reform proposals, but was unable to reach a consensus on the appropriate action to take. Some state legislators, however, saw an opportunity to take advantage of Congress' indecision and went ahead with legislation of their own.[406]

---

400. S.1886, 100th Cong., 2d Sess. (1988).

401. H.R. 5094, 100th Cong., 2d Sess. (1988).

402. Pub. L. No. 101-73, 103 Stat. 183 (1989).

403. S.305, 101st Cong., 1st Sess. (1989).

404. 12 U.S.C. §§ 378, 378 (1988).

405. H.R. 1992, 101st Cong., 1st Sess. (1989).

406. The most familiar state law is that of South Dakota, referred to as the "South Dakota Loophole", passed on March 2, 1983, S.D. CODIFIED LAWS ANN. § 51-18-30 (1984). It permits South Dakota state banks and their subsidiaries to engage in "all facets of the insurance industry". In addition, S.D. CODIFIED LAWS ANN. § 51-16-40(b)(1984) permits out-of-state BHCs to acquire South Dakota banks. However, under S.D. CODIFIED LAWS ANN. § 51-16-41 (1984) a South Dakota bank acquired by an out-of-state BHC must conduct its insurance business in such a manner as to not attract customers from the general public in South Dakota to the detriment of existing insurance companies, brokers and agents in the state. In effect the goal of this statute is to entice out-of-state BHCs to come into South Dakota to acquire South Dakota "banks" (*i.e.* non-member banks) to be used as a vehicle to do a nationwide insurance business, but not within the state. For the Board's view of the matter, see the text following *supra* note 309.

A statute was passed by Delaware on May 30, 1990,[407] which permits Delaware state banks to sell *and underwrite* all types of insurance nationwide. A most unusual aspect of this law is its authorization to conduct the insurance business directly within the bank, rather than through a legally separate subsidiary (although such is also authorized). If conducted within the bank, it must be in a separate department with separate officers and a separate set of books, with the same minimum capital requirement as the Delaware Insurance Code requires of independent insurance companies. After providing for this superficial facade of separateness, the statute goes on to authorize the bank to "make loans to and transact other business with such department, division or subsidiary" as it would with other customers.[408] It is astonishing to find that this statute authorizes a behavior pattern which even the most expansionist proponents of bank deregulation would be opposed to, *viz.*, that the insurance business be permitted to be conducted *inside* the bank and that interaffiliate loans and transactions between the bank and the insurance entity be allowed. Almost without exception, deregulation proponents advocate absolute separation of the insurance and securities functions from the banking activity (through a subsidiary of the holding company), and mandatory comprehensive financial insulation of the bank (*i.e.* the bank subsidiary within the holding company structure) from the other affiliates (referred to as noninsured affiliates, *i.e.* not insured by the FDIC). But as shall be seen from the *Citicorp and Family Guardian Life Insurance* order, there was "method to the madness" of the Delaware legislation.

In addition, the Delaware legislature apparently did not make a legal analysis to determine the legal status of the insurance "department" or "division." Such status can become extremely important in certain situations. Suppose a BHC wants to acquire a Delaware bank with an insurance department. The Board, in order to grant or deny the application, will have to determine whether the "department" is or is not in fact a separate subsidiary for purposes of the BHCA. It might become an extremely delicate legal issue, only determinable on a case-by-case basis. Or suppose the bank becomes insolvent and the FDIC has to take over? Will the assets of the insurance "department" be swept in with the other assets of the bank to compensate the FDIC for its salvage operation? In other words, will the policyholders of the insurances underwritten by this insurance "department" bail out the depositors of the bank, leaving the policyholders with no assets? And in such a case would the insurance guaranty funds of the various states be required to rescue the policyholders? The foregoing two examples

407. The Bank and Trust Company Insurance Powers Act of 1989, DEL. CODE. ANN. tit. 18, § 2304 (Cum. Supp. 1990).

408. DEL. CODE ANN. tit. 5, § 767(b)(Cum. Supp. 1990).

are but a fraction of the situations where the legal status of the insurance "department" becomes a critical matter. These are the kinds of statutes that become the nightmares of regulators and judges.

The Independent Insurance Agents of America (IIAA) moved quickly to nullify the potential effects of this legislation, by filing with the Federal Reserve Board a "petition for enforcement" to require Citicorp to terminate prohibited insurance activities conducted pursuant to the aforementioned Delaware statute by its nonbank subsidiary, Family Guardian Life Insurance Company.[409] The IIAA argued that Citicorp cannot rely on the "operating subsidiary"[410] rule to continue insurance activities through Family Guardian. It maintained that the statute does not permit state banks to directly underwrite or sell insurance, but only permits their quarantined and separated "insurance division" to do so. Thus, the fundamental requirement of the "operating subsidiary" rule is missing. Citicorp's response was weak: it contended that the rule does apply since the statute "on its face" authorizes Delaware state banks to transact an insurance business and the requirement that it be done in a separate department is the traditional way of doing it.

The Board rejected Citicorp's arguments. The Board reiterated the operating subsidiary rule limiting a subsidiary of a state bank to the same activities that the parent bank may engage in directly. The Board found that although on its face the statute permits Delaware state banks to underwrite and sell insurance,

> [T]he Board cannot ignore the fact that this authorization is conditioned on compliance with an unprecedented and comprehensive set of regulatory restrictions, the practice effect of which is to treat the insurance division as a separate corporate entity. For example, the separation has been carried to such an extent that the routine authority of the state bank regulator over the insurance division is restricted, and the insurance division is regulated under the insurance laws as a separate corporate entity from the bank. Thus, in the Board's view, the Delaware statute does not authorize banks to engage in the insurance business directly, as is required by the operating subsidiary rule.[411]

The Board then ordered Citicorp to immediately prohibit Family Guardian from providing any further insurance services (except as allowed under § 4(c)(8)(A)[412] of the BHCA).

VII. SUMMARY AND CONCLUSION

A. In General

The principal objectives of bank regulation that have developed

409. Citicorp, 76 Fed. Res. Bull. 977 (1990).
410. 12 C.F.R. § 225.22(d)(1992); *see also supra* text accompanying notes 293, 294.
411. Citicorp, 76 Fed. Res. Bull. 977, 978 (1990).
412. 12 U.S.C. § 1843(c)(8)(A)(1988).

through the years are safety and soundness[413] of the individual banks and stability of the financial system.[414] Safety and soundness were accomplished by intense risk control regulation[415] and stability through the deposit insurance protection[416] of the FDIC and FSLIC. At the time these regulatory laws were passed and for decades thereafter, they were acceptable to the banking industry because banks' intermediation function was all pervading and their lending rates assured them of a good return with relatively little risk. There was no need for banks to diversify[417] into other activities. But since the late 1960s, the financial markets have undergone a major revolution. The cash flow from savers' checking accounts, savings accounts and bank CDs began to bypass the banking system en route to borrowers. There was a vast disintermediation from banks to other institutions,[418] such as money market mutual funds, cash management accounts, pension plan funds, nonbank CDs, and other nonbank investments.[419] Furthermore, individual borrowers have substantially replaced the banks as their main source of funds, obtaining loans from finance companies, credit unions and thrifts. Worst of all, major corporations which were the heaviest bank customers are now relying on the commercial paper and securities markets as their sources of credit.[420] To add salt to the wounds, the very *raison d'être* of banks, lending, has become less profitable. Repeal of Regulation Q raised the cost of funds to banks,[421] reducing the profit on the lending of these funds.

Thus it became obvious that the legal and financial environment under which banks are now[422] operating has changed drastically since passage of Glass-Steagall and the BHCA.[423] The question continues to be raised whether these statutory barriers are adequately performing their intended functions or whether they have become counterproductive and imperil the safety, soundness and stability of the banking system.[424] The insurance industry, and to a much lesser degree the securities industry[425] maintain that regardless of the changes in the

413. *See supra* text following note 73.
414. *See supra* text accompanying note 62.
415. *See supra* note 65, 101, and text accompanying note 234.
416. *See supra* text accompanying notes 67-69.
417. From 1933 to 1970 there was only one case interpreting Glass-Steagall, Board of Governors of the Fed. Reserve Sys. v. Agnew, 329 U.S. 441 (1947).
418. *See supra* text accompanying notes 204-220.
419. *Id.*
420. *See supra* text accompanying notes 213-216.
421. *See supra* note 207.
422. Or more precisely, during the past 30 years.
423. 1933 and 1956 respectively.
424. Unfortunately, Congress has not yet answered this question. *See* part VI. C.
425. The securities industry has lost case after case, both before the Board and the courts. Bowing to the inevitable, the SIA (Securities Industry Association) submitted a compromise bill.

financial industry environment, the barriers must remain, lest a deregulated banking industry result in calamity.[426]

426. Bank failures during the six year period 1985-1990 almost equal the number of failures in the fifty year period 1934-1984!

	Failures
1934-1984	1165
1985	116
1986	138
1987	184
1988	200
1989	206
1990	169
	1013

Source: Various FDIC annual reports. Reports on file with author. In addition, during 1985-1990, 53 banks received financial assistance from the FDIC.

Those who oppose deregulation point to (among other things) the Continental Illinois debacle in 1983. There were lengthy Congressional hearings in this matter, which revealed many disturbing aspects of the banking industry, *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 2d Sess. (1984).

Continental Illinois National Bank (CINB) has been in business more than 125 years. It began as a conservative institution, focusing on time deposits and lending to good credit risks. Continental Illinois Corporation, incorporated in 1968, began operating in 1969 after acquiring almost all of the outstanding stock of CINB. The Corporation engaged in lease and debt financing, mortgage lending and banking, asset-based financing, merchant banking overseas, reinsurance of certain credit life and credit health insurance, fiduciary and investment services, and most importantly, financing of energy development and exploration. In 1976 bank management announced their decision to become one of the top three American corporate lenders. The adverse effects of the bank's pro-growth policy were not obvious for many years. In 1978, *Dun's Review*, a widely respected financial magazine, described Continental as one of the five best managed companies in America. At the end of 1983, it was the largest bank in Chicago and the seventh largest in assets and deposits among some 15,000 national and state banks in the United States.

The hearings offer an insight to the reasons of the failure of this mammoth bank as well as an insight into the current relationship between banks and their regulatory agencies, the inadequacies of our regulatory system, and the amount of risk that bank management will take given a federally insured guarantee of success. The recent destruction of the wall between the banking and securities industries and the possibility of an upcoming merger between the banking and insurance industries make the insights offered by the Continental fiasco even more important. During the hearings on the problems of Continental, Congressman Stewart McKenney (Conn.) asked the question: "Why should we trust a banker who can't manage a loan portfolio to be able to successfully engage in insurance, securities, or real estate?" *Id.* at 89.

Continental tried to put the blame on the downturn in the economy, especially the downward spiral of oil and gas prices which caused huge loans to go bad. But Subcommittee Chairman St Germain did not agree:

> And if the problems of Continental were simply an unexpected downturn in prices of an otherwise solid oil and gas portfolio, one must

B. The Arguments for Deregulation

1. The Capital Mobility Problem

Members of the banking industry and others who favor deregulation are surprisingly willing to use the horrendous increase in bank

---

again wonder the regulator. Regulators, like prudent bankers, presumably do watch the concentration of assets in a single industry and are in a position to demand the type of diversification that would enable the bank to ride out unforseen storms. *Id.* at 2.

With this statement, the problems at Continental stood exposed. The banks weren't prudent, and the regulators must have been daydreaming. Although nothing illegal became evident in the hearings, one must wonder whether there was dishonest activity, or whether the bankers and regulators were really so inept that it just seems that way. Somehow, the bankers and regulators had allowed heavy concentration in oil and gas loans, averaging twenty percent of the total loan portfolio, leaving the bank extremely vulnerable to the decline of this highly volatile industry. Between July 1982 and September 1984, oil and gas loans accounted for approximately two-thirds of the bank's losses.

The oil and gas loan problems were only a manifestation of the larger problems at the bank. CINB management failed to set corporate loan quality standards. The aggressive lending policy of CINB was extremely decentralized, allowing loan account officers to respond directly to customers, rather than requiring loan approval by committee, like most banks. According to the OCC, "[t]op management had created an environment where aggressive lending was not only condoned but encouraged. In this atmosphere, a high quality system of controls was secondary." *Id.* at 205. In fact, the policies and controls governing loan approval, review, and classification could hardly have been worse. It is interesting that the deficiencies in the internal controls seem to have been noted by bank examiners, but without any sense of urgency. During the summer of 1981, Kathleen Kenefick, a loan officer in the oil and gas division, wrote a five page memo describing the deficiencies in the internal control system and recommending ways to fix it. Although her memo stressed the urgency of the bank's problems and the need for immediate action, and although the memo was in possession of both her supervisor and the bank examiner, it went largely ignored both by her superiors and the bank examiner. However, the bank examiner's 1981 report described the oil and gas division as follows:

> CINB is adequately staffed with both sound lending officers and scientific (engineers and geologists) personnel to handle current relationships and meet continued strong growth anticipations. . . . No significant problems are evident.

Id. at 62.

Also during this examination the examiner noted a near doubling in the loans going unreviewed by the bank, which failed to review $1.6 billion one year and $2.4 billion the second year. As noted by the writers of the 1984 staff report to the subcommittee, these statistics would seem to indicate a severely deficient and worsening credit review and quality control system in the bank, and they deserved some attention. However, in his letter to the Board of Directors the examiner wrote a shamefully weak statement:

> . . . the issue of timeliness or frequency of review is noted since bank records indicate a general increase in the number . . . of loans not being reviewed. . . . Although this list is up from last examination, it has not adversely impacted the reported results from Loan Administration.

In June 1982 the examiner was offered employment with Continental, which he

failures[427] to bolster their contention that these failures are due to the regulatory limitations on bank activities. These limitations inhibit the mobility of capital both out of and into the banking industry. These restraints protect other industries from a fully competitive banking industry. For example, the securities industry is protected from incursions by the banking industry, thus enabling brokerage firms to escalate their fees with impunity.

The banking industry also argues that regulation prevents the normal outflow of capital from a declining industry (*i.e.*, profits are falling).[428] This causes the retention of an excess number of entities, while the weaker ones go bankrupt.[429] In fact the number of bankruptcies may actually be increased (beyond what would take place normally) by intense rivalry among banks seeking a share of the declining business. Such rivalry motivates the making of riskier loans (real estate development, oil, third world countries, etc.) and other risky transactions.

Conversely, preventing entry into the banking industry by other financial or non-financial entities permits banks to conduct their affairs less responsibly[430] and efficiently[431] since they fear no competition. Furthermore, this restraint prevents the use of outside capital from shoring up weak banks. Thus, a strong investment bank or strong brokerage house (or for that matter a strong auto manufac-

---

accepted after removing himself from the examination to avoid a conflict of interest.

These are only a few examples of the serious oversights and understatements made by the regulators and the risky and poorly managed lending practices that created the need for a very expensive bailout funded without consent by the taxpayers of our nation. Thus it would be highly dangerous to expand the industries into which banks may enter when experience has shown that bankers can be irresponsible, regulators can be blind, and Uncle Sam will reward this dangerous combination with a 100 percent insurance guarantee at the taxpayers' expense. So say those who fear and oppose deregulation. They also point out that at present the banking industry is functioning at an extremely high operating leverage, that its credit quality has deteriorated to unacceptable levels (write-offs are the worst in its history) and because of a public perception of high risk, there is a withdrawal of investment and credit (deposit) support. To allow banks to now assume additional (and different) risks would be suicide, according to this view.

427. *See id.*

428. When profits fall within an industry the affected members (here the banks) would normally shift their capital into more profitable industries by making acquisitions therein. The result would be a revival in the industry which is being reduced (here the banking industry—the same *total* profit divided among fewer entities).

429. With the FDIC paying off the depositors or even a bailout of the bank at taxpayers' cost.

430. Since FDIC insurance will take care of losses.

431. Entry of *new* competitors into an industry is the motivating force of competition. Even the mere perception of entry by "outsiders" greases the wheels of the competition machine (so as to discourage entry).

turer) could not acquire a weak commercial bank and infuse it with new additional capital.

It appears that in this age of revolution in the financial services industry[432] and disintermediation of the banking function[433] the Glass-Steagall restrictions actually have an adverse effect on the stability and soundness of commercial banking, the very things that the act is supposed to protect. Therefore it is the author's opinion that most of the limitations of Glass-Steagall and the BHCA need to be removed—what was good in 1932 is not necessarily good in 1992. At the same time, the safety and stability of the banking system and soundness of the FDIC must be retained even at a more exacting level of control than under the present system. Consequently, any of the additional activities to be permitted to banks must be performed in a holding company structure with the permissive activities to be effectuated in subsidiaries of the holding company while the bank is completely insulated from all other affiliates of the holding company.

Under the BHCA a BHC can only own banks or other entities permitted under § 4(c)(8).[434] Under the proposed system a financial services holding company structure would be formed under enabling legislation. Such a holding company (FSHC) could own commercial banks, investment banks, brokerage firms or any kind of financial services company.[435] The FSHC itself need not be a bank or financial institution but can be any type of commercial entity.[436] Indeed, the FSHC itself could be the subsidiary of a nonfinancial entity. The perceived additional risk to the banks and the FDIC under such a structure can be minimized by proper insulation of the banks. The FSHC is to be so structured that its management can allocate financial resources among the subsidiaries at its discretion based presumably on a desire to maximize its return *provided* that the bank subsidiaries will always be allocated the minimum statutory capital requirements and such minimums will always be maintained. This sort of scheme would in large measure solve the mobility of capital problem described above.

2. *Retention of the Wall—The Insulation Device*

As indicated above,[437] under the author's proposal the affiliates of a bank could be other financial institutions or commercial entities ex-

---

432. *See supra* part V. A.

433. *See supra* text accompanying notes 213-219.

434. 12 U.S.C. § 1843(c)(8)(1988).

435. The term "financial service company" does not include an insurance company.

436. There are at present many commercial companies that own financial services companies. *See supra* note 204.

437. *See supra* text accompanying notes 435, 436.

cept insurance companies.[438] It shall be imperative that no lending take place between any bank and any of its affiliates, and "lending" shall include purchase of any kind of assets by the bank from an affiliate, or the sale of any kind of an asset by the bank to an affiliate. Thus the prohibitions of §§ 23A and 23B[439] would be expanded to an abso-

438. The legislative means of generally achieving this result is to repeal portions of 12 U.S.C. §§ 24, 377 and 378 (Glass-Steagall §§ 16, 20 and 32 respectively) and 12 U.S.C. § 1843 (Federal Reserve Act § 4).

439. 12 U.S.C. § 371c-371c-1 (1988). Portions of each follows:

§ 371c. Banking affiliates

(a) Restrictions on transactions with affiliates

(1) A member bank and its subsidiaries may engage in a covered transaction with an affiliate only if—

(A) in the case of any affiliate, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 10 per centum of the capital stock and surplus of the member bank; and

(B) in the case of all affiliates, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 20 per centum of the capital stock and surplus of the member bank.

(2) For the purpose of this section, any transactions by a member bank with any person shall be deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate. (3) A member bank and its subsidiaries may not purchase a low-quality asset from an affiliate unless the bank or such subsidiary, pursuant to an independent credit evaluation, committed itself to purchase such asset prior to the time such asset was acquired by the affiliate.

§ 371c-1. Restrictions on transactions with affiliates

(a) In general

(1) Terms

A member bank and its subsidiaries may engage in any of the transactions described in paragraph (2) only—

(A) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or

(B) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies.

(2) Transactions covered

Paragraph (1) applies to the following:

(A) Any covered transaction with an affiliate.

(B) The sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase.

(C) The payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise.

(D) Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person.

(E) Any transaction or series of transactions with a third party—

(i) if an affiliate has a financial interest in the third party, or

(ii) if an affiliate is a participant in such transaction or series of transactions.

(3) Transactions that benefit an affiliate

For the purpose of this subsection, any transaction by a member

lute restraint. In fact, one of the provisions of the enabling legislation ought to provide that in case of failure of any bank affiliate, the FSHC will have to reimburse the FDIC for the monies disbursed by the latter. The reason for such an exacting provision is to prevent the FSHC from siphoning off[440] resources of a bank to assist an affiliate that is faltering, causing the bank to fail. Managers of entities not subject to control and supervision as are banks,[441] need be made to understand that banks under their control are not merely another subsidiary. The temptation for the above described bail out is especially great because a bank's assets can cover another affiliate's losses many times larger than the bank's own capital. If the bank fails as a result of this drain, the parent FSHC stands to lose only the equity invested in the bank; the rest of the affiliate's loss (equal to the deficit in the bank) would be, in effect, redeemed by the FDIC.[442]

Strict insulation would also ensure that *legal* separateness not ever be questioned. Thus if an affiliate were to cause a loss to a third party, such person should not be able to make a claim against the bank. This matter is only one of the many problems with the Delaware deregulation statute.[443]

C. Other Matters

1. Subtle Anti-competitive Issues

An additional argument against affiliate connections is the belief that the bank would use subtle means of "steering" its customers toward the services offered by these affiliates, thereby creating unfair

---

bank or its subsidiary with any person shall be deemed to be a transaction with an affiliate of such bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, such affiliate.

440. To see how this was done in the insurance industry see *supra* notes 174-182, 198 and accompanying text.

441. The FSHC would not be a regulated entity *per se* as the BHCs are at present, except for supervision limited to determination that minimum capital requirements of banks within the FSHC are maintained, as well as sufficient minimum capital within the FSHC to be able to provide the minimum bank capital needs at any and all times is available. Neither the acquisition of banks nor divestitures thereof require prior approval of a regulatory agency such as the FRB. Mere notification is sufficient. On the other hand, regulation and supervision of the banks themselves will continue under the same agencies. If the bank is a national bank it will be supervised by the Comptroller of the Currency and the FDIC; if it is a BHC (as a subsidiary of an FSHC), by the Fed; and if it is a state member bank then by the state agency and FDIC.

442. In fact, one of the arguments against permitting banks to affiliate with others is the belief that such affiliates will then indirectly enjoy the benefits of the insured bank (*i.e.* FDIC insurance). Not only is it imperative that such a situation not exist, but it is absolutely essential that any *perception* of such an advantage to an affiliate must be eliminated. Absolute insulation is, of course, the answer.

443. *See supra* text following note 408.

competition. For example, assume a bank is affiliated with a stock brokerage firm, a mutual fund, a title insurance company, a casualty insurance company, a life insurance company, an automobile dealership, and an investment bank, all under the umbrella of an FSHC. A customer of the bank requests a loan and is willing to pledge securities he owns. The loan officer indicates that it would be more convenient for the bank if the customer deposited the securities with the affiliate broker and then assign the account to the bank (thus the bank would not have to "handle" the securities). The customer complies believing it necessary to get the loan. Or a customer of the bank requests an auto loan. A bank officer explains that loans on autos purchased from its affiliate auto dealer are much easier to process. Since the auto dealer has the same car at same price that customer wants to buy, customer complies. Or a customer of the bank requests a mortgage on a home he is in the process of buying. The bank officer tells him that the bank relies on affiliate title insurance company more than on other title companies, and that an affiliate casualty insurer is very knowledgeable in writing insurance on homes. The customer obtains both title and casualty insurance from the bank's affiliated companies.

That such abuses might develop cannot be denied. However, if a bank officer is prone towards such behavior, he could do so whether or not there is affiliation. The solution of such problems lies in proper enforcement of existing laws. Proper execution of present oversight powers by the regulatory agencies should reduce such abuses to a minimum whether or not deregulation takes place.

2. *The Case Against Insurance Integration*

The additional activities to be permitted commercial banks as suggested heretofore,[444] would be congruent with activities presently permitted them[445] and there would therefore be a "natural" extension of functions with which bankers are familiar and experienced. These additional activities would be very much related to and similar to banking activities, thus enabling the bankers to assess the risk level they would be assuming when entering the "new" fields. Insurance underwriting is a totally different matter. It is not similar to usual banking transactions,[446] bankers are not familiar with the nature of the indus-

444. To do as investment banks do (*i.e.* underwrite all kinds of securities), as brokerage firms do, as mutual funds do, etc.

445. *See supra* notes 101, 219, 271 and text accompanying note 273 and text following note 275.

446. There is a strong view that insurance and banking are very similar and compatible: insurance policies and demand deposits are both ways of funding investment assets. Insurance, at least from the underwriter's perspective, is like a demand deposit. The depositor or insured exchanges money in the present for the bank's or insurer's promise to pay in the future. The underwriter can use the premiums to buy investments, just as a bank uses demand deposits or any other debt obliga-

tion. A bank is willing to pay interest, giving its depositors more than the amount deposited. Similarly, an insurance underwriter is willing to pay out more in claims than it has taken in as premiums. This is because both the bank and the insurer can more than offset the deficit with investment income generated before paying back the obligation. From a bank's point of view, insurance could be another source of funding for its asset portfolio.

Payment of insurance claims are not on a definite time schedule; they are tied to the hands of fate. Nevertheless the unpredictable nature of the liability is not a deterrent because this does not prevent the insurer from determining the probable amounts of claims each year. An insurer has a large pool of similar obligations and can analyze historical data to find the probability of an average customer claim. For example, an underwriter of automobile collision insurance may conclude from available data that an average driver in his pool has a 5% chance of having an accident in any given year, that an average customer subscribes for 10 years and that an average accident costs the insurer $100. If there are 1000 customers in this pool and it charged a premium of $4.7619 per year it would be as if it had taken 1000 $4.7619 time deposits with an average maturity of 10 years at 5% interest in that given year. Whenever it receives a $4.7619 premium it may expect to pay $5 in claims to the insured, just like a bank that takes deposits and repays the principal plus interest. Because the insurer has a large pool of customers, it can use averages and historical data to predict the amount it expects to pay each year. Any variance between the estimated liability and actual claims paid is usually small and therefore not a significant concern. Such annual volatility is adjusted in the following year's estimate. Bankers too are not strangers to volatility of liabilities, but with bankers it is on the asset side of the balance sheet: It makes loans with the expectations that some of them will not be repaid; a bank must determine an expected amount of default. The actual amount will vary around this expected amount. The risk of default is implicit in the interest rate.

There are similar economic components in insurance (as a liability) and loans (as an asset). There is an extension of credit and an assumption of risk for each. An insurer in effect borrows money from its customer, which it can use until it must pay a claim. To some extent part of the premium rate reflects an expected risk-free interest rate, determined by the demand for and supply of money from premiums. In addition, insurance premiums also reflect the risk that the insurer assumes in agreeing to pay when a claim is made. Similarly, the bank loan interest rate partly reflects the price of risk-free credit, which is a function of the supply and demand for money. In addition, it also reflects the risk of default. A bank can enter into the insurance business without introducing any new elements onto its balance sheet.

A primary benefit from adding insurance underwriting to the business of banks is a reduction in the risk of illiquidity due to interest rate movements by reducing the interest rate gap between the interest rate banks must pay on demand deposits and the interest rate they receive on their loans. The interest rate gap creates a risk of illiquidity because bank assets (loans) are usually of longer duration than bank liabilities (deposits), and it is possible for interest rates to move up sharply and unexpectedly, leaving a bank stranded with relatively low yielding assets which it must fund with more expensive higher interest rate liabilities. (This is one of the causes of the savings and loan crisis.) Insurance liabilities are usually of longer duration than demand deposits and other bank liabilities, and to the extent that bank assets are usually of longer duration than bank liabilities, adding insurance to banks' business would reduce the risk of liquidity problems created by suddenly increased interest rates.

Another benefit would be the decrease in the cost of gathering information

try and, therefore, could not accurately assess the risks involved[447] in entering the field. The insurance industry has been in a near crisis state for the past few years.[448] In fact, the insurance industry's

---

which would occur by each customer using only one financial institution for many of his/her financial services. A customer with credit cards, mortgages, car loans, checking accounts, etc. would be more efficiently evaluated by a single institution rather than several. A bank that has underwritten life insurance for an individual who later asks for a car loan would have an easier time evaluating the risk, since it has already done much of the preliminary information gathering.

A third benefit is that with increased knowledge of a loan candidate's insurance coverage, a bank can more accurately assess the risk of lending and can price its loans more competitively. For example, a personal loan candidate with independent personal liability insurance and property insurance poses little risk of default due to some catastrophic accident. This implies that tie-in sales would be a beneficial practice. The risk of default is implicit in the interest rate paid on a loan. This risk premium is presently not situation specific; it represents an average bundle of what can go wrong. But what can go wrong varies greatly between customers. Forcing all those who are on a particular risk to insure against it would reduce the risk of lending to them, and it would make the process of charging for the risk of lending more explicit and subject to clear negotiation.

447. Notwithstanding the argument *id.*, it is recognized that insurance underwriting carries dissimilar risks. *See supra* note 8. Furthermore, a time of crisis in the banking industry, *see supra* note 426, is not the time to experiment by permitting unfamiliar risky undertakings by this weakened financial group.

448. One would have thought that after Baldwin-United (*see supra* note 198) and after the post-Baldwin Model Insurance Laws (1985)(*see supra* note 199 and accompanying text) the insurance industry would be safe. Not so. Since then many large insurers failed, causing vast losses to the public. One such was Mission Insurance Company:

> The factual causes of Mission's demise are quite clear. As the receiver succinctly stated, the two direct causes were high losses from the nature of the business Mission held, coupled with the failure of the company's reinsurers to pay their share of those losses. He described the situation as two guns, one pointed at each temple. The cause of insolvency was a question of which bullet did the job, since each was a fatal shot on its own.
>
> The receiver estimated the ultimate cost to the public of Mission's collapse will be *$1.6 billion.* The obvious question is, "How could a company with less than $240 million in capital surplus write enough bad business to cause a $1.6 billion failure?" The answer lies in excessive use of reinsurance.

Failed Promises: Insurance Company Insolvencies, Report by the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce, 101st Cong., 2d Sess. 12 (1990)(emphasis added)[hereinafter Dingell].

> Reinsurance is the process whereby insurance companies spread their risk exposure by transferring portions of specific policy liability to other insurance companies in return for their receiving part of the premiums. The company that originates business is compensated for its efforts, brokers earn commissions for arranging reinsurance of the business, and intermediary agencies receive commissions for managing pools where reinsurance companies share in specific risks as joint venture participants. These reinsurance pools are a key method for coordinating the joint participation of many companies in sharing business that is centrally managed.
>
> Agencies that manage reinsurance pools are usually responsible for

problems can be traced back to the late 1970s. The high interest rates that developed during that period along with the money market funds flooding the market[449] and the interest rate deregulation[450] has had a tremendous adverse impact on life insurance companies. Policyholders borrowed against their policies at ridiculously low rates[451] and invested the proceeds in higher yielding instruments (MMFs; CDs; NOW accounts; municipals; government bonds, notes and bills; and other similar instruments). The life insurance industry responded by issuing new high yielding products, such as single premium annuities, universal life policies, variable universal life policies, and guaranteed investment contracts[452] (GICs). In order to be able to pay these high yields, life insurers had to invest into risky, high yielding instruments, including "junk bonds." The collapse of the junk bond market in 1989

---

underwriting business accepted by the pools, handling claims, collecting and distributing premiums to pool members, and establishing adequate reserve guidelines. Within set limits per risk and general management terms, such agencies can obligate pool members on any type of property/casualty business, and accept as many separate risks as they consider desirable during the one-year period common to most pool agreements. Pool members are, therefore, dependent on the managing agency to determine the quality and amounts of business accepted by a reinsurance pool.

For reinsurers, the benefit of reinsurance participation is an opportunity to share for a fee in the business generated by other companies, without the responsibility for developing customers and handling claims. For insurance companies whose business is reinsured, the benefit is to reduce their risk exposure on specific policies, and increase the amount of new policies they can write. Business that is properly reinsured and secured by letter of credit or trust funds put in escrow by the reinsurer can be removed from the originating company's balance sheet. Because a company's ability to accept new business is controlled by the ratio of business on its books to its capital surplus, transferring business to the books of reinsurance companies creates room to write new business and earn more fees [and this excess new business is what breaks the camel's back].

Id. at 9.

Reinsurance abuse has been a key factor in every insolvency studied by the Subcommittee. The level of reinsurance has been excessive, the quality has been poor, and controls on reinsurers have been minimal or nonexistent. Conflicts of interest in arranging reinsurance have been fairly common, and reinsurance problems seem to grow geometrically with the number of reinsurers involved. In addition, letters of credit have not worked to guarantee the performance of these reinsurers, and foreign reinsurers appear beyond the effective reach of state regulators, especially when they are domiciled in countries where regulation is weak.

Id. at 69.

449. *See supra* text accompanying note 218.

450. 12 C.F.R. pt. 217 (1992); *see also supra* note 207.

451. Typically the rate is five percent. Low rates were written into the terms of millions of insurance policies issued prior to the 1980s.

452. Some of these were guaranteeing an 18% return for terms as long as ten years.

has put enormous pressure on the stability and solvency[453] of the life insurance industry. In addition, even mortgage loans, the "safe" traditional investment vehicle of insurance companies, has recently turned into an underperforming asset (*i.e.* the debtors can't make their payments).[454] The alarming increase in death claims due to AIDS and AIDS related causes of death has put, and will continue to put, a sharp dent into the assets of life insurers.[455]

The investment scenario of the property and casualty insurance industry is much rosier since it apparently avoided involvement with junk bonds. The industry's investment income has been high; however, the underwriting performance has been negative for a long time. Earthquakes, floods, and now unforseen environmental cleanup liabilities and asbestosis claims have resulted in deteriorating operating income.[456] Insolvencies in the insurance industry have been heavy,[457] as is the case in the banking industry.[458] Now is not the time to permit integration of two weak and poorly regulated industries.[459]

---

453. Two giant life insurers were taken over by the State of California in 1991 due to their insolvency directly attributable to their holdings of large amounts of junk bonds.

454. As an example, Travelers Insurance, a giant in the industry, has set up reserves of over $1 billion against its holdings of about $4 billion of underperforming mortgage loans. In other words Travelers has practically written off $1 billion of assets! *See* INVESTMENT VISION, Nov.-Dec. 1990, p.27.

455. The industry anticipates $50 billion in claims for premature deaths due to AIDS in the next ten years alone. *Id.*

456. Operating income is the net result of investment income and underwriting income (loss).

457.

Insurance Industry Insolvencies

	LIFE	PROPERTY AND CASUALTY
1985	9	25
1986	12	16
1987	19	14
1988	13	12
1989	43	23
1990	30	10 (1/2 year)

Sources of figures on file with the author.

458. *See supra* note 426.

459. But if the same insulation devices as described in *supra* part VI. B. 2. were erected around a bank affiliated with an insurance company, would that not be enough protection? Probably not. It appears that regulation of insurers is in disarray. Here is what the California Insurance Commissioner had to say about this matter:

> Legislative and regulatory oversight to the insurance industry now is "very weak" and will likely "get worse before it gets better," according to California Insurance Commissioner Roxani Gillespie.
>
> "The trend in government in the last 10 years has been paralysis," she said.
>
> Despite "a lot of fire and brimstone" from regulators and elected offi-

3. *The 1991 Treasury Department Deregulation Proposal*

On March 20, 1991 a Treasury Department banking reform bill was introduced in the House and Senate: The Financial Institutions Safety and Consumer Choice Act of 1991.[460] The intent of this massive piece of legislation is summarized as follows:

> Section 2 provides that the purposes of the Financial Institutions Safety and Consumer Choice Act of 1991 (FISCCA) are to return deposit insurance coverage to its original purposes of protecting small depositors and promoting financial stability; to strengthen the role of capital, enhance the supervision, and restrict risky activities of insured depository institutions; to permit nationwide banking and branching; to authorize the establishment of financial services holding companies to permit companies owning depository institutions to engage in other financial services with appropriate safeguards; to promote consumer convenience by permitting banking organizations a broader range of financial products; to simplify the regulatory structure for depository institutions by establishing a consolidated regulatory agency, the Office of Depository Institutions Supervision; and to recapitalize the Bank Insurance Fund.[461]

A large portion of the bill is devoted to reforming the Federal Deposit Insurance system by placing new limits on deposit insurance coverage, by requiring the FDIC to use the least costly method to resolve insured depository institutions, by requiring the setting of insurance premiums for depository institutions on a risk-based assessment system, by cracking down sooner on troubled banks, by expanding the bank examinations, by raising capital requirements and by several other changes from the present law. Another portion of the bill tightens regulations in relation to foreign banks operating in the United States. The bill also proposes a restructuring of the regulatory entities

---

> cials, there has been very little real action in terms of insurance regulation, charged Ms. Gillespie.
>
> * * *
>
> "The expectations of the public and the ability of government to deliver are poles apart," Ms. Gillespie noted.

Stacy Adler, *Oversight of Insurers 'Weak': Gillespie*, BUSINESS INSURANCE, Aug. 20, 1990, at 14.

The Dingell report observed:

> Under the present regulatory framework, state insurance departments are responsible for regulating insurance company solvency, and administering the liquidation of insolvent companies. The Sub-committee found numerous weaknesses and breakdowns in this system, including lack of coordination and cooperation, infrequent examinations based on outdated information, insufficient capital requirements and licensing procedures, failure to require use of actuaries and independent audits, and improper influence on regulators. Inadequate staffing and regulatory resources is also a serious problem, yet state governments collect twenty times more from premium taxes than they spend on insurance regulation. Realistically, can the present system correct these problems when 50 state legislatures and insurance commissions are involved?

Dingell, *supra* note 444 at 72.

460. S.713, H.R. 1505, 102d Cong., 1st Sess. (1991).

461. *Id.* § 2, as summarized by the Treasury Department's section-by-section analysis.

by abolishing the Office of the Comptroller of the Currency and the Office of Thrift Supervision and creating the Office of Depository Institutions Supervision with broad administrative and supervisory powers over particular institutions.

There are several other areas of regulatory matter, but the one most germane to this paper is Title II of the bill, entitled "Financial Services Modernization." It creates (as of January 1, 1993) the Financial Services Holding Company (FSHC) and the Diversified Holding Company (DHC). The FSHC will be able to own banks directly and engage in activities currently permissible for BHCs (except that a bank will not be able to be a FSHC) as well as participate in a broad range of financial services through subsidiary institutions. Thus, banks owned by a FSHC will be affiliated with a variety of financial entities. A DHC may own or control a company engaged in activities not permitted for FSHC subsidiaries. A DHC may not own a bank directly, but it may own or control a FSHC and thus control a bank indirectly. A bank may not be a DHC, but any commercial entity may be a DHC. A sketch of these holding companies follows:

Financial Service Holding Company

A FSHC itself will be permitted to engage directly only in what was permitted BHCs under the "closely related" standard[462] of § 4(c)(8),[463] but not in any new activities that may be approved under the "financial nature" standard,[464] nor in the securities or insurance activities authorized under §§ 4(c)(15) and 4(c)(16).[465] All of these new activities will have to be undertaken through subsidiaries. Thus, a FSHC can continue to pursue those activities permitted under the regulations and orders of the Board[466] in which it was engaged as a BHC on December 31, 1992. However, specific provisions address the question of underwriting and dealing in ineligible securities.[467] The FSHC will be permitted to continue these activities[468] for a period of only three years (subject to the limitations imposed by the Board when it authorized such activity[469]) and then convert the § 20 subsidiary[470] into a § 4(c)(15) subsidiary.[471] A FSHC will be permitted to establish (or acquire) securities affiliates, referred to as § 4(c)(15)

462. *See* 12 U.S.C. § 1843(c)(8)(1976). The closely related standard has been replaced in the FISCCA by the "financial nature" standard. The Board will determine (by regulations, rules and orders) what activities are permissible under this new standard.
463. 12 U.S.C. § 1843(c)(8)(1982).
464. *See supra* note 445.
465. S.713, H.R. 1505, 102d Cong., 1st Sess., § 203(a)(2)(C)(1991).
466. *See supra* text accompanying notes 241-242, 275.
467. *See supra* note 257.
468. Referred to as section 20 subsidiaries. *See supra* note 273.
469. *See supra* text accompanying notes 257-264, 272 and 273.
470. *See supra* note 273.
471. *See supra* note 465.

subsidiaries. Such a subsidiary may engage in underwriting, distributing and dealing in any type of security; organize, sponsor, control and distribute mutual fund shares; do private placements, investment advisory services, full service brokerage activities and so on. A FSHC will also be permitted to establish or acquire insurance affiliates, referred to as § 4(c)(16) subsidiaries. Such a subsidiary will be able to provide insurance as a principal (*i.e.* underwrite), broker or agent without geographic or product limitations.

The FISCCA classifies banks into 5 zones. Zone 1 banks are the highest level, as expressed in terms of capital. Thus a zone 1 bank is defined as a bank that maintains a risk-based capital ratio that is significantly in excess of the minimum ratio required by the appropriate federal banking agency under its risk-based capital standard and tier 1 capital that is significantly in excess of the required minimum for tier 1 capital.[472] Zone 5 banks are banks that are at the level of need for immediate salvaging action by the appropriate federal banking agency.[473] A FSHC that owns a zone 1 bank has certain privileges and rights in procedures relative to expansion and acquisition of subsidiaries. Similarly, the bounds of permissible activities of FSHCs that control banks other than zone 1 banks are determined by the zone classifications of the banks they hold.

Diversified Holding Company

Section 204 of the bill[474] establishes the DHCs, a means whereby there can be affiliation between commercial firms and banks. DHCs may own only well capitalized banks, and own them only indirectly. In practical terms it means that DHCs may acquire FSHCs, but only those that meet the requirements of zone 1. Furthermore, all lending between a FSHC or any of its subsidiaries, and an affiliated DHC or any of its affiliates is strictly forbidden. Additionally, a number of other transactions between the aforementioned entities is prohibited.

Other Matters

Amendments to the Glass-Steagall Act are included in order to conform the permissible activities of national banks to the expanded powers of FSHCs. Similarly, amendments have been made to the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as the Investment Company Act of 1940. Provision for nationwide banking by FSHCs and branch banking by national and state banks has been included in the bill.

For a decade Congress has been presented with bills to modernize

472. " 'Tier 1 capital' shall have the meaning given [that] term by the appropriate Federal banking agencies in the risk-based capital standards adopted by such agencies." S.713, H.R. 1505, 102d Cong., 1st Sess., § 251(a)(1991).

473. Zones 2, 3 and 4 are, of course, between these extremes. Each zone is described at length in § 251 of the bill.

474. S.713, H.R. 1505, 102d Cong., 1st Sess., § 204 (1991).

the American financial services system,[475] without a successful resolution. Will it work this time?

> The banking overhaul, championed by Treasury Secretary Nicholas F. Brady, faces a myriad of legislative obstacles, as well as a mine field of special interests. And lawmakers fear that they may be wading into another savings and loan quagmire, which is blamed in part on deregulation legislation of the early 1980s.
>
> * * *
>
> "It will require Herculean effort and Job-like patience to get the whole thing through," said Bryce L. Harlow, until recently the Treasury's liaison with Congress and now a lobbyist. "There is a fantasmagoria of special interests cutting this way or that. It's going to be a tough job to get those groups together."
>
> White House Chief of Staff John Sununu told a group of California bankers last week, "It is doubtful you'll see this legislation [get] through the Congress this year," and Rep. Chalmers Wylie (R-Ohio), the ranking minority member of the House Banking Committee, has given the measure only a 50-50 chance of passing.
>
> * * *
>
> "I don't see the perception out there of the seriousness, the depth, the complexity of the crisis facing the banking system," said Gonzalez.[476] "If we had the perception of what the real serious nature of the crisis is, the people would demand that we concentrate on the fundamentals."[477]

A miracle is apparently needed. Miracles do happen. Let's hope.

VIII. ADDENDUM

On June 10, 1991 the Second Circuit overruled[478] the Board's ruling in *Citicorp*[479] and put to rest, at least for the time being, uncertainties over the Board's state bank "operating subsidiary" rules.[480] The court appears to have determined that once the Board conceded that it had no jurisdiction over state bank subsidiaries of BHCs[481] it had cut off its jurisdiction over the subsidiaries of those banks.

Later in the year, on November 27th, Congress passed the Federal

---

475. *See* part VI. C.

476. Rep. Henry B. Gonzalez (D-Tex.), chairman of the House Banking Committee.

477. The Washington Post, March 21, 1991, p. B11, col. 5. Jerry Knight & Steve Mufson, *Hill Obstacle Course Awaits Banking Bill; Administration Expects Congressional Fight*, WASH. POST, March 21, 1991, at B11.

478. In *Citicorp v. Board of Governors*, 936 F.2d 66 (2d Cir. 1991).

479. 876 Fed. Res. Bull. 977, 978 (1990); *see also supra* 411 and accompanying text.

480. 12 C.F.R. § 225.22(d)(2)(ii). *See also supra* notes 293, 304 and accompanying text.

481. The Board ruled that whether bank subsidiaries may engage in nonbanking activities is a matter for the chartering authorities of those banks, and not for the Board. Once that decision was made, we cannot agree that the Act can sensibly be construed to permit the Board to displace bank-chartering authorities in determining what activities are permitted for the subsidiaries of bank subsidiaries.

Citicorp v. Board of Governors of the Federal Reserve Sys., 936 F.2d 66, 75 (2d Cir. 1991).

Deposit Insurance Corporation Improvement Act of 1991,[482] which was signed by the President on December 19, 1991. The scope of this banking omnibus act is extremely broad, and only the one aspect germane to this paper will be mentioned here. Section 303 of the FDIC Improvement Act effectively overturns the decision in *Citicorp*[483] as well as *Merchants National*[484] and thus (again, for the time being) forecloses the underwriting of insurance by banks.

The last relevant event to be mentioned is *Independent Insurance Agents of America v. Clarke*,[485] in which the D.C. Circuit Court of Appeals declared section 92[486] void, thereby eliminating the loophole created by the Comptroller of the Currency in permitting national banks located in towns of less than 5,000 population to sell insurance to any customer.[487]

482. Pub. L. No. 102-242, 105 Stat. 2236 (1991).
483. *See supra* note 481.
484. *See supra* text accompanying notes 330 through 357.
485. 955 F.2d 731 (D.C. Cir. 1992).
486. 12 U.S.C.A. § 92 (West 1945).
487. *See supra* notes 118-125 and accompanying text.