Product Expansion in the Banking Industry: An Analysis and Revision of Section 4(c)(8) of the Bank Holding Company Act

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INTRODUCTION

A major restructuring of the financial services industry is occurring1 as


Congress is attempting to close the nonbank loophole by redefining “bank” more restrictively. See H.R. 15, 99th Cong., 1st Sess. § 201(a) (1983) (suggesting definition of bank as any institution that utilizes borrowing, discount or payment system services provided by the Federal Reserve System). This loophole recently has been challenged in the judicial arena. See Florida Dept. of Banking and Fin. v. Board of Gows. of the Fed. Res. Sys., 760 F.2d 1135, 1138-44 (11th Cir. 1985) (literal definition of “bank” should not be applied to reach a result contrary to the underlying policy of Congress). If these attempts are ultimately successful, it would merely preclude the acquiring institutions from utilizing the nonbank route to expand their range of financial services. Financial institutions can and do diversify in other ways. See E. Bowden & J. Holbert, supra, at 243-44. Indeed, the present restructuring and diversification of the financial services industry has been referred to as an “homogenization” of institutions. American Bankers' Ass'n Ad Hoc Comm. on Developments in Investment Services, Homogenization of Financial Insti-
depository\(^2\) and nondepository\(^3\) institutions vigorously compete with one another in a variety of fields.\(^4\) This competition, resulting from eco-


2. The phrase “depository institutions” refers to financial organizations, such as commercial banks, savings and loan associations, mutual savings banks, and credit unions, that hold liabilities in the form of deposits or shares and assets in the form of loans and investments. See S. Rep. No. 487, 94th Cong., 1st Sess. 3-4 (1975). Commercial banks are those banks that originally concentrated on providing financial services, such as short-term loans, to businesses. K. Cooper & D. Fraser, Banking Deregulation and the New Competition in Financial Services 9-10 (1984). Today, however, commercial banks do make consumer and mortgage loans and encourage savings deposits by individuals. See id. at 11-14. Nonbank depository institutions are the savings and loan associations, mutual savings banks, and credit unions, collectively referred to as “thrift institutions.”

C. Golembe & D. Holland, Federal Regulation of Banking 1983-84, at 9 (1983). Mutual savings banks and savings and loan associations were originally formed to provide credit for the purchase of homes. K. Cooper & D. Fraser, supra, at 10; see C. Golembe & D. Holland, supra, at 9. Mutual savings banks differ from savings and loan associations in that the former’s depositors are considered to be creditors of the bank and, hence, in theory, “have a higher legal standing than if they were considered mere shareholders.”

C. Golembe & D. Holland, supra, at 183. “In view of the pervasiveness of deposit insurance, however, the distinctions probably have little practical significance.” Id. at 186. Credit unions were originally designed to provide small, often unsecured, personal loans to consumers. K. Cooper & D. Fraser, supra, at 10. All of these institutions are chartered by either the federal or state government. See C. Golembe & D. Holland, supra, at 182, 185-88. For a general discussion of the dual nature of the American banking system, see Scott, The Dual Banking System: A Model of Competition in Regulation, in Issues in Financial Regulation 1, 3-8 (F. Edwards ed. 1979).


3. Nondepository institutions competing with commercial banks include both financial firms, such as insurance companies, securities brokerage firms, mutual fund companies and consumer finance companies, and nonfinancial firms, such as retailers and manufacturers. See E. Bowden & J. Holbert, supra note 1, at 231.

4. Although commercial banks are the major supplier of credit in our economy, their share of total short-term, nonfinancial debt decreased from 69.8% in 1970 to 59.1% in 1980, reflecting competition with commercial finance companies and the commercial paper market. Golembe Associates, Inc., Product Expansion by Bank Holding Companies: An Assessment of Present and Future Policy Considerations 44 (Jan. 1982) (discussion paper prepared for the Association of Bank Holding Companies) (available in files of Fordham Law Review) [hereinafter cited as Product Expansion]; see also Stevens, The Intersection of the Banking and Securities Industries and Future Deregulation, in The Deregulation of the Banking and Securities Industries 295, 295-96 (L. Goldberg & L. White eds. 1979) (foreign banks, the commercial paper market and finance companies are lending money to businesses at an increasing rate). Banks also face significant competition in the area of consumer lending, primarily from finance companies. See Rosenblum, Siegel & Pavel, Banks and Nonbanks: A Run for the Money, Econ. Persps., May/June 1983, 3, 5-6. Finally, money market mutual funds can offer higher rates because they do not have to keep a certain percentage of their customers’ money as “reserves.” See K. Cooper & D. Fraser, supra note 2, at 7-8. Commercial banks are thus no longer the sole provider of checking account services. Compare Bank Holding Company Act Amend-
nomic,\(^5\) technological\(^6\) and demographic changes,\(^7\) is desirable because it provides consumers with a broad range of financial services characterized by high returns, liquidity and convenience.\(^8\) At the same time, however, this competition is challenging the long-established policy of separating banking from commerce.\(^9\)

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\(^5\) High market rates of interest have made the yields of unregulated money market mutual funds competitive with regulated bank savings instruments. See *Competition and Conditions in the Financial System: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs, 97th Cong., 1st Sess. 71 (1981)* (statement of John G. Heimann, Comptroller of the Currency) (technology has reduced the cost of exchanging assets); *E. Bowden & J. Holbert, supra* note 1, at 193-207 (discussing development of electronic banking). Technology also permits economies of scale and of scope—economies of joint production. See *K. Cooper & D. Fraser, supra* note 2, at 194. In addition, reduced data processing costs have made possible the issuance of small-savers' debt instruments by both financial and nonfinancial institutions. *Id.* at 193.

\(^6\) Computer technology has made possible the quick and low cost transfer of funds from one asset and institution to another. See *Financial Institutions in a Revolutionary Era: Hearing Before the House Comm. on Banking, Finance and Urban Affairs, 97th Cong., 1st Sess. 45-49 (1981)* (statement of Almarin Phillips, Professor of Economics, Law and Public Policy, University of Pennsylvania) (technology has reduced the cost of exchanging assets); *E. Bowden & J. Holbert, supra* note 1, at 193-207 (discussing development of electronic banking). Technology also permits economies of scale and of scope—economies of joint production. See *K. Cooper & D. Fraser, supra* note 2, at 194. In addition, reduced data processing costs have made possible the issuance of small-savers' debt instruments by both financial and nonfinancial institutions. *Id.* at 193.

\(^7\) See *1981 Senate Hearings, supra* note 5, at 72 (statement of John G. Heimann, Comptroller of the Currency) (migration from northern and eastern sections of the country to southern and western sections has stimulated the development of financial products); *Heimann, Forces for Change in Banking,* in 1 Ann. Rev. of Banking L. 53, 54 (1982) (same).

\(^8\) See *E. Bowden & J. Holbert, supra* note 1, at 227-29 (financial institutions hope to attract savers by offering various combinations of financial instruments); *Walliston, The Emerging Regulatory Structure for Banks: Implications for the Insurance Industry,* in The Emerging Financial Industry 73, 73 (A. Sametz ed. 1984) (“competition improve[s] the services offered to consumers”). One example of a financial service that has benefited the consumer is the “asset management account,” which offers money market interest rates, check-writing privileges, and a line of credit accessible by credit card. *E. Bowden & J. Holbert, supra,* at 237-38.

\(^9\) The National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified as amended in scattered sections of 12, 19 & 31 U.S.C.), restricts national banks to “carry[ing] on the business of banking.” See *12 U.S.C. § 24 Seventh* (1982). It also restricts the holding of real estate, see *id.* § 29, and prohibits loans of more than 10% of the bank's capital and surplus to any individual, partnership or corporation, see *id.* § 84. The Banking Act of
A major form of banking organization in America is the bank holding company, which is a corporation that controls one or more banks. These companies, however, are restricted from meeting the competitive challenges of the marketplace by an outmoded regulatory structure. Under section 4(c)(8) of the Bank Holding Company Act (Act), bank holding companies may engage in certain nonbank activities that the Federal Reserve Board—the agency responsible for the regulation of bank holding companies—has determined to be “so closely related to banking . . . as to be a proper incident thereto.” Under the “closely


11. 12 U.S.C. § 1841(a)(1) (1982). A bank holding company is deemed to have control over a bank when it has the power to vote 25% or more of any class of voting securities of the bank, elect or influence the election of directors or trustees of the bank, or when the Board of Governors of the Federal Reserve System determines that it exercises a controlling influence over the management or policies of the bank. Id. § 1841(a)(2); 12 C.F.R. § 225.2(d) (1985).

12. See Gorinson & Manishin, Garn-St. Germain: A Harbinger of Change, 40 Wash. & Lee L. Rev. 1313, 1335 (1983) (“Regulatory attempts to compartmentalize institutions and to structure competition along prescribed lines create perverse incentives and straightjacket the ability of the regulated firms to respond to market changes.”) (footnote omitted). See infra Pt. I.C. Although nondepository firms are free to compete with bank holding companies by engaging in a wide range of financial services, bank holding companies may not underwrite securities, 12 U.S.C. §§ 24 Seventh, 377-378 (1982), or certain kinds of insurance, id. §1843(c)(8). See 1984 Hearings, supra note 1, at 418, 424 (testimony of the Consumer Bankers Ass’n).

13. 12 U.S.C. § 1843(c)(8) (1982). Section 4(c)(8) formulates the following test: The prohibitions in this section [concerning nonbanking activities] 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 or 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 in limited circumstances. . . . 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 ef-
related” language, the Board regards past or present operations and functions of banks in general as a limitation on what bank holding companies may do in the future.\textsuperscript{16} In determining what is a “proper incident” to banking, the Board is directed to consider whether the applicant’s conduct of the proposed activity will 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.”\textsuperscript{17} This is known as the “public benefits” test.\textsuperscript{18}

There are several reasons for reexamining the viability of the present section 4(c)(8). First, there is the desire to promote competition in the rapidly changing financial services industry.\textsuperscript{19} Second, diversification can provide a bank holding company with new sources of income that could be used, to a certain extent, to stabilize earnings.\textsuperscript{20} Finally, liberalization of section 4(c)(8) would be consistent with the recent trend to-

\footnotesize{\textit{Id.} Board determinations under § 4(c)(8) are reviewable in the Circuit Courts of Appeals. \textit{Id.} § 1848.}


\footnotesize{17. 12 U.S.C. § 1843(c)(8) (1982).}


\footnotesize{19. See 1984 Hearings, \textit{supra} note 1, at 423-25 (testimony of the Consumer Bankers Ass’n); K. Cooper & D. Fraser, \textit{supra} note 2, at 18-19. See \textit{supra} note 8 and accompanying text.}


Financial diversification and deregulation is occurring in other free world countries. K. Cooper & D. Fraser, \textit{supra} note 2, at 75-90 (comparing financial systems of West European nations, Canada, Australia, New Zealand and Japan). “Most Western nations, even though their individual banking structures all display unique characteristics, are exhibiting strong tendencies to unfetter their financial systems and allow competition to play a greater role.” \textit{Id.} at 102.
ward banking deregulation.\textsuperscript{21}

This Note argues that the regulatory separation of banking from commerce—which furthers the goals of ensuring bank safety and soundness, avoiding conflicts of interest, and preventing undue concentration of resources—should be maintained but adjusted through revision of section 4(c)(8). After describing the requirements of section 4(c)(8), Part I of this Note reviews the significant legislative and regulatory liberalizations that have taken place since the original section 4(c)(8) was passed and concludes that the statutory standard still restricts the ability of bank holding companies to compete in the financial services marketplace. Part II formulates a "reasonably related to banking" standard that looks not at the operations of banks, but at whether the proposed activity is financial in nature and consistent with bank safety and soundness and the avoidance of conflicts of interest. The financial activity limitation and a separate competitive criterion are included in the proposed scheme in order to address, in part, antitrust concerns and to ensure competition in the financial services industry.

I. SECTION 4(c)(8) OF THE BANK HOLDING COMPANY ACT OF 1956

A. Statutory Interpretation

Section 4(a) of the Act prohibits bank holding companies from engaging in nonbanking activities.\textsuperscript{22} Section 4(c) enumerates exceptions to this rule.\textsuperscript{23} Section 4(c)(8) has the most important and controversial implica-


\textsuperscript{22} See 12 U.S.C. § 1843(a) (1982). Section 4(a) reads in relevant part:

Except as otherwise provided in this chapter, no bank holding company shall—

(1) . . . acquire direct or indirect ownership or control of any voting shares of any company which is not a bank or . . .

(2) . . . retain direct or indirect ownership or control of any voting shares of any company which is not a bank . . .

\textit{Id.}

\textsuperscript{23} These exceptions include, inter alia, holding property used by any banking subsidiaries of the bank holding company, 12 U.S.C. § 1843(c)(1)(A) (1982), conducting a safe deposit business, \textit{id.} § 1843(c)(1)(B), providing services to the bank holding company or its banking subsidiaries, \textit{id.} § 1843(c)(1)(C), owning shares of any company provided such ownership does not include more than five percent of the outstanding voting shares
tions for bank product expansion. It contains a two pronged test: First, is the activity closely related to banking? second, do the public benefits outweigh any adverse effects? If the Board determines that an activity is not closely related to banking, it need not consider the public benefits test.

1. The Closely Related Test

When the Act was passed in 1956, Congress did not specify the criteria to be used in determining what is "closely related" to the business of banking. Nor did it do so in 1970 when it amended the statute by deleting the phrase "business of." Hence, the issue was ripe for judicial

of such company, id. § 1843(c)(6), owning shares of foreign companies that conduct most of their business outside the United States, provided such ownership is not substantially at variance with the purposes of section 4(a) and is in the public interest, id. § 1843(c)(9), and owning shares of export trading companies provided that such ownership has not been disapproved by the Board and that the investment, whether direct or indirect, in such shares does not exceed five percent of the bank holding company's consolidated capital and surplus, id. § 1843(c)(14). Section 4(c)(6) has been interpreted by the Board to allow for only passive investments amounting to not more than five percent of a company's outstanding stock; that is, two or more bank holding companies may not pool their shares under section 4(c)(6) in order to gain control of a company. 12 C.F.R. § 225.137(d)(2) (1985). If the Board determines that authority to engage in a particular nonbank activity can be found in one of the other 4(c) exceptions as well as under section 4(c)(8), it may elect to treat that activity under the other exception. See 46 Fed. Reg. 38,493, 38,494 (1981) (authority under section 4(c)(8) for bank holding companies to sell certain kinds of insurance removed to the servicing exceptions, 12 U.S.C. § 1843(a)(2)(A), (c)(1)(C) (1982)).


26. See supra note 15 and accompanying text.

27. See supra note 17 and accompanying text.


interpretation. In *National Courier Association v. Board of Governors*, the Court of Appeals for the District of Columbia Circuit stated that the following criteria were relevant in deciding whether an activity is closely related to banking:

1. Banks generally have in fact provided the proposed services.
2. Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed service.
3. Banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.

The *National Courier* court did not intend the above criteria to be determinative but gave "considerable deference" to the Board to refine the guidelines "in a reasoned fashion consistent with the legislative intent." [33]

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31. 516 F.2d 1229 (D.C. Cir. 1975).
32. Id. at 1237.
33. Id. The Board has stated that it will consider "in addition to the *National Courier* criteria, any other factor that an applicant may advance to demonstrate a reasonable or close connection or relationship of the activity to banking." 49 Fed. Reg. 806 (1984).

Under the rubric of "deference to the Board," courts have been able to apply the *National Courier* criteria liberally. For example, in *Association of Data Processing Serv. Orgs. v. Board of Govs. of the Fed. Res. Sys.*, 745 F.2d 677 (D.C. Cir. 1984), the court deferred to the Board's determination that the provision of specialized computer hardware by a bank holding company came within the third *National Courier* guideline, id. at 694, and stated:

The record of the present proceeding displays a careful and conscientious effort by the Board to cope with these difficulties [of interpretation]. We are not inclined to complicate its task further by attempting to exercise close and necessarily inexpert supervision of its judgments. That would be particularly inappropriate under a governing statute such as this one, which commits it to the Board to apply a standard of such inherent imprecision . . . that a discretion of almost legislative scope was necessarily contemplated. If there is a problem in such broad delegation, it would assuredly not be solved by effectively taking the delegation from the Board and placing it in our own hands. Having assured ourselves that the Board has acted reasonably, consistently and with procedural regularity in giving content to the statutory standard, our task is at an end.

Id. at 697; *see also* Securities Indus. Ass'n v. Board of Govs. of the Fed. Res. Sys., 104 S. Ct. 3003, 3009 (1984) ("[T]he Board has articulated with commendable thoroughness the ways in which banking activities are similar to the [discount] brokerage activities at issue here."); Board of Govs. of the Fed. Res. Sys. v. Investment Co. Inst., 450 U.S. 46, 78 (1981) (Whether bank holding companies may act as investment adviser to closed-end investment companies is a decision that is "best resolved by deferring to the Board's expertise in determining what activities are encompassed within the plain language of the statute.").

The justifications for this deference were discussed by Justice Rutledge in his concurrence in *Board of Govs. of the Fed. Res. Sys. v. Agnew*, 329 U.S. 441 (1947) (challenge under the Glass-Steagall Act):

[n]ot only because Congress has committed the system's operation to [the Board's] hands, but also because the system itself is a highly specialized and technical one, requiring expert and coordinated management in all its phases.
The Supreme Court has approved the *National Courier* guidelines.\(^3\)

\[\ldots\] Their specialized experience gives them an advantage judges cannot possibly have, not only in dealing with the problems raised for their discretion by the system's working, but also in ascertaining the meaning Congress had in mind in prescribing the standards by which they should administer it. Accordingly their judgment in such matters should be overturned only where there is no reasonable basis to sustain it or where they exercise it in a manner which clearly exceeds their statutory authority.

*Id.* at 450 (Rutledge, J., concurring).


Regulation Y lists, inter alia, the following activities as closely related to banking: (1) making and servicing loans or extending credit such as would be made by a mortgage, finance, credit card, or factoring company; (2) performing trust or fiduciary activities; (3) acting as investment or financial adviser to the extent of (i) serving as advisory company to a mortgage or real estate investment trust, (ii) serving as investment adviser to mutual funds, including sponsoring, organizing and managing a closed-end investment company, (iii) providing portfolio investment advice to other persons, (iv) furnishing general economic information and advice, general statistical forecasting services, and industry studies, and (v) providing financial advice to state and local governments; (4) leasing personal and real property provided the transaction is the functional equivalent of an extension of credit; (5) making equity and debt investments in community development corporations or projects designed to promote community welfare or rehabilitation; (6) furnishing certain data processing and transmission services, data bases or facilities provided the data to be processed is financial, banking or economic; (7) acting as insurance agent or broker, except as prohibited by Title VI of the Garn-St. Germain Depository Institutions Act of 1982, 12 U.S.C. § 1843(c)(8) (1982), see *infra* note 62 and accompanying text, in offices at which the bank holding company or its subsidiaries are otherwise engaged in business, or in an office adjacent thereto, with respect to insurance that is directly related to certain extensions of credit or to provision of other financial services by a bank or a bank-related firm, and any insurance sold in a community that has a population not exceeding 5000 residents; (8) underwriting credit life, accident and health insurance that is directly related to an extension of credit by the bank holding company system; (9) providing courier services for financially related documents, instruments, and audit and accounting media;
2. The Public Benefits Test

Under the public benefits test, the Board examines a proposed activity (10) providing management consulting to nonaffiliated bank and nonbank depository institutions; (11) performing real estate appraisals; (12) offering discount brokerage services and certain margin lending activities; (13) arranging commercial real estate equity financing; (14) underwriting and dealing in government obligations and money market instruments; (15) providing foreign exchange advisory and transactional services; and (16) acting as a futures commission merchant. 12 C.F.R. § 225.25 (1985).

The Board may also approve "any incidental activities that are necessary to carry on" activities determined to be closely related to banking. 12 C.F.R. § 225.21(a)(2) (1985); see Association of Data Processing Serv. Orgs. v. Board of Govs. of the Fed. Res. Sys., 745 F.2d 677, 694-96 (D.C. Cir. 1984) (provision of computer hardware in conjunction with banking, financial or economic data software held incidental to data processing); Alabama Ass'n of Ins. Agents v. Board of Govs. of the Fed. Res. Sys., 533 F.2d 224, 242-45 (5th Cir. 1976) (liability insurance held incidental to providing property damage insurance for the collateral in bank loans), modified on other grounds per curiam, 558 F.2d 729 (5th Cir. 1977), cert. denied, 435 U.S. 904 (1978). But see National Courier Ass'n v. Board of Govs. of the Fed. Res. Sys., 516 F.2d 1229, 1240-41 (D.C. Cir. 1975) (courier services that were not financially related and that were provided as a matter of convenience to customer held not incidental to financially related courier services).

In addition to the activities listed in Regulation Y, the Board has authority to issue specific orders approving additional activities, see 12 U.S.C. § 1843(c)(8) (1982), such as buying and selling gold and silver bullion, see JCT Trust Co., 67 Fed. Res. Bull. 635, 635, 637 (1981), and providing personal financial management courses, Citicorp, 65 Fed. Res. Bull. 265, 265 (1979). Approval by order allows the Board to consider applications to engage in activities not listed in Regulation Y. C. Golembe & D. Holland, supra note 2, at 155-56.


The Federal Reserve Board has recently voted to seek public comment on whether bank holding companies should be permitted to engage in real estate development activi-
to see if it will result in any adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices, "even if [these effects do] not reach the level of an antitrust violation." The Board may also look at other adverse


The Board also favors de novo entry into nonbanking activities—the creation of a new subsidiary to compete in an existing market—rather than entry by acquisition because de novo entry generally promotes competition. *See Imperial Bancorp., 68 Fed. Res. Bull. 784, 784 (1982); United Oklahoma Bancshares, Inc., 65 Fed. Res. Bull. 363, 364 (1979); National Cent. Fin. Corp., 60 Fed. Res. Bull. 790, 791 (1974); C. Golembe & D. Holland, supra note 2, at 155; P. Heller, supra, at 267. The Board is specifically authorized by section 4(e)(8) to consider the factor of de novo entry. See supra note 15. The statute, however, does not permit the Board to approve automatically all de novo entries. *See Independent Ins. Agents v. Board of Govs. of the Fed. Res. Sys., 658 F.2d 571, 574-76 (8th Cir. 1981) (Board required to hold evidentiary hearing on the manner in which de novo entry is to be effected); Florida Ass'n of Ins. Agents v. Board of Govs. of the Fed. Res. Sys., 591 F.2d 334, 341 n.18 (5th Cir. 1979) (because Board "conclusorily" stated that no undue concentration of resources would result from applicant's de novo entry into insurance field, case was remanded for further introduction of evidence).

36. *See Connecticut Bankers Ass'n v. Board of Govs. of the Fed. Res. Sys., 627 F.2d 245, 254 (D.C. Cir. 1980) ("[A]lthough the Board's inquiry must proceed with rigor, we cannot require it to investigate every potential adverse contingency which a contestant hypothesizes.").
factors, such as possible violations of state law\(^{37}\) and the existence of a separate congressionally mandated regulatory structure.\(^{38}\)

The Federal Reserve Board has held that an applicant bank holding company must demonstrate net public benefits, even in the absence of adverse effects.\(^{39}\) This interpretation has been disputed, however, because it appears to run counter to the plain language of the statute.\(^{40}\) If adverse effects are possible, the applicant certainly must show that public

\(^{37}\) Compare Florida Ass'n of Ins. Agents v. Board of Govs. of the Fed. Res. Sys., 591 F.2d 334, 341-42 (5th Cir. 1979) (Board failed to adequately consider state statutes that prohibited banking institutions from engaging in insurance agency activities) with Alabama Ass'n of Ins. Agents v. Board of Govs. of the Fed. Res. Sys., 533 F.2d 224, 252-53 (5th Cir. 1976) (Board reasonably assumed that bank holding company's application to engage in certain insurance activities would comply with state law), modified on other grounds per curiam, 558 F.2d 729 (5th Cir. 1977), cert. denied, 435 U.S. 904 (1978).


Activities determined to be permissible under section 4(c)(8) may be conducted through a bank service corporation, as opposed to a bank holding company. 12 U.S.C. § 1864(f) (1982). As its name suggests, a bank service corporation provides certain services to the banks that own it. Id. § 1861(b)(2). The Bank Service Corporation Act, id. §§ 1861-1865, however, lacks an explicit net public benefits test, thus presenting a more liberal standard than §4(c)(8). Data Processing Activities Put in BSC by Citicorp, 3 Banking Expansion Rep. 18, 18-19 (Nov. 19, 1984); see 12 U.S.C. § 1865(e) (1982) (listing factors Board is authorized, not required, to consider; no requirement that factors beneficial to public outweigh possible adverse effects).

\(^{40}\) See P. Heller, supra note 35, at 276 ("The statute does not require that there shall be public benefits for every acquisition that receives approval."). The meaning of the statute must be first sought in its language. 2A N. Singer, Sutherland Statutory Construction § 46.01, at 73-74 (C. Sands rev. 4th ed. 1984). The language of section 4(c)(8) requires that public benefits be demonstrated if a nonbank acquisition could have possible adverse effects, but is silent as to whether public benefits need be demonstrated in the absence of adverse effects. See supra note 15.
benefits, such as greater convenience, increased competition, or gains in efficiency, will outweigh adverse effects. 41

B. Liberalization of the Original Section 4(c)(8)

The original section 4(c)(8) 42 allowed bank holding companies to engage in those activities of a "financial, fiduciary, or insurance nature" 43 that were determined by the Board to be "closely related to the business of banking." 44 The Board took a very restrictive view of the phrase "business of banking," declaring that the language requires a "direct and significant connection between the proposed activities of the company to be acquired and the business of banking . . . as conducted by the bank holding company or its banking subsidiaries." 45 The Board also limited the geographic expansion of the nonbanking activities of bank holding companies. 46


44. Id.


46. See First Bank Stock Corp., 44 Fed. Res. Bull. 917, 926 (1959) (denying acquisition of finance company by bank holding company because bank holding company could "acquire installment paper over much wider areas than would be feasible for nonholding
Congress amended section 4(c)(8) in 1970. The words "business of" in the phrase "closely related to the business of banking" were deleted, as was the phrase that referred to activities of a "financial, fiduciary, or insurance nature." Congress decided to retain the words "closely related," despite proposals in both houses of Congress that a more lax "functionally related" standard be employed. A "laundry list" of six impermissible activities was also rejected in favor of the closely related standard. In addition, the public benefits test was added, thus introducing antitrust considerations into section 4(c)(8) determinations.


The restrictions of the Bank Holding Company Act did not apply to one-bank holding companies—that is, those corporations controlling only one bank—because the Act defined a bank holding company as a corporation controlling two or more banks. See Bank Holding Company Act of 1956, ch. 240, Pub. L. No. 84-511, § 2(a), 70 Stat. 133, 133 (current version at 12 U.S.C. § 1841(a)(1) (1982)). Thus, during the 1960's, the number of one-bank holding companies rapidly increased. Chase I, supra note 24, at 1227 & n.5. Many of these one-bank holding companies engaged in a wide range of nonfinancial activities. House Comm. on Banking & Currency, 91st Cong., 1st Sess., The Growth of Unregistered Bank Holding Companies—Problems and Prospects 50 (Comm. Print 1969) (about half of all one-bank holding companies are involved in over 90 different nonfinancial activities, such as farming, mining and manufacturing). The fear of large banking institutions and the apparent abrogation of the traditional separation of banking from commerce, see 1970 Conference Report, supra note 30, at 11-12; 1970 Senate Report, supra note 35, at 3-4, led Congress in 1970 to extend the restrictions of the Act to one-bank holding companies, see 12 U.S.C. § 1841(a) (1982).

48. See 1970 Conference Report, supra note 30, at 15-16. This revision was intended to allow bank holding companies to engage in nonbanking activities that were related to banking generally but not directly connected with the activities of banks in a particular geographic region. Id. at 16 (letter of Arthur Burns, Chairman, Board of Governors, Federal Reserve System). See supra notes 45, 46 and accompanying text.


50. See 1970 Conference Report, supra note 30, at 13-16, 19-22 (discussing the differences between the Senate and House bills and recommending a closely related standard); 1970 Senate Report, supra note 35, at 12 (recommending a functionally related standard); H.R. Rep. No. 387, 91st Cong., 1st Sess. 1, 3, 9 (1969) (favoring the more flexible functionally related standard); 1969 Hearings, supra note 4, at 199 (statement of William Martin, Jr., Chairman, Board of Governors, Federal Reserve System) ("... Section 4(c)(8) should be amended to eliminate the reference to close relationship of the proposed activity to the business of the subsidiary banks, which we regard as unnecessarily constricting.").


Congress did not promulgate a specific antitrust standard as it did in section 3 of the Act but did want the Board to conduct a more thorough examination of anticompetitive effects and concentration of resources than that mandated under the existing antitrust laws.

The House and Senate conferees disagreed on whether the amendments rejected or adopted an expansive approach to section 4(c)(8). The Supreme Court eventually declared that the amendments broadened the Board's discretion as to permissible activities. Beyond this pronouncement, the present section 4(c)(8) lacks the support of a clear, positive legislative history.

Since 1970, the public benefits component has undergone a distinct liberalization. The Board originally limited section 4(c)(8) acquisitions to small companies, but in recent years it has considered larger acquisitions to be publicly beneficial and thus permissible. Hence, the Board

54. See supra note 35 and accompanying text.
has retreated from a harsher application of the searching antitrust inquiry that Congress intended in the public benefits test.59

As a result of intense lobbying efforts by the insurance industry,60 the legislative and regulatory modifications of section 4(c)(8) were sharply curtailed in 1982 by the passage of Title VI of the Garn-St. Germain Depository Institutions Act (Garn-St. Germain Act).61 This law precludes bank holding companies from engaging in certain insurance activities.62 Insurance holding companies, however, are free of many activity restrictions63 and vigorously compete with bank holding companies.64 Hence, Title VI is a step backward in promoting a competitive financial services market.

59. See supra note 35 and accompanying text.


62. See supra note 15. Insurance activities are not closely related to banking unless they fall into one of seven express exceptions: (1) credit insurance covering death, disability or involuntary unemployment of a debtor; (2) credit property damage insurance on loans of not more than $10,000 ($25,000 in the case of residential manufactured homes) where the insurance was provided by a finance company subsidiary of a bank holding company; (3) insurance agency activities in places with population not exceeding 5,000 or which the bank holding company demonstrates have inadequate insurance agency facilities; (4) insurance activities engaged in by a bank holding company or any of its subsidiaries on or before May 1, 1982, or which the Board approved for such company or any of its subsidiaries on or before May 1, 1982; (5) supervision, on behalf of insurance underwriters, of retail insurance agents who sell fidelity, property and casualty, and group employee coverages to a bank holding company or its subsidiaries; (6) any insurance agency activity if the bank holding company has total assets of $50 million or less to the extent allowed in (1), (2), and (3) above; and (7) continuance of insurance agency activities of registered bank holding companies commenced prior to January 1, 1971 as a consequence of approval by the Board. 12 U.S.C. § 1843(c)(8)(A)-(G) (1982).


64. In a decade in which non-depository financial institutions increasingly are engaging in de facto banking notwithstanding the Glass-Steagall Act, and in which insurance/brokerage combinations such as Prudential/Bache and Sears are positioning themselves to offer so-called "total financial planning," new restrictions on commercial bank and bank holding company activities only can further hamstring their competitiveness and profitability. From both a competitive and policy perspective, [Title VI of the Garn-St. Germain Act] is an anachronism.

Gorinson & Manishin, supra note 12, at 1334; see K. Cooper & D. Fraser, supra note 2, at 198-203; see also 1984 Hearings, supra note 1, at 424-28 (testimony of Consumer Bankers Ass'n) (insurance companies have expanded their range of financial services).
C. Weaknesses of Section 4(c)(8)

Despite the significant liberalization discussed above, section 4(c)(8) remains deficient. The National Courier guidelines highlight the inherent weakness of the "closely related" test of that section: The applicant bank holding company must, under the holding of National Courier, look to past or present activities or functions to demonstrate a substantial link between the proposed activity and banking operations. In reviewing Board rulings under section 4(c)(8), courts will look at the "general practices" and "traditional functions" of banks. The Board thus pays careful attention to such criteria. The result is unfortunate: A bank holding company could be denied permission to engage in a financial activity simply because the activity is outside the traditional realm of bank operations.

Another deficiency of section 4(c)(8) is in the public benefits test. This test requires an applicant bank holding company to demonstrate that, even in the absence of adverse effects, public benefits will result from the conduct of the proposed activity. Savings and loan holding companies and nondepository institutions, on the other hand, need not demonstrate public benefits when they broaden their range of activities. Moreover,

65. See, e.g., NCNB Corp. v. Board of Govs. of the Fed. Res. Sys., 599 F.2d 609, 613 (4th Cir. 1979) (upholding Board’s determination that underwriting property and casualty insurance failed to meet any of the three National Courier guidelines); Association of Bank Travel Bureaus v. Board of Govs. of the Fed. Res. Sys., 568 F.2d 549, 552-53 (7th Cir. 1978) (upholding Board’s determination that, because the nature of travel services had changed over time and less than one percent of all banks provided travel agency services, operating a travel agency was not closely related to banking). See supra notes 16, 32 and accompanying text.


69. See supra note 39 and accompanying text.

70. See 12 U.S.C. § 1730a(c)(2) (1982) (activities of savings and loan holding companies; no public benefits test in statute); K. Cooper & D. Fraser, supra note 2, at 197 (nondepository institutions are largely free of activity constraints); Fein, The Fragmented Depository Institutions System: A Case for Unification, 29 Am. U.L. Rev. 633, 693 (1980) ("Multiple S & L holding companies . . . are immune from the ‘public benefits’ test applied to bank holding company activities."). Moreover, savings and loan associations may organize service corporations, see 12 U.S.C. § 1464(c)(4)(B) (1982), to provide a
"[n]o one has shown why, when financial intermediaries are involved, so-called public benefits, such as making new services available in a town, should weigh either more or less heavily in the balance against possible anticompetitive effects than they do in ordinary antitrust reasoning."篇章

Indeed, the Board is called upon to weigh a variety of factors without any clear congressional guidance.篇章

The public benefits test also contains unclear terms. The reference to "undue concentration of resources" represents a nebulous fear of bank/nonbank mergers—the belief that bigness is bad per se—without articulating the specific ways in which financial conglomerations threaten the public well-being.篇章

"The joining of two large financial institutions by merger may frighten legislators but still have no adverse competitive effects (indeed, may have pro-competitive consequences). . . ."篇章

Indeed, section 4(c)(8) applications have not been denied solely on the basis of the undefined statutory reference to "undue concentration of resources;" the elimination of present or potential competition was always an accompanying factor.篇章

Corporate bigness has also been feared for its presumed social and political dangers, such as undue influence on government officials."篇章

[These] fears have a certain plausibility, although intrinsically unmeasurable in fact and even conceptually indefi-
Finally, the entrance of financial and nonfinancial institutions into the banking field has challenged the presumed "power" of commercial banks. Thus, for all these reasons, the overwhelming fear of "undue concentration of resources" should not warp section 4(c)(8) regulatory policy. The deletion of this factor from section 4(c)(8) would not leave it unconsidered in a nonbanking application. Rather, jurisdiction would be returned to the Antitrust Division of the Justice Department, which regularly deals with the problem of concentration of resources in all industries.

Finally, as has already been discussed, the flexibility of section 4(c)(8) has been vitiated by the Garn-St. Germain Act. Congress in 1970 had specifically rejected the inclusion of a list of impermissible activities. It preferred to leave such determinations to the Federal Reserve Board, which possesses the requisite expertise and awareness of the financial system. The Garn-St. Germain Act's prohibition against engaging in certain insurance activities precludes bank holding companies from a new source of income. The restriction unfairly inhibits competition at a time when insurance companies compete vigorously with banking institutions in such fields as deposit-taking and commercial mortgage lending.

The above analysis of the deficiencies of the present section 4(c)(8) suggests that a revision of the Act is necessary in order to achieve a competitive balance in the financial services industry.

II. REVISING SECTION 4(c)(8)

Historically, banks and their holding companies have been regulated to promote their safety and soundness, to avoid conflicts of interest,
and to prevent the concentration of economic power and the resultant potential for abuse and decreased competition. The policy of separating banking from commerce furthers these goals. This Part proposes that the goals of bank regulation can be adequately achieved by a "reasonably related to banking" standard combined with a finding that the conduct of the proposed nonbanking activity does not result in decreased competition in the financial services marketplace. Responsibility for determining what constitutes "undue concentration of resources" should be returned to the Antitrust Division of the Department of Justice. Unlike the "closely related" standard, which focuses on traditional banking activities, this new scheme focuses directly on whether the proposed activity is consistent with historic bank policies and on the methods of achieving such consistency. The proposed revision would allow bank holding companies to diversify into new financial activities and to compete more effectively with other providers of financial services.

A. Policy Guidelines

1. Bank Safety and Soundness

Risk results from the lack of perfect knowledge in decisionmaking. Hence, banking, like other businesses, is not risk free. Traditional banking risks relate to the granting of credit; for example, borrowers may default on their loans or the interest rates that are paid on deposits may rise after a bank has lent out money at a fixed rate. The risks associated with commercial ventures, on the other hand, relate to factors beyond

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87. See Investment Co. Inst. v. Camp, 401 U.S. 617, 630-31, 633-34 (1971) (Congress thought that the desire to sell insurance might impair a bank's ability to function as an impartial source of credit); Independent Ins. Agents v. Board of Govs. of the Fed. Res. Sys., 736 F.2d 468, 475 (8th Cir. 1984) (desire to sell insurance could interfere with bank officer's fiduciary obligation to customer); Transamerica Corp., 43 Fed. Res. Bull. 1014, 1016 (1957) ("The public interest requires that decisions as to whether or not a bank extends credit in a particular case should be based, as far as possible, solely on creditworthiness."); Symons, supra note 9, at 681 (neutrality in the allocation of credit is a principle central to the concept of the business of banking). See infra Pt. II.A.1.

88. See Cameron Fin. Corp. v. Board of Govs. of the Fed. Res. Sys., 497 F.2d 841, 846 (4th Cir. 1974) (Congress in 1956 was concerned about the increasing concentration of banking resources and the "combination in one enterprise of a major creditor in a locality, a bank, and another service business[,] creat[ing] a condition ripe for exploitation through tying relationships."); Clark, supra note 63, at 795 (the furtherance of general antitrust policies is an objective of federal regulations concerning bank mergers and holding company acquisitions); Product Expansion, supra note 4, at 8-13 (guarding against undue concentration of economic power is a public policy objective). See infra Pt. II.A.3.

89. See supra notes 65-68 & accompanying text.

90. Drum, Nonbanking Activities of Bank Holding Companies, Econ. Persps., March/April 1977, 12, 16.

mere credit errors, such as the risk that the market price of a parcel of property will fall after its purchase. Nevertheless, bank holding companies are exposed to a certain degree of this "market risk." For example, bank holding companies are permitted to underwrite and deal in government securities and, under the Edge Act, may underwrite foreign securities.

Methods exist for limiting the risk of a proposed activity. The most effective device would be a Board-imposed limitation on the percentage of assets that a bank holding company could commit to all nonbank activities, to a certain nonbank activity or to both. This would prevent a bank holding company from committing too much of its resources to any particular venture. Asset limitations could be combined with higher minimum capital requirements for either the bank holding company or its bank subsidiary. In addition, the holding company structure itself

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92. Symons, supra note 9, at 717.
96. Asset limitations have been incorporated into federal and state banking law. See, e.g., 12 U.S.C. § 1464(c)(4)(B) (1982) (three percent cap on investments in savings and loan service corporations); id. §1843(c)(6) (five percent cap placed on bank holding company investment in the shares of any company); Can Fed-FDIC Real Estate Conflict Be Avoided?, 4 Banking Expansion Rep. 3-4 (Feb. 4, 1985) (newly-granted real estate investment powers of state-chartered banking institutions have limitations ranging from five percent of assets to one hundred percent of shareholders' equity).

In the securities field, putting aside Glass-Steagall problems, limitations might also be set on the amount of capital that may be placed at risk in the underwriting of any one issue of a particular security. Bank Underwriting, supra note 20, at 735. Bank holding companies could also be permitted to underwrite only high quality issues, Bank Underwriting, supra note 20, at 734; see also 12 C.F.R. § 337.4 (1985) (underwriting of investment quality debt or equity securities by securities subsidiaries of certain insured state banks), such as high-grade municipal bonds and mortgage-backed securities, see S.2181, 98th Cong., 1st Sess. § 203(e)(3) (1984), reprinted in 1984 Hearings, supra note 1, at 22-26.

The structure of the fee system used by bank holding company subsidiaries can also be altered to limit risk. Fees paid to the realty advisory subsidiaries of bank holding companies were originally based on the income and asset size of the real estate investment trust being advised. See A. Keeffe & M. Head, What is Wrong With the American Banking System and What to Do About It, 36 Md. L. Rev. 788, 809 (1977). This tempted the advisor to recommend a rapid growth strategy which focused more on profits than on safety. Id. The Board no longer allows fees to be based on the profits derived from the underlying activity. See BankAmerica Corp., 68 Fed. Res. Bull. 647, 649 (1982).

97. Capital includes, inter alia, common stock, perpetual preferred stock, surplus and undivided profits. 12 C.F.R. § 225.43 app. A (1985). Capital requirements create a cushion for creditors in case the institution fails. See K. Cooper & D. Fraser, supra note 2, at 180-81 & n.32; see also Drum, supra note 90, at 17 (evidence exists indicating under-
can be used to facilitate the enforcement of regulations designed to prevent fraud and other abuses.\textsuperscript{98} The activities of the nonbank business can be confined to a separate subsidiary of the bank holding company.\textsuperscript{99}

\textsuperscript{98} The goal of bank safety and soundness and the desire for fair competition suggest that nonbank subsidiaries be subjected to the same, if not greater, regulation against fraud and other abuses than nonaffiliated companies in the same field. See Mutual Fund Underwriting by Banks: A Panel Discussion, 2 Ann. Rev. Banking L. 81, 108-09 (remarks of David Silver, President, Investment Co. Inst.); Bank Underwriting, supra note 20, at 731 & n.78. The investment activities of banks are currently exempt from major provisions of the securities laws. Id.

\textsuperscript{99} Bank Underwriting, supra note 20, at 735-36. The Federal Deposit Insurance Corporation has promulgated rules for ensuring the separateness of a bank from a securities affiliate. 12 C.F.R. § 337.4(2) (1985). The following are listed as the characteristics of separation:

\begin{itemize}
\item [(A)] "[b]ona fide subsidiary" . . . (i) is adequately capitalized; (ii) is physically separate and distinct in its operations from the operation of the bank; (iii) does not share a common name or logo with the bank; (iv) maintains separate accounting and other corporate records; (v) observes separate formalities such as separate board of directors' meetings; (vi) maintains separate employees who are compensated by the subsidiary; (vii) shares no common officers with the bank; (viii) a majority of its board of directors is composed of persons who are neither directors nor officers of the bank; and (ix) conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the Federal Deposit Insurance Corp., and are not guaranteed by the bank nor are otherwise obligations of the bank.
\end{itemize}

\textit{Id.} at 46,723 (footnotes omitted). These rules try to enforce the separateness of subsidiaries in the minds of the public, so that should the nonbank affiliate perform poorly, public confidence in the bank will not be impaired. Product Expansion, supra note 4, at 19; see also Chase & Mingo, The Regulation of Bank Holding Companies, 30 J. Fin. 281, 290 (1975) (arguing that banks are often "closely associated with their parent companies and nonbank affiliates").

If a bank holding company respects the separate identity of its nonbank subsidiary, a court would be unlikely to "pierce the corporate veil" and hold the parent company responsible for the debts of the subsidiary upon the failure of the latter. See P. Heller, supra note 35, at 163 & n.17; Product Expansion, supra note 4, at 16-17; see also Chase, The Bank Holding Company as a Device for Sheltering Banks from Risk, in Proceedings of a Conference on Bank Structure and Competition 38, 45 (Fed. Res. Bank of Chicago 1971) ("under present law, requiring some or all 'expanded' activities of banks to be performed by holding companies rather than by banks per se would tend to insulate [to a certain extent] the resources of banks from risks entailed in expanded activities.") [hereinafter cited as Chase II]. Although a bank holding company could avoid a legal obligation, it might accept a moral obligation to assume the debts of its failed subsidiary. P. Heller, supra note 35, at 164; see Eisenbeis, supra note 34, at 147. In the 1970's, several large bank holding companies sought to aid their poorly performing real estate investment trusts with bank loans, and thus protect the holding companies' reputations. A. Keeffe & M. Head, supra note 96, at 808-11. "[T]he banks' efforts to save face in the [real
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Moreover, diversification of bank holding companies may reduce risk to the overall organization by reducing dependence on one activity and by stabilizing the flow of earnings.\(^{100}\) If bank holding companies engage in nonbanking businesses whose return on equity is inversely or weakly correlated with that of banking, these nonbanking activities might be able to pick up the slack and stabilize the earnings of the parent company when the banking business sours.\(^{101}\)

The public benefits component of section 4(c)(8) explicitly recognizes the importance of risk limitation.\(^{102}\) The "closely related" determination also functions in part to guard against risk: If the proposed activity is similar to current or past operations, the bank holding company presumably possesses a certain amount of managerial and technical expertise.\(^{103}\) Any revision of section 4(c)(8) that replaces the current standards should thus allow the Board to examine, as part of its risk inquiry, the applicant’s managerial and technical resources.\(^{104}\)

Risk has thus far been discussed from the point of view of the public. Bank holding companies, however, view the failure to deregulate as a

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\(^{100}\) Id. at 811. Nevertheless, “externally imposed restrictions on the use of banking resources to meet claims on affiliated corporations” could be imposed to buttress the subsidiary organizational form as a risk limiting mechanism. Chase II, supra, at 44.

\(^{101}\) See Edwards & Scott, supra note 20, at 93 (“there is actually good reason to think that, as a diversification constraint, [activity restrictions] make banks more vulnerable to insolvency.”); Rose, supra note 97, at 159 (evidence exists that bank holding company expansion into new activities may both reduce the overall risk exposure of the bank holding company organization and yield diversification benefits); Bank Underwriting, supra note 20, at 720, 729 (diversification can help stabilize bank holding company revenues); see also Heggestad, supra note 20, at 222-23 (same, but admits some uncertainty as to risk prediction).

\(^{102}\) Heggestad, supra note 20, at 222-23; Bank Underwriting, supra note 20, at 729 & n.61. It should be noted, however, that “[o]nce banking is combined with another activity under the same corporate umbrella,” the inverse correlations may be affected. Drum, supra note 90, at 17.

\(^{103}\) “Unsound banking practices” is specifically referred to as an adverse factor in the public benefits test. See supra note 15. The Board may impose a business risk test under the “unsound banking practice” factor. See BankAmerica Corp. v. Board of Gove's. of the Fed. Res. Sys., 491 F.2d 985, 988 (9th Cir. 1974) (leasing arrangements that do not permit a bank holding company to recover its full investment in the property to be leased would subject bank holding company to greater risks than would otherwise be the case).

\(^{104}\) See Real Estate Experts Spot Trouble In Activities of Novice Developers, Wall St. J., Dec. 19, 1984, at 31, col. 5 (“Allowing thrifts to develop property ‘is like saying a dermatologist would be a good neurosurgeon because they both have an M.D.’ ”) (quoting Kenneth Nitzberg, President of Equitec Financial Corp., a California syndicator); see also Thrift Units on Coast Surging, N.Y. Times, Nov. 15, 1984, at D10, col. 4 (“Talent is the major issue, it’s not regulations . . . .”) (quoting Christopher Leinberger, President of the Robert Charles Lesser Co., a consulting concern).

major long term risk. Without deregulation, banks and their holding companies are at a competitive disadvantage compared to other financial institutions. A revision of section 4(c)(8) would allow bank holding companies to engage in a broader range of somewhat riskier business activities. Nevertheless, definite methods of risk limitation do exist and diversification itself can reduce the risk of dependence on one activity.

2. Conflicts of Interest

The structure of bank holding companies presents the danger of serious conflicts of interest that threaten bank soundness and skew the impartial allocation of credit in our economy. Banks might aid their nonbank affiliates with loans, grant credit to preferred customers of its nonbank subsidiaries or deny credit to competitors of its nonbank affiliates. Other problems include access to confidential information by both bank and nonbank officials, pressures on the nonbank affiliate to skew its business decisions in favor of the bank affiliate, the granting of


106. Id.


111. Confidential credit information maintained by the commercial loan department of a bank could be useful in the investment banking activities of the bank’s affiliates. Bank Underwriting, supra note 20, at 729. Confidential information can also flow from the nonbank subsidiary to the bank affiliate. See Security Pac. Corp., 71 Fed. Res. Bull. 118, 121 (1985) (denying acquisition by bank holding company of credit rating portion of investment advisory business because agency could release confidential information obtained during the credit rating process to its affiliated bank).

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excessive bank dividends to finance nonbank growth,113 and self-dealing, which occurs when a party to a transaction has "power to influence the decisions of both bargaining entities but a greater interest in how well one of them fares."114 The Board has prohibited bank holding companies from engaging in certain activities, such as credit rating and general management consulting, because conflicts of interest could result.115

The possibility of conflicts of interest, like bank risk, can be minimized.116 Legislation exists permitting regulation of transactions among affiliates. Section 23A of the Federal Reserve Act,117 for example, limits loans to any single affiliate to ten percent of a bank's equity capital118 and requires loan collateral in excess of one hundred percent of the dollar amount of the loan in certain circumstances.119 One could also simply prohibit all transactions among subsidiaries of a bank holding company, with limited exceptions.120 This would effectively prevent self-dealing. The granting of excessive dividends, which drains capital from the bank subsidiary, could be discouraged by varying the premiums of deposit insurance funds to reflect any increased riskiness121 or by higher capital

113. Clark, supra note 63, at 829-30. Such a practice "leave[s] the intermediary more highly leveraged [with less capital] and thus more risky and less able to support new business." Id. at 830.

114. Id. at 841. A typical situation would be where one subsidiary purchases services or property at inflated prices from other affiliates in the same bank holding company. Id. at 829.


116. See infra notes 117, 118 and accompanying text. In the securities field, where banks may sponsor closed-end investment companies, 12 C.F.R. § 225.25(4)(ii) (1985), section 17(b) of the Investment Company Act, 15 U.S.C. § 80a-17(b) (1982), requires that transactions between such companies and other subsidiaries of the company's adviser be fair to all parties involved. The Board has also relied on conflict of interest regulations promulgated by other agencies. See Citicorp., 68 Fed. Res. Bull. 776, 778 (1982) (rules promulgated by Commodity Futures Trading Commission substantially reduce the possibility for significant conflicts of interest).


118. See id. § 371c(a)(1)(A).

119. See id. § 371c(c)(1)(B)-(D).

120. Clark, supra note 63, at 842-43, 862-63. An exception would be allowed for dividends and capital contributions and where a nonbank affiliate could "clearly demonstrate that the proposed transaction would generate a significant 'self-dealing surplus'—it would be better than a fair, or open-market, transaction—and that the [affiliate] will share significantly in it." Id. at 862-63.

121. Clark, supra note 63, at 847.
The problems of access to confidential information and the granting of credit to preferred customers can be prevented by erecting a "Chinese Wall"—formal written internal procedures designed to sever the flow of sensitive information among the various affiliates of a holding company. A bank holding company is uniquely suited to establishing this barrier because nonbank subsidiaries are physically separate from bank subsidiaries and can be treated as distinct companies. Investment banking firms and bank trust departments both have successfully utilized the Chinese Wall.

The possibility that credit will be denied to competitors has been overemphasized. Banks do make loans to firms, such as finance companies, with which they presently compete. Moreover, in today's competitive environment, banks may not be inclined to turn away customers. Banks, after all, are not the sole providers of credit in our economy.

It is apparent from the above discussion that a liberalized section 4(c)(8) must consider the important policy of avoidance of conflicts of interest. Methods such as the Chinese Wall and the limitations on transactions between affiliates can be employed to prevent the conflicts of interest that might otherwise arise.

3. Antitrust Considerations

The fear of banking power has been ingrained into the American economy. See K. Cooper & D. Fraser, supra note 2, at 180-81, 184 n.32; Edwards & Scott, supra note 20, at 93. This approach may be somewhat costly, however, because "a truly dramatic increase in net worth over past and present levels [may be needed] before there is a significant impact on an [affiliate's] probability of failure." Clark, supra note 63, at 846.

A Chinese Wall can prevent a bank subsidiary from asking for the names of, or other material information about, customers of the nonbank affiliate. Id. In addition, if bank holding companies were allowed to engage in a broader range of securities activities, bank examiners could be required to "compare [a] securities affiliate's buy-and-sell lists and records regarding underwriting customers with the bank's classified loans." Bank Underwriting, supra note 20, at 737.

See Bank Underwriting, supra note 20, at 736. See supra note 99 and accompanying text. But see Security Pac. Corp., 71 Fed. Res. Bull. 118, 121 (1985) ("[T]he Board believes that the conflicts in the relationship between a major lender and a credit rating company are so pervasive they cannot be overcome through the adoption of a 'Chinese wall'.")

See supra note 99.

Herzel & Colling, supra note 123, at 130.

See P. Teplitz, Trends Affecting the U.S. Banking System 67, 86-87 (1976) (tables indicating the sources of funds of other financial institutions); Standard & Poor's Industry Surveys B20 (1985) (table indicating that banks loan money to other financial institutions).

See K. Cooper & D. Fraser, supra note 2, at 198-203.

Product Expansion, supra note 4, at 7; see also K. Cooper & D. Fraser, supra note 2, at 9 (table illustrating the financial services offered by depository and nondepository institutions). Other suppliers include the commercial paper market, commercial finance companies, and insurance companies. Product Expansion, supra note 4, at 7.
Banks have been seen as possessing certain advantages over other businesses—for example, access to low cost funds, the ability to deduct the interest cost of holding municipal bonds, and the potential to "tie" the sale of a bank service to the sale of a nonbank service. In a business climate characterized by heavy competition, these special attributes may not be as valuable to banks as was once believed. But while the value of these advantages has eroded, the formal barrier of section 4(c)(8) has continued to hamper competition between bank holding companies and other financial service providers.

The need to promote competition in the banking industry was recognized by Congress in the Bank Merger Acts of 1960 and 1966, which extended antitrust concerns to the merger of banks.
Holding Company Act Amendments of 1970 further extended antitrust considerations by applying the public benefits test to the affiliation of banks and nonbanks. Although deficient in certain respects, the public benefits test has merit because it recognizes the desirability of competition. Indeed, the most potent argument that can be advanced in favor of expanded investment powers is that such powers would enhance competition between bank holding companies and nonbank financial institutions. It would be rather anomalous, therefore, for section 4(c)(8) to be devoid of any competitive standard.

The desire to promote competition in the financial services industry justifies a regulatory approach requiring an applicant bank holding company to demonstrate that its conduct of a proposed activity will not result in decreased or unfair competition in the financial services marketplace. Such an approach would reduce the need for any reference to "undue concentration of resources," because an increase in concentration often results in a decrease in either present or potential competition.

B. A "Reasonably Related" Test

One alternative for a revised section 4(c)(8) consistent with the major bank policies analyzed above might be formulated as follows:

Bank holding companies may engage in those activities determined by the Board to be reasonably related to banking provided the Board finds that the conduct of such activities would be unlikely to result in decreased or unfair competition. In determining what is reasonably related to banking, the Board shall consider whether the proposed

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140. See K. Cooper & D. Fraser, supra note 2, at 197 (nondepository institutions are largely free of activity restraints while depository institutions are not); Edwards & Scott, supra note 20, at 93 (activity restrictions diminish competition in financial markets); Product Expansion, supra note 4, at 50 (unlike other financial organizations, bank holding companies are compelled to "pick their way through the statutory and administrative land-mines set out by Section 4(c)(8)"); see also 1984 Hearings, supra note 1, at 422-23 (testimony of the Consumer Bankers Ass'n) (banks eager to offer full range of mutual fund and other services).
141. See Chase Manhattan Corp., 60 Fed. Res. Bull. 142, 144 (1974) (bank holding company's acquisition of nonbank firm would cause increase in concentration of resources and elimination of potential competition); U.S. Bancorp, 58 Fed. Res. Bull. 177, 178 (1972) (bank holding company's acquisition of nonbank firm would cause increase in concentration of resources and elimination of potential competition); BTNB Corp., 58 Fed. Res. Bull. 70, 71 (1972) (same). "[I]n the absence of market effects, there are no obvious or accepted reference points for judging asset concentration mergers. To deal with them, one must be prepared to formulate a host of specific and entirely arbitrary rules that are not grounded in theoretical or empirical understanding, either economic or, for that matter, political." 5 P. Areeda & D. Turner, supra note 77, ¶ 1143f, at 253 (1980); see also Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 53 n.21 (1977) ("[A]n antitrust policy divorced from market considerations would lack any objective benchmarks.").
activity (1) is financial in nature, (2) presents a substantial risk of loss of assets to the bank holding company or any of its subsidiaries, and (3) may result in serious conflicts of interest. The Board may in its discretion impose asset limitations or other control devices to achieve the goals of this section.

Under this scheme, the applicant bank holding company is freed from the burden of trying to pigeonhole a proposed activity into some bank function or operation. The focus is shifted to the activity itself to see if it presents conflicts of interest or substantial risk to bank assets. The methods described earlier may be utilized under the new test to ensure bank soundness and limit the potential for conflicts of interest. The limitation to financial activities is desirable because it defers to the public policy objective of limiting bank power, and it is in the financial area that bank holding companies would be able to provide the greatest public benefits. Thus, bank holding companies will truly be viewed as financial institutions in a broad sense of the term and not merely as banks hiding under a shell.

The new analysis retains flexibility by discarding the specific activity limits of Title VI of the Garn-St. Germain Act, which were imposed as a result of lobbying by the insurance industry. Likewise, certain activities that have been determined by the Board to have failed the "closely related" test, such as home loan and group mortgage life insurance underwriting, could now be added to the list of permissible activities.

Competitive concerns are retained because, as has already been dis-

142. See supra Pts. II.A.1 & 2.
143. Attempts have been and are being made to incorporate a financial activity standard of one variety or another into section 4(c)(8). See H.R. 15, 99th Cong., 1st Sess. § 203(a) (1985) (permitting activities of a financial nature designed to enable bank holding companies to adjust to technological innovations in the provision of banking services or which are substantially identical to products or services offered by nonbanking concerns that are competitive with bank services); S.1609, 98th Cong., 1st Sess. § 10 (1983) (permitting activities of a financial nature, including insurance underwriting and brokerage, real estate development and brokerage, and certain securities activities), reprinted in Moratorium Legislation and Financial Institutions Deregulation: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 1st Sess. 7, 9 (1983).
144. Product Expansion, supra note 4, at 28. See supra Pt. II.A.3. The limitation to financial activities, combined with the requirement of increased competition, would prevent the growth in this country of zaibatsu, the huge banking/commercial concerns of Japan that monopolistically control certain aspects of Japan's economy. Note, Regulating the One-Bank Holding Companies—Precluding Zaibatsu?, 46 St. John's L. Rev. 320, 320-21 (1971). Mitsubishi, the largest zaibatsu in 1970, was equivalent in size to a combination of Sears & Roebuck, American Export Lines, First National City Bank, and Prudential Life Insurance Company. Id. at 321.
145. Product Expansion, supra note 4, at 29 ("These are, after all, activities with which bankers are most familiar and the ones for which they should possess the greatest comparative advantage.").
146. See Product Expansion, supra note 4, at 43.
147. See supra notes 15, 62 and accompanying text.
148. See supra note 61 and accompanying text.
cussed, the new banking climate is characterized by competition. The proposed elimination of most of the public benefits test might seem to be too liberal a standard, but it actually presents a stricter test for bank holding companies: The proposed section 4(c)(8) will not tolerate anticompetitive effects, while the present standard dilutes competitive concerns with other factors. Hence, the proposed scheme is better tailored to address the major concern of bank expansion today: competition.

In order to retain flexibility in the application of the statute and to defer to the expertise of the Board, the proposed statutory language does not define the phrase "financial activity." Activities furthering a bank's historic role as a credit provider and deposit taker would certainly qualify. Fiduciary and insurance activities included in the original section 4(c)(8) language would also be within the intended scope of financial activities. Any activity involving a financial agency or intermediary relationship, such as securities and insurance underwriting, could qualify as a financial activity. Ultimately, the Board will determine the meaning of the phrase. In 1857, the New York Court of Appeals dealt with a similar problem and one judge aptly stated that "[n]o human sagacity can foresee what implied powers may, in the progress of time, . . . be required to give effect to the express powers. They are, therefore, left to implication."

150. See supra notes 1, 4, 8 and accompanying text. The "decreased competition" factor employed here would allow the Board to continue to evaluate anticompetitive effects, "even if [they] do not reach the level of an antitrust violation." P. Heller, supra note 35, at 263. See supra note 35 and accompanying text.

151. Clark, supra note 63, at 836-37.
152. Symons, supra note 9, at 680-82, 724-25.
153. See supra note 43 and accompanying text.
155. See H. Hutchinson, supra note 10, at 24-26; Symons, supra note 9, at 724-25.
156. See Symons, supra note 9, at 724-25.
157. Cf. Product Expansion, supra note 4, at 47-48 ("insurance activities in all of its forms [and] investment banking activities in all of its forms" are financial activities). The proposed scheme, however, would still be subject to the Glass-Steagall Act's prohibition on affiliations between banks and securities firms, 12 U.S.C. § 377 (1982), until such prohibition is modified or removed.
CONCLUSION

Confronted with competitive pressures resulting from changing economic and technological conditions, bank holding companies must deal with a regulatory system out of touch with these modern trends. Despite significant liberalization, section 4(c)(8) still focuses on the traditional operations of banks in determining what they may do in the future, and it lists factors that are unclear. A “reasonably related” analysis focusing on the traditional regulatory policies of bank safety and soundness and avoidance of conflicts of interest, combined with the proposed competitive criterion, would eliminate the rigidity of the present section 4(c)(8) while maintaining control over the expansion of bank holding companies. It would allow bank holding companies to meet competitive challenges and to diversify, thus remaining important economic institutions in our society.

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