THE EXPANSION OF STATE BANK POWERS,
THE FEDERAL RESPONSE, AND THE CASE
FOR PRESERVING THE DUAL
BANKING SYSTEM

ARTHUR E. WILMARTH, JR.*

Introduction ................................................... 1135
I. The Transformation of the Competitive Environment for
the Banking Industry ........................................... 1139
   A. Traditional Regulation of the Banking Industry ........ 1139
   B. Changes in the Financial Marketplace Since 1975 and
      the Growth of Nonbank Competitors .................. 1141
   C. The Removal of Barriers to Bank Expansion and
      Increased Competition from Foreign Banks .......... 1144
   D. The Decline in Bank Profitability and the Increase in
      Bank Failures ....................................... 1147
   E. The Debate Over Expanded Bank Powers .............. 1149

II. The Dual Banking System and Legislative Actions of
Congress and the States with Respect to New Bank
Powers ........................................................ 1152
   A. Federal and State Regulation of Banks Under the Dual
      Banking System ...................................... 1153
      1. Historical Background of the Dual Banking
         System ........................................... 1153
      2. The Dual Banking System's Record of Innovation . 1155
      3. The Current Regulatory Structure .................. 1159
   B. Federal Restrictions on Banking Powers ............ 1161
      1. Federal Restrictions on Bank Involvement in
         Securities Underwriting ........................ 1161
      2. Federal Restrictions on Bank Involvement in
         Insurance Activities ............................. 1166
      3. Federal Constraints on Bank Involvement in Real
         Estate Investment or Development ............... 1169
   C. The Failure of Congress to Expand Banking Powers .... 1171
   D. State Initiatives to Expand State Bank Powers ...... 1177

* Associate Professor of Law, George Washington University National Law
  Center. B.A. 1972, Yale University; J.D. 1975, Harvard University. The author wishes
to thank the National Law Center, Dean Jack Friedenthal and former Dean Jerome Barron for
summer research grants that assisted him in preparing this Article. The author also wishes to
thank Jim Bell, Barkley Clark, Tamar Frankel, Helen Garten, Kenneth Scott, Andy Spanogle
and Luize Zubrow for their helpful comments, and Brian Ashe for his able research assistance,
on a preliminary draft of this Article.

This Article includes developments through June 15, 1990.
III. The Response of the Federal Agencies and Congress to the Expansion of State Bank Powers 1181
   A. The Responses of the FRB and the FDIC to the Expansion of State Bank Powers 1181
      1. The Response of the FRB 1181
      2. The Response of the FDIC 1184
   B. The Response of Congress to Expanded State Bank Powers 1185

IV. The Limited Authority of the Federal Reserve Board and the FDIC to Restrict the Powers of State Banks 1189
   A. Standards for Reviewing Claims of Statutory Authority By the FRB and the FDIC 1189
   B. Limitations on the Authority of the FRB and the FDIC to Regulate the Activities of State Banks 1191
      1. The FRB’s Authority to Place Conditions on the Entry of State Banks into the Federal Reserve System 1191
      2. The FDIC’s Authority to Review the Powers of State Nonmember Banks Applying for Deposit Insurance 1195
      3. The FDIC’s Authority to Terminate Deposit Insurance and to Issue Regulations to Protect the Deposit Insurance Fund 1196
      4. The Authority of the FRB and the FDIC to Require State Banks to Terminate Unsafe or Unsound Activities 1200
         a. Statutory Provisions of Section 8(b) of the FDI Act 1200
         b. Judicial Interpretations of Section 8(b) 1204
         c. Legislative History of Section 8(b) 1207
      5. The FRB’s Authority to Regulate Bank Transactions with Affiliates 1209
      6. The Authority of the FRB and the FDIC to Adopt Capital Adequacy Requirements 1211
   C. The Absence of Authority under the BHC Act for FRB Regulation of the Activities of Holding Company-Owned State Banks and Their Operations Subsidiaries 1213
      1. The Statutory Provisions 1214
         a. Section 3 of the BHC Act 1214
         b. Section 4 of the BHC Act 1217
            i. Application of Section 4(a) to Holding Company-Owned Banks 1218
            ii. Application of Section 4(a) to Operations Subsidiaries of Holding Company-Owned Banks 1219
      2. The Legislative History of the BHC Act 1227
INTRODUCTION

The banking industry in the United States presently confronts its greatest challenge since the Depression. This Article describes the factors that have combined to erode the profitability and long-term viability of the banking industry in its present highly regulated form. The Article considers the restraints currently imposed on bank operations by federal law, and it then examines the initiatives taken by a number of states to expand the powers of state banks. In light of the present economic vulnerability of the banking industry and the ongoing debate concerning the ability of banks to use expanded powers safely, this Article argues that state experimentation with broader bank powers can provide a critically needed testing ground for the industry. An experimental role for the states with regard to the desirability and safety of new bank powers would be consistent with the history of our nation's dual banking system. Under that system, the federal and state regulatory components have each played a creative role in helping the banking industry to adapt to changing competitive conditions.

As explained in Part I of this Article, the banking industry's current predicament is the result of several related developments in the financial markets that have increased competitive pressures on banks and reduced their profit-making opportunities. First, between 1980 and 1986, the federal government removed its regulatory controls over the interest rates paid on bank deposits. These federal controls were lifted in response to the high inflation and volatile market interest rates of the late 1970s and early 1980s, which made it extremely difficult for banks to attract low-interest deposits from the public. The removal of these federal controls enabled banks once again to compete effectively for deposits, but banks can no longer obtain deposits at low cost.¹

Second, rapid technological advances over the past two decades in data

¹ For a discussion of the former federal controls on deposit interest rates and the impact of their removal, see infra notes 15 & 28-34 and accompanying text.
processing and telecommunications have deprived banks of their formerly preeminent position as expert lenders. Banks previously served as the leading source of commercial and consumer credit, based on their unparalleled ability to collect and analyze information about the creditworthiness of individuals and businesses. However, since 1970 the information revolution has greatly reduced the cost of collecting, analyzing and disseminating financial data. This cost reduction in information management has enabled nonbanking firms in the securities, insurance, commercial finance and consumer credit industries to compete successfully with banks in providing funds to the public and the business community.

Third, the increasingly national and international scope of the financial markets has led to the expansion of domestic banking organizations and the entry into the United States of many foreign banking interests. The past decade has witnessed hundreds of interstate acquisitions of banks by bank holding companies, as well as a tripling of foreign-owned banking offices in the United States. This unprecedented expansion of banking institutions in the domestic markets as well as overseas has greatly increased the competitive pressures on individual banks.

The foregoing developments have seriously eroded the profits that banks once enjoyed in the United States under the traditional structure of bank regulation. As a consequence of this declining profitability, nearly six hundred banks failed during the three-year period ending on December 31, 1989. Indeed it appears that the traditional regulatory structure, with its careful separation of banking from nonbanking activities and its geographic segmentation of banking markets, may no longer be viable in light of current competitive realities.

In light of the current vulnerability of the banking industry, many observers have called for an expansion of banking powers in order to pro-

---

2. For a discussion of the impact of technological advances and nonbank competition on the financial services industry, see infra notes 23-27 and accompanying text.
3. For a description of the effects of domestic bank expansion and foreign bank entry during the 1970s and 1980s, see infra notes 35-52 and accompanying text.
4. For a discussion of the decline in bank profitability and the increasing rate of bank failures in recent years, see infra notes 53-61 and accompanying text.
5. For a discussion of the apparent inadequacy of the traditional bank regulatory structure, see infra notes 12-22, 32-34 & 62-63 and accompanying text. Professor Helen Garten has suggested that federal banking regulators have already largely abandoned their traditional approaches to bank regulation and are experimenting with new regulatory approaches that would be appropriate for nationwide banking enterprises engaged in a wide variety of banking and nonbanking activities. See Garten, Regulatory Growing Pains: A Perspective on Bank Regulation in A Deregulatory Age, 57 Fordham L. Rev. 501, 528-41, 545-46 (1989). For recent statements by federal banking regulators indicating that they are adopting new supervisory methods, see State of the Bank and Credit Union Insurance Funds: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs, 101st Cong., 1st Sess. (1989) 160-72 [hereinafter 1989 House Hearings] (testimony of L. William Seidman, Chairman of the FDIC); id. at 179-84, 188 (testimony of Robert L. Clarke, Comptroller of the Currency).
vide banks with new competitive opportunities. Skeptics, however, have questioned whether banks can safely and effectively exercise new powers in nontraditional areas. In addition, as described in Part II of this Article, national banks and bank holding companies are substantially barred under current federal law from engaging in securities underwriting, insurance underwriting and sales, and real estate investment and development. State banks that are members of the Federal Reserve System ("state member banks") are subject to many of these federal constraints on bank powers. However, state banks that are not members of the Federal Reserve System ("state nonmember banks") are largely exempt from these federal limitations.

Under our nation's dual banking system, as described in Part II, Congress has reserved to the states a broad discretion to determine the scope of state bank powers. During the past decade, many states have exercised this discretion by granting to state banks expanded powers in the securities, insurance and real estate areas. These state laws continue a long-established pattern of state regulatory innovation within the dual banking system. Indeed, state initiatives in expanding state bank powers stand in sharp contrast to the inability of Congress since 1982 to act on numerous proposals to authorize new banking activities.

Part III of this Article discusses the responses of the Federal Deposit Insurance Corporation ("FDIC") and the Federal Reserve Board ("FRB") to the expansion of state bank powers. The FDIC is the primary federal regulator for FDIC-insured state nonmember banks, and the FRB has similar supervisory authority over state member banks and bank holding companies. While neither agency has yet taken definitive action to prohibit state bank activities in the securities, insurance or real estate areas, both agencies have claimed a general authority to forbid or restrict such activities. In contrast, Congress has taken no action (except for a temporary moratorium in 1987-88) to restrain state bank powers, despite numerous proposals by the FRB and nonbank industry groups for preemptive legislation.

Part IV examines the limits of the statutory authority of the FDIC and the FRB to regulate the activities of state banks. The FDIC and the FRB have authority to impose capital adequacy requirements on state

---

6. For a description of the current debate over the desirability of expanded bank powers, see infra Part I(E).


banks, to regulate transactions between state banks and their affiliates, and to prevent individual state banks from engaging in unsafe or unsound practices. However, Part IV shows that Congress has purposefully withheld from the FRB and the FDIC any general authority to prohibit state banks from engaging in activities authorized by state law. In particular, Part IV(C) demonstrates that the Bank Holding Company Act ("BHC Act")\(^9\) does not authorize the FRB to restrict the state-authorized activities of either state banks owned by bank holding companies or operations subsidiaries of such banks.\(^{10}\)

Part V considers and responds to two major critiques of the dual banking system. The first and more traditional criticism is that the dual banking system leads to a dangerous "competition in laxity" between state bank supervisors and the Office of the Comptroller of the Currency ("OCC"), which regulates national banks. Part V(A) demonstrates, however, that over the past several years the average capital ratios and earnings of state banks have been consistently higher than those of national banks. Moreover, to date no significant safety or soundness problems have resulted from the exercise by state banks of expanded securities, insurance or real estate powers. In this regard, the misuse of liberal state powers by state-chartered thrifts in certain states (especially California and Texas) during the 1980s is not comparable to the successful experience thus far with expanded state bank powers, evidently because state banks have been subject to more stringent federal and state regulation than that applied to thrifts. Thus, the "competition in laxity" argument does not find substantial support in the empirical evidence with regard to state banks.

Recently, Professors Henry Butler and Jonathan Macey have articulated a second critique of the dual banking system—namely, that the system creates only a "myth" of competition between state and federal regulators of banks.\(^{11}\) Professors Butler and Macey argue that state and federal regulators have actually collaborated to perpetuate an uncompetitive industry cartel. As shown in Part V(B), Butler and Macey have minimized the extent of state innovation and exaggerated the degree of federal preemption within the dual banking system. In addition, they have overlooked evidence of a longstanding rivalry between state bank supervisors and the OCC that has resulted in significant regulatory improvements. Moreover, the most workable proposal made by Butler and

---


10. A bank that is owned by a bank holding company will generally be referred to herein as a "holding company-owned bank." An "operations subsidiary" is a subsidiary of a bank that engages in activities authorized for its parent bank at locations permitted to its parent bank. See, e.g., 12 C.F.R. § 250.141(b)-(d) & (i) (1989) (authorizing establishment of operations subsidiaries by state member banks).

Macey calls for a complete federal preemption of state banking laws that would result in an uncompetitive federal monopoly of regulation.

In sum, this Article contends that the dual banking system has fostered a substantial degree of supervisory innovation within the banking industry. The recent state initiatives in expanding state bank powers should not be preempted by Congress in the absence of substantial evidence indicating that the new powers pose a serious threat to the federal deposit insurance fund. Indeed, because there is, at present, considerable uncertainty regarding the proper scope of banking powers, state initiatives should provide useful practical experiments that will be of substantial assistance in fashioning a new federal approach to banking regulation.

I. THE TRANSFORMATION OF THE COMPETITIVE ENVIRONMENT FOR THE BANKING INDUSTRY

Since the mid-1970s, the banking industry in this country has experienced a series of radical and wrenching changes. The most important of these changes have been (i) rapid advances in communications and computer technology, which have enabled nonbank financial companies to offer services that compete directly with those provided by banks, (ii) a substantial rise in the interest rates paid on deposits, due to the removal of federal controls on interest rates and inflationary pressures during the late 1970s and early 1980s, (iii) a significant liberalization of state laws with respect to interstate acquisitions of banks by bank holding companies, and (iv) a sharp increase in competition from foreign banks. In combination, these developments have undermined the stability and profitability that the banking industry enjoyed prior to 1975. In response to these developments, an increasing number of commentators and bank regulators have called for an expansion of bank powers in order to restore the competitive viability of banks. However, some other observers have questioned whether banks have the financial and managerial resources to exercise such powers safely.

A. Traditional Regulation of the Banking Industry

Before the mid-1970s, the domestic banking industry was significantly insulated by federal regulation from both external and internal competition. For example, federal law generally separated commercial banking from securities underwriting and dealing, prohibited bank holding companies from engaging in unrelated nonbanking activities, and barred banking organizations from establishing banking offices across

12. For a description of the separation of commercial banking from securities underwriting and dealing under the Glass-Steagall Act, see infra notes 122-42 and accompanying text.

13. For a discussion of the restrictions placed on the nonbanking activities of bank holding companies under Section 4 of the BHC Act, see infra notes 443-47 and accompanying text.
state lines. In addition, commercial banks, like thrift institutions, were able to collect low-cost deposits due to the combined effect of federal deposit insurance and federal controls that restricted the interest rates paid on deposits. Banks used these deposits, in accordance with their traditional role as financial intermediaries, primarily to make commercial loans to businesses and consumer loans to individuals. For example, in 1972 commercial banks originated eighty-two percent of the short and intermediate-term credit provided to domestic nonfinancial corporations, and in 1977 banks made sixty percent of all domestic automobile loans.

The federal banking laws that separated banking from commerce and restricted the geographic expansion of banking organizations did not have the articulated purpose of protecting the banking industry from external and internal competition. Instead, these laws had the dual objec-

---

14. The McFadden Act of 1927 ch. 191, § 7, 44 Stat. 1228 (1927) (codified as amended at 12 U.S.C. § 36 (1988)), prohibits a national bank from establishing branches across state lines and allows a national bank to open branches within its home state only to the extent that competing state banks are expressly authorized to branch by state statutory law. The McFadden Act's restrictions on branching are applicable to state member banks under 12 U.S.C. § 321 (1988). Section 3(d) of the BHC Act, 12 U.S.C. § 1842(d) (1988), popularly known as the "Douglas Amendment," prohibits a bank holding company from acquiring a bank outside of the state in which the holding company's principal operations are located, unless such an acquisition is specifically authorized by the statutory law of the acquired bank's home state.


16. Banks are said to be financial "intermediaries" because they collect large pools of liquid funds in the form of deposits and lend out those funds based upon their assessment of borrowers' creditworthiness. Thus, banks are able to satisfy both the desire of individual depositors to invest in short-term, liquid obligations and the need of borrowers to obtain longer-term, less liquid credit. Because banks act as secure depositories and centralize the process of assessing credit risk and extending loans, they perform a valuable and cost-efficient service in acting as specialized intermediaries between depositors and borrowers. However, banks remain chronically vulnerable to the inherent mismatch between their more liquid, shorter-term deposit liabilities and their less liquid, longer-term loan assets. One of the primary purposes of federal deposit insurance has been to provide greater stability to the banking system, and to discourage depositor runs on banks, by assuring depositors that their insured deposits will be paid notwithstanding a liquidity crisis involving one or more banks. See R. Litan, supra note 15, at 8-12; Fischel, Rosenfield & Stillman, The Regulation of Banks and Bank Holding Companies, 73 Va. L. Rev. 301, 306-13 (1987).


---
tive of maintaining a decentralized banking industry, in order to prevent a concentration of financial power in a few banking organizations, and of ensuring that businesses could obtain credit from banks in an environment free from bank conflicts of interest. Nevertheless, the practical result of these legal restraints was to create a "government-enforced cartel in banking" that stabilized the banking system by providing both "segmented markets" and "explicit government protection against market competition" from nonbanking firms.

As Professor Helen Garten has pointed out, the traditional approach to bank regulation was successful for many years in enabling banks to earn high profits and avoid undue risks. Indeed, it was the profitability of the traditional banking business that induced nonbanking companies to look for ways to compete with banks by offering substitutes for bank deposits and loans.

B. Changes in the Financial Marketplace Since 1975 and the Growth of Nonbank Competitors

A combination of factors has undermined the economic viability of the regulated banking system during the past decade and a half. Two particularly important factors have been (i) the development of low-cost information technology, which currently enables many nonbank financial businesses to compete directly with banks in providing financial services, and (ii) high and volatile interest rates, which now require banks to pay...
market interest rates on deposits in order to avoid losing funds to deposit substitutes offered by nonbank competitors.

The revolutions in data processing and telecommunications have deprived banks of their preeminent status as expert intermediaries for the collection, processing, and analysis of information relating to extensions of credit. The costs for data recording, processing and transmission have fallen by more than ninety-five percent since 1964. This cost reduction has enabled many nonbanking entities, including securities firms, insurance companies, commercial finance companies, and consumer loan firms, to compete with banks in providing credit to businesses and consumers. For example, securities firms have used the new technology to provide funding to businesses through the issuance of securities (such as, corporate commercial paper and asset-backed securities), thereby replacing their customers' need for more expensive bank loans.23

These developments have had a significant adverse impact on bank lending. The percentage of domestic short-term and intermediate-term commercial credit provided by banks declined from eighty-two percent in 1972 to only forty-nine percent in 1989.24 This decline in the percentage of commercial credit provided by bank loans has been mirrored by a substantial increase in the amount of commercial credit provided through the issuance of securities. For example, between 1975 and 1985 the amount of outstanding commercial paper increased at a rate almost four times as fast as the growth in bank commercial loans. Similarly, from 1979 to 1985 the volume of securities other than commercial paper grew at a rate more than four times as fast as the increase in bank commercial loans.25

23. The foregoing paragraph is based on the following sources: R. Litan, supra note 15, at 1-2, 9-10, 33, 41; Mandate for Change, supra note 17, at 5-10, reprinted in 1987 House Hearings, supra note 17, at 146-51; S. Rep. No. 305, 100th Cong., 2d Sess. 10-11 (1988); id. at 117-18 (additional views of Senators Dixon, Sanford and Garn); see also Garten, supra note 5, at 523 & n.107 (explaining that commercial paper consists of short-term unsecured promissory notes issued by corporations in the public debt markets without the necessity of registration under the federal securities laws); Boemio & Edwards, Asset Securitization: A Supervisory Perspective, 75 Fed. Res. Bull. 659, 660 (1989) (explaining that asset-backed securities are securities representing interests in a pool of bank loans of a particular type, such as home mortgages or consumer debt).


In addition to losing market share in the area of commercial lending, banks have experienced an overall decline in their percentage share of total consumer loans. For example, the portion of automobile loans held by banks declined from sixty percent in 1977 to forty-one percent in 1986, as automobile manufacturers greatly expanded the operations of their consumer finance subsidiaries. Banks are likely to suffer a further loss in their market share of consumer loans as the trend toward securitization of consumer-related debt continues. For example, the total annual issuances of securities backed by loans other than mortgages increased from about $1 billion in 1985 to more than $16 billion in 1988.

At the same time that nonbank competitors were aggressively entering the commercial and consumer credit markets, high and volatile interest rates impaired the ability of banks to retain low-cost deposits. Inflationary pressures increased steadily during the 1970s. In response to these pressures, the FRB determined in October 1979 to abandon its efforts to control interest rates, and instead sought to control the money supply in order to reduce inflation. The short-term result of the FRB's new monetary policy was high and volatile interest rates. Banks and especially thrift institutions suffered disintermediation as their customers withdrew funds from deposit accounts controlled by Regulation Q and instead placed their funds in money market mutual funds ("MMMFs") offered by securities firms, which were not subject to Regulation Q. The total assets of MMMFs increased from $3 billion in 1977 to $233 billion in 1982.

Faced with this critical situation, Congress in 1980 mandated the phasing out of federal interest rate controls, a process that was completed in 1986. In addition, Congress in 1982 authorized banks and thrifts to offer money market deposit accounts ("MMDAs") in order to compete with MMMFs. These actions enabled banks and thrifts to compete for mortgage-backed securities and high-yield (or "junk") bonds increased from comparatively small amounts in the mid-1970s to $810 billion and $130 billion, respectively, by the end of 1988).

26. See Mandate for Change, supra note 17, at 7, 9, reprinted in 1987 House Banking Hearings, supra note 17, at 148, 150.

27. See Mandate for Change, supra note 17, at 9-10, reprinted in 1987 House Banking Hearings, supra note 17, at 150-51; Boemio & Edwards, supra note 23, at 660.


deposits, but the traditional ability of banks and thrifts to obtain low-cost deposits was largely ended.\textsuperscript{31}

In practical effect, the actions of Congress abolishing Regulation Q and authorizing MMDAs deregulated the liability side of the balance sheet for banks.\textsuperscript{32} However, Congress has \textit{failed} to deregulate the asset side of the balance sheet by expanding the powers of banks.\textsuperscript{33} In part because of this inconsistent approach to deregulation, there has been a marked decline in the profitability and soundness of banks.\textsuperscript{34}

\textbf{C. The Removal of Barriers to Bank Expansion and Increased Competition from Foreign Banks}

Additional competitive pressures on banks have resulted from the relaxation of geographic restraints on the expansion of domestic banking organizations and the increased presence of foreign banks in the American market. Federal and state laws generally prohibit both national and state banks from branching across state lines.\textsuperscript{35} However, in the 1970s and 1980s, twenty-eight states reduced their restrictions on intrastate branching, with the result that thirty-five states now permit statewide expansion of banks through branching or merger. In addition, most of the remaining states permit statewide expansion through the creation of multibank holding companies.\textsuperscript{36}

Even more significant than the relaxation of intrastate restrictions has been the movement toward interstate banking. As stated above, the Douglas Amendment establishes a general federal prohibition against interstate acquisitions of banks by bank holding companies but permits the states to lift this barrier.\textsuperscript{37} Beginning with Maine in 1975 and continuing


\textsuperscript{31} By 1985, MMDAs totalled $500 billion while MMMFs, after decreasing to $181 billion by the end of 1983, had grown back to $250 billion. \textit{See} R. Litan, \textit{supra} note 15, at 35. As of October 1989, MMMFs had grown to about $400 billion, while banks MMMDA's amounted to $473 billion. The relative closeness of these figures indicates that MMMFs continue to exert significant competitive pressure on deposit-taking activities by banks. \textit{See} Aguilar, \textit{Still Toe-to-Toe: Banks and Nonbanks at the End of the ‘80s}, Econ. Perspectives, Fed. Res. Bank of Chicago, Jan./Feb. 1990, at 12, 14.


\textsuperscript{33} \textit{See infra} Part II(C).

\textsuperscript{34} \textit{See infra} Part I(D).

\textsuperscript{35} For a discussion of the prohibition against interstate branching by national banks and state member banks under the McFadden Act, see \textit{supra} note 14. \textit{Cf.} Miller, \textit{Interstate Branching and the Constitution}, 41 Bus. Law. 337, 345 (1986) (describing state laws preventing state banks from branching across state lines, but suggesting that state prohibitions on interstate branching by state \textit{nonmember} banks may be unconstitutional under the dormant commerce clause).


\textsuperscript{37} For further explanation of terms of the Douglas Amendment, see \textit{supra} note 14.
with forty-five other states and the District of Columbia since 1981, state legislatures have enacted laws permitting, at least to some degree, the acquisition of local banks by out-of-state bank holding companies.\footnote{38}

The most common of these state laws are nationwide entry statutes and regional reciprocity laws. As of March 1990, twenty-four states permitted their local banks, under specified conditions, to be acquired by bank holding companies located in any other state.\footnote{39} In addition, as of that date, twenty-two other states and the District of Columbia had in force regional reciprocity laws that allow bank holding companies located within a specified region to acquire local banks if the home state of the acquiring bank holding company grants reciprocal privilege to bank holding companies headquartered in the acquired bank's state. Six of these regional reciprocal state laws will drop their regional limitation, and permit nationwide entry, on or before July 1, 1992.\footnote{40}

The liberalization of state laws governing bank structure has unleashed a wave of bank mergers and acquisitions, including more than 400 interstate acquisitions of banks between 1982 and 1988.\footnote{41} The impact of this trend toward greater consolidation in the banking industry has been significant. Although the number of banks has declined only slightly (a four percent decrease from 14,399 in 1976 to 13,753 in 1987), the number of separate banking organizations has declined substantially (a seventeen percent drop from 12,404 in 1976 to 10,279 in 1987).\footnote{42} In addition, the number of banks controlled by multibank holding companies approximately doubled between 1976 and 1987 (from 2,296 to 4,465), and the percentage of total banking assets held by such companies also doubled.
The greatest increase in size during the 1980s occurred among the group of "superregional" bank holding companies that control banks in more than one state with more than $10 billion in total assets. These regional organizations took advantage of the problem loans and the regional reciprocal state laws that constrained the expansion of "money center" banking organizations in New York, California and Illinois during the 1980s. As a result, superregional bank holding companies grew to a size where they could successfully compete with the money center banks. However, regional banking organizations have recently begun to experience their own loan problems, particularly in the real estate area.

The creation and growth of regional bank holding companies was one of the primary objectives of the regional banking movement, which sought to allow local banks to expand and grow within their home region before taking on the full competitive force of the money center banks. By facilitating this development, the states may have helped to preserve a competitive banking environment in an era of interstate banking. Nevertheless, the movement toward bank consolidation has substantially increased the percentage of total domestic banking assets held by the largest 100 banking organizations (from 50.2 percent in 1977 to 61.5 percent in 1987) and intensified the competitive pressures on all banks.

Additional competitive stresses have resulted from the increased presence of foreign banks in the domestic market. During the ten-year period ending on December 31, 1986, the number of foreign bank offices in the United States more than tripled (from 155 to 487), and domestic assets held by foreign banks quadrupled, a rate of increase that was more than twice as rapid as the growth in domestic assets held by U.S. banks. By 1988 foreign banks held eighteen percent of all domestic commercial and industrial loans, and by 1989 foreign bank offices in the United States controlled about one-quarter of total domestic banking assets.

Foreign bank entry into the domestic banking market, like nonbank competition and the growing activities of American banks abroad, reflects the ongoing movement toward a global financial market. Federal bank regulators have predicted that the planned movement of the Euro-

---

43. See id. at 124-25.
44. See id. at 125-27.
47. See Amel & Jacowski, supra note 36, at 126-28, 133.
48. See Mandate for Change, supra note 17, at 10, reprinted in 1987 House Hearings, supra note 17, at 151.
50. See Corrigan, supra note 49, at 3; R. Litan, supra note 15, at 55-57; Reed, Moving
pean Community to a single financial market in 1992 will strengthen European banks and increase competitive pressures on U.S. banks. Japanese banks have already emerged as major and potentially dominant competitors, increasing their share of global banking assets from twenty-four to forty percent between 1980 and 1987, while the share of such assets held by U.S. banks declined from sixteen to less than nine percent during the same period.

D. The Decline in Bank Profitability and the Increase in Bank Failures

Nonbank competition, geographic expansion and foreign bank entry, together with adverse economic developments during the 1980s such as inflation, recession, and the decline in agricultural and oil prices in the world markets, have exerted a serious downward pressure on bank profitability. For the decade of the 1970s, the average rate of return on assets for U.S. banks was 0.80 percent, but this rate declined to 0.70 percent during 1981-85 and 0.64 percent in 1986. The overall decline in bank profitability was most severe for small banks with less than $100 million in assets, but affected banks of all sizes. Bank profitability has remained generally weak since 1986.

The decline in bank profitability has been accompanied by an increase in risk-taking by banks. As banks have lost many of their largest and most creditworthy corporate customers to the commercial paper and se-

53. See Mandate for Change, supra note 17, at 11-12, reprinted in 1987 House Banking Hearings, supra note 17, at 152-53.
In securities markets, they have shifted their lending to more risky borrowers, such as less developed countries ("LDCs"), oil and gas producers, farmers, real estate developers and companies acquired or reorganized in highly leveraged transactions ("HLTs").6 Not surprisingly, many of these higher-risk loans have gone sour.

Many defaults occurred on LDC, farm and energy loans during the early 1980s, in response to a severe recession in the American economy and the collapse of agricultural and petroleum prices on the world markets. More recently, serious problems have emerged with respect to real estate and HLT loans because of a slowdown in the domestic economy, an overbuilt real estate market, and concerns about excessive levels of debt in the business sector.57 Thus, by the end of 1989, despite seven years of expansion in the domestic economy, nonperforming bank loans had more than doubled in amount since the end of 1982.58

Predictably, the competitive squeeze on bank profits and the increase in bank risk-taking have resulted in a sharp rise in the rate of bank failures. During the entire decade of the 1970s there were only seventy-six bank failures, but that number was exceeded in 1984 alone, when seventy-nine banks failed.59 Since 1984 there has been a steady increase in the number of bank failures, with 120 in 1985, 138 in 1986, 184 in 1987, 200 in 1988, and 206 in 1989.60 The number of FDIC-insured institutions on the FDIC's problem list has similarly increased from 200 in the


57. See Miller, supra note 19, at 10-11; McLaughlin & Wolfson, supra note 55, at 465-66; Simpson, supra note 28, at 3; 1989 House Hearings, supra note 5, at 191-93, 205 (testimony of Manuel H. Johnson, Vice Chairman of the FRB); 54 Banking Rep. (BNA) 425, 426 (1990) (reporting statement by Chairman L. William Seidman of the FDIC on March 7, 1990, discussing the substantial increase during 1989 in problem real-estate loans held by banks).


59. See Amel & Jacowski, supra note 36, at 124 (Table 1); Miller, supra note 19, at 8.

60. See Amel & Jacowski, supra note 36, at 124 (Table 1) & n.4 (stating total number of FDIC-insured bank failures in years 1977 through 1988); Bank Failures Nationwide Reach 206 at End of 1989, 54 Banking Rep. (BNA) 14 (Jan. 8, 1990) (stating total number of 1989 bank failures).

Poor management and insider fraud and abuse have been cited, along within excessive risk-taking, as primary factors contributing to bank failure. See Safe Banking Perspectives, supra, note 15, at 2-11; Miller, supra note 19, at 8-12; Office of the Comptroller of the Currency, Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks (1988), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶87,387 (during 1979-87, poor management oversight contributed to 90 percent of the difficulties encountered by failed and problem national banks, excessively risky management policies contributed to 80 percent of such difficulties, and insider fraud and abuse was a significant factor leading to 35 percent of national bank failures). Cf. More than Half of Failed S & Ls Were Fraud Victims, Seidman Says, 54 Banking Rep. (BNA) 375 (Mar. 5, 1990) (reporting statement by FDIC Chairman L. William Seidman estimat-
spring of 1981 to almost 1,100 as of December 31, 1989.61

E. The Debate Over Expanded Bank Powers

The foregoing discussion indicates that the U.S. banking industry is in a condition of prolonged decline and threatened viability. The most widely advocated solution for this critical problem is an expansion of banking powers that would allow banks to increase their earnings and reduce their risk by diversifying their operations. However, a number of critics have questioned whether banks have the financial and managerial resources to make safe and profitable use of expanded powers.

As explained below, the powers of national banks, state member banks and bank holding companies are significantly restricted in the areas of securities underwriting, insurance sales and underwriting, and real estate investment and development.62 Many professional economists, academics and federal banking regulators believe that the powers of banking organizations should be expanded in at least some of these areas.63

Two major arguments have been advanced in support of increasing bank powers. First, it is argued that bank entry into the securities, insurance, and real estate businesses would benefit consumers by creating greater competition and thereby reducing prices in these businesses.64 Second, it is suggested that expanded powers would strengthen banks and bank holding companies by enabling them to diversify their activities. Such diversification could improve profitability by allowing banking organizations to take advantage of potential synergies and economics of scope associated with the joint offering of related financial services.65 In
addition, diversification could reduce the risk of bank failure associated with the excessive concentration of bank loans in industries subject to cyclical fluctuations in the economy.66

Notwithstanding these arguments in favor of expanded bank powers, critics have challenged the view that a diversification of bank activities is likely to result in increased bank profitability without undue risk.67 For example, some critics have argued that nonbank activities, particularly in the areas of securities and real estate, would involve undue risks for banks.68 Others have suggested that banks may lack the managerial ex-

---


For studies relating to the riskiness of specific nonbanking activities, see Brewer, Fortier & Pavel, Bank Risk from Nonbank Activities, Econ. Perspectives, Fed. Res. Bank of Chicago, July/August 1988, at 14, 23-24 (concluding that limited involvement by bank holding companies in insurance underwriting and sales would probably reduce overall risk, and that small investments in real estate and securities activities would probably not cause a substantial increase in overall risk; however, a 10 percent or larger investment in securities activities would increase risk substantially); Felgran, Bank Participation in Real Estate: Conduct, Risk and Regulation, New England Econ. Rev., Fed. Res. Bank of Boston, Nov./Dec. 1988, at 57, 68-72 (concluding that real estate investments would not pose undue risk to banks, and could reduce bank risk through diversification, if such investments are limited to less than six percent of bank assets); Pace, Financing Deregulation: The Merging of Banking and Insurance Agency Activities, Issues in Bank Regulation, Bank Ad. Inst., Summer 1989, at 24, 27 (concluding that insurance agency activities would not involve undue risk for banks and could reduce bank risk by diversifying bank operations).

67. See, e.g., Boyd & Graham, The Profitability and Risk Effects of Allowing Bank Holding Companies to Merge with Other Financial Firms: A Simulation Study, Quarterly Rev., Fed. Res. Bank of Minneapolis, Spring 1988, at 3, 3-13 (suggesting that risk of bank failures would be increased by mergers between banking organizations and securities or real estate development firms, but not necessarily by mergers between banking organizations and life insurance companies); Dale, The Grass May Not Be Greener: Commercial Banks and Investment Banking, Econ. Perspectives, Fed. Res. Bank of Chicago, Nov./Dec. 1988, at 3, 3-11 (suggesting that entry of commercial banks into the investment banking business may not result in increased bank profitability, because of costly barriers to entry and the likelihood that bank entry would result in greater competition and lower profit margins in the securities business).

For other commentaries opposing or questioning bank entry into nonbanking businesses, see DiLorenzo, Public Confidence and the Banking System: The Policy Basis for Continued Separation of Commercial and Investment Banking, 35 Am. U.L. Rev. 647 (1986) (arguing that the businesses of commercial banking and investment banking should continue to be separated in view of the risks and conflicts of interest that would result from joinder of these businesses); Rhoades, Interstate Banking and Product Line Expansion: Implications from Available Evidence, 18 Loy. L.A. L. Rev. 1115, 1145-57 (1985) (suggesting that potential advantages of diversification of bank powers may be outweighed by increased operating risks resulting from inadequate managerial expertise to administer a wider range of activities).

68. See, e.g., Boyd & Graham, supra note 67, passim (discussing potential risks resulting from bank involvement in real estate and securities activities); Dale, supra note 67,
rrtise and experience needed to compete successfully in businesses that are unrelated to traditional banking activities. These critics point out that many thrift failures in recent years have arisen out of the imprudent investment of thrift assets in nontraditional areas such as commercial real estate and high-yield debt securities ("junk bonds").

A recent analysis of nonbank activities of bank holding companies indicates that the profits for nonbank subsidiaries between 1986 and 1988 followed a similar pattern to the profits for bank subsidiaries. This analysis "raises questions about the potential gains from diversification resulting from currently allowed nonbank activities," because it suggests that the trend in earnings from nonbanking activities may not necessarily provide a countervailing balance to the pattern of earnings from traditional banking operations. The analysis also indicates that nonbank subsidiaries of bank holding companies, although more highly capitalized than their bank affiliates, appear to involve a higher degree of risk in their operations.

A comprehensive analysis of the arguments for and against the expansion of bank powers is beyond the scope of this Article. One practical problem is that there is a relative lack of hard information concerning the safety and profitability of bank involvement in securities underwriting, insurance underwriting, and real estate development. This information is lacking because federal law substantially restricts the ability of banks and bank holding companies to engage in these activities.

For present purposes, however, it is significant that support for new bank powers has grown considerably over the past two decades in response to the widespread perception that traditional banking methods may no longer be competitively viable. For example, Professor Garten, passim (discussing potential risks resulting from bank involvement in securities activities); DiLorenzo, supra note 67, at 674-86 (same).

69. See, e.g., Garten, supra note 5, at 556-58; Rhodes, supra note 67, at 1149-57.
70. See, e.g., N. Strunk & F. Case, Where Deregulation Went Wrong: A Look at the Cause Behind Savings and Loan Failures in the 1980s, at 54-81 (1988); Wallace, U.S. May Become Largest 'Junk Bond' Holder, N.Y. Times, Mar. 13, 1990, at D5, col. 1 (describing difficulties encountered by some failed or troubled thrifts due to investments in "junk bonds").
72. Id. at 289-92.
73. See Rhodes, supra note 67, at 1146, 1149. For a discussion of the restrictions placed by federal law on the involvement of banks and bank holding companies in securities, insurance and real estate activities, see infra Part II(B).
who has expressed some skepticism about expanded bank powers,\(^\text{75}\) agrees that the traditional activities of banks can no longer ensure profitability and that some form of product deregulation is needed.\(^\text{76}\) In fact, she has stated that “all observers of bank regulation today are to some degree deregulators.”\(^\text{77}\)

As shown below in Part II, Congress and the states have responded in differing ways to the growing movement in favor of expanded bank powers. Congress has been unable to enact comprehensive legislation concerning bank powers, because of a legislative gridlock created by competing interest groups. A number of states, however, have chosen to grant broader powers to state-chartered banks. These state experiments may well provide concrete data that will assist in resolving the ongoing debate over the desirability and safety of expanded bank powers. If so, the states will have continued their record of constructive innovation under our dual banking system.

II. THE DUAL BANKING SYSTEM AND LEGISLATIVE ACTIONS OF CONGRESS AND THE STATES WITH RESPECT TO NEW BANK POWERS

Since the early days of our Republic, the federal government and the states have shared responsibility for the regulation of banking. Despite numerous efforts to remove state authority over bank regulation, Congress has consistently upheld the dual banking system. This congressional policy has produced a decentralized and unconcentrated banking system and a tradition of innovation in bank regulation.

The actions of many states in expanding bank powers provide the most recent example of state experimentation within the dual banking system. Federal law currently prohibits national banks and bank holding companies from engaging in most types of securities underwriting, insurance underwriting and sales, and real estate investment and development activities. In recent years Congress has been stymied by contests among competing interest groups and has not acted on legislative proposals to authorize new bank powers. In contrast, many state legislatures have enacted laws permitting banking organizations to engage to some degree in securities, insurance or real estate activities.

that broad-based entry by banks into the securities business, especially with regard to the underwriting of equity or corporate debt securities, would be unsafe and undesirable).

\(^{75}\) See Garten, supra note 5, at 551-58 (suggesting that a diversification of banking powers may increase rather than reduce the operating risks for banks, due to the inherent tendency of banks to use banking assets to support nonbanking affiliates, the difficulties involved in divesting ownership of unprofitable subsidiaries, and the lack of bank managerial expertise to administer a wide variety of activities).

\(^{76}\) See id. at 505-06, 521-28, 568.

\(^{77}\) Id. at 568.
A. Federal and State Regulation of Banks Under the Dual Banking System

1. Historical Background of the Dual Banking System

Since the founding of the United States, the federal and state governments have each exercised regulatory power over banks.\textsuperscript{78} Between 1787 and 1836, the federal government chartered and regulated only two banks—the First (1791-1811) and Second (1816-36) Banks of the United States—while the states chartered and regulated many banks. Due in part to the intensity of public distrust of concentrated financial power, the agrarian and pro-state bank elements of the Jeffersonian party defeated the rechartering of the First Bank of the United States, and the Jacksonian party prevented the rechartering of the Second Bank.\textsuperscript{79}

Following the destruction of the Second Bank of the United States, state legislatures (led by Michigan in 1837 and New York in 1838) enacted "free banking" laws. These laws departed from the prior practice of chartering banks by special legislative acts. Free banking laws were essentially general incorporation laws that permitted any person to obtain a bank charter upon the satisfaction of specified conditions.\textsuperscript{80} These laws greatly facilitated the chartering of new banks and assured the development of a decentralized banking industry. Significantly, when Congress decided to reinstitute a system of national banks in 1863, it chose the state free banking model instead of the centralized federal approach of the First and Second Banks of the United States.\textsuperscript{81}

Congress did not intend to create a dual banking system when it authorized the chartering of national banks in 1863. Congress expected that state banks would voluntarily convert to national charters in order to issue the newly-authorized national bank notes. When most state banks chose not to convert, Congress attempted, in 1865, to drive state

\textsuperscript{78} For example, our nation's first bank, the Bank of North America, received a federal charter from the Confederation Congress on December 31, 1781, and subsequently obtained a state charter from Pennsylvania on April 1, 1782, due to doubts about the federal charter's validity. See B. Hammond, Banks and Politics in America, from the Revolution to the Civil War 48-51 (1957).

\textsuperscript{79} Approval of the charter of the First Bank of the United States was successfully obtained by Alexander Hamilton over the strenuous opposition of Thomas Jefferson and James Madison. See id. at 114-18. For discussion of the public and congressional debates leading to the defeat of the rechartering of the First Bank and the prevention of rechartering of the Second Bank, see id. at 210-26, 326-450.

In vetoing the bill to recharter the Second Bank in 1832, President Andrew Jackson declared that the Second Bank was "unauthorized by the Constitution, subversive of the rights of the States, and dangerous to the liberties of the People." E. Symons & J. White, Banking Law: Teaching Materials 14-15 (2d ed. 1984) (reprinting portions of Jackson's veto message of July 10, 1832). The Second Bank was especially dangerous, in Jackson's opinion, because it made possible "a concentration of power in the hands of a few men irresponsible to the people." Id. at 16.

\textsuperscript{80} See B. Hammond, supra note 78, at 572-604, 617-22; E. Symons & J. White, supra note 79, at 21-23.

\textsuperscript{81} See B. Hammond, supra note 78, at 723-28; E. Symons & J. White, supra note 79, at 23-24; Wilmarth, supra note 38, at 1023.
banks out of business by placing a prohibitive ten percent tax on their circulating notes. This attempt failed, however, because state banks successfully shifted from a note-based operation to a deposit-based business by adopting the widespread use of checking accounts.  

While the survival of a dual banking system after 1865 may have been "an historical accident,"  

Congress in this century has repeatedly acted in a manner that has preserved a central role for the states in bank regulation. In 1933, Congress rejected proposals that probably would have destroyed the state banking system by allowing national banks to branch across state lines and by providing federal deposit insurance only to national banks and state member banks. Instead, Congress allowed national banks to establish branches only within their home state and only to the degree expressly permitted by state law, and Congress also made federal deposit insurance available to all state banks. Additionally, in 1956 Congress prohibited interstate acquisitions of banks by bank holding companies without state authorization, in part because that prohibition was deemed necessary to preserve state control over the expansion of banking organizations.

Both in 1933 and 1956, Congress determined that state control over bank expansion would preserve a decentralized banking industry and prevent the growth of concentrated financial power. More recently, Congress has failed to act on several legislative proposals that would have rescinded the existing authority of the states to prevent interstate branching by national banks and interstate acquisitions of banks by bank holding companies. Thus, Congress has continued to maintain an im-

82. See B. Hammond, supra note 78, at 728-34; E. Symons & J. White, supra note 79, at 24-25; Wilmarth, supra note 38, at 1023 n.29.
83. See Butler & Macey, supra note 11, at 681.
84. See Wilmarth, supra note 38, at 1024-25.
85. See id. at 1025-31.

In 1984, the Senate passed a bill that would have clarified the states' authority to adopt regional reciprocal banking laws, see Wilmarth, supra note 38, and 1049 n.163, but such
important role for the states in determining the structure of the banking system.88

2. The Dual Banking System’s Record of Innovation

Beyond the historic support that the dual banking system has enjoyed because of its role in maintaining a decentralized banking system,89 many scholars and government officials have supported the system because of its record of innovation in bank regulation. These commentators argue that the dual banking system contains an inherent competitive dynamic that causes both federal and state bank regulators to be flexible and innovative in order to retain their regulated constituents.90 As Professor Kenneth Scott has explained, the federal and state banking agencies “can be viewed as firms producing different brands of regulation and engaged in a species of competition for market shares.”91

Thus, under the dual banking system it is not possible for one banking agency to exercise a regulatory monopoly that would enable it to create and enforce a “single industry cartel.”92 Because federal and state banking laws allow banks to convert between national and state charters without the approval of their current regulator, the dual banking system contains a “safety valve” allowing banks to escape from arbitrary, inflexible or outdated regulation.93 In addition, by allowing the states to adopt new approaches to bank regulation, the dual banking system permits individual states to act as “laboratories for change” and to have their experiences made unnecessary by the Supreme Court’s subsequent decision in Northeast Bancorp, Inc. v. Board of Governors, 472 U.S. 159, 168-78 (1985). In 1985, a House committee approved a bill that would have required any state allowing any degree of entry by out-of-state bank holding companies to permit nationwide entry by July 1, 1992. See H.R. Rep. No. 174, 99th Cong. 1st Sess. 18-20 (1985). This bill, however, failed to achieve passage in either the House or the Senate.

88. See, e.g., National State Bank v. Long, 630 F.2d 981, 985 (3d Cir. 1980) (discussing congressional deference to state banking regulation); Independent Bankers Ass’n of Am. v. Smith, 534 F.2d 921, 930-32, 936, 950 (D.C. Cir.) (same), cert. denied, 429 U.S. 862 (1976). Even critics of the dual banking system recognize the considerable political support it enjoys in Congress. See Butler & Macey, supra note 11, at 677-78; Miller, supra note 19, at 1-2.

89. See supra note 86 and accompanying text (explaining support for decentralized banking system as a key reason for congressional retention of state control over the geographic expansion of banking organizations).


91. Scott, supra note 8, at 32.

92. See id. at 35. According to Professor Scott, “[t]he closest analogy to the dual system is a situation akin to oligopoly, involving competing cartels.” Id.

93. See W. Brown, supra note 90, at 59, 60; Blueprint for Reform, supra note 32, at 43; State Regulation of Banks, supra note 90, at 17; Safe Banking Perspectives, supra note 15, at 277-78; Scott, supra note 8, at 8-13.
periments adopted by Congress if they prove to be successful.94

The benefits and costs of the dual banking system have been sharply debated. Part V of this Article responds to two major criticisms of the system—first, that the system encourages a "competition in laxity,"95 and second, that the competition permitted by the system is more mythical than real.96 For present purposes, it is important to note that the dual banking system has produced a continuing series of innovations in bank regulation at both the state and federal levels.

During the 19th and early 20th centuries, the state banking system originated free banking laws, checking accounts, branch banking, real estate lending, trust services, reserve requirements, and deposit insurance, all concepts that Congress later incorporated in laws governing national banks.97 More recently, the states have (i) permitted banks to create interstate electronic funds transfer ("EFT") systems through the establishment of networks of automated teller machines ("ATMs"),98 (ii) initiated the concept of negotiable order of withdrawal ("NOW") accounts,99 and (iii) authorized interstate acquisitions of banks by bank

95. See, e.g., Address dated Oct. 21, 1974 by Chairman Arthur Burns of the FRB, quoted in Scott, supra note 8, at 13. For a discussion of the "competition in laxity" argument, see infra Part V(A).
96. See Butler & Macey, supra note 11, passim. For a discussion of the argument that competition within the dual banking system is a "myth," see infra Part V(B).
97. See, e.g., B. Hammond, supra note 78, at 556-63, 572-604, 617-22, 695-98 (describing state innovations in deposit insurance, free banking and reserve requirements); E. Symons & J. White, supra note 79, at 21-25, 33-34 (discussing state initiatives in deposit insurance, free banking, checking accounts and trust services); State Regulation of Banks, supra note 90, at 9-10, 11, 17 (describing state initiatives in deposit insurance, free banking, checking accounts, real estate lending, and branch banking).
98. Interstate shared EFT systems enable customers of a participating bank to obtain access to their accounts by using ATMs located at other participating institutions in the same state or in different states. See Bell & Wilmarth, supra note 87, at 730. As of December 31, 1987, more than 40 states permitted the creation of interstate shared EFT systems. See Conference of State Bank Supervisors, A Profile of State-Chartered Banking 188-90 (12th ed. 1988) [hereinafter State Banking Profile].
99. NOW accounts are savings accounts which allow the customer to withdraw funds by means of a negotiable instrument such as a check. In practical effect, NOW accounts are equivalent to interest-bearing checking accounts. See S. Rep. No. 368, supra note 15,
holding companies.100

The authorization of NOW accounts and interstate bank acquisitions are especially striking examples of recent state innovations. In the case of NOW accounts, Congress gave nationwide authorization for this convenient service only after several states had demonstrated that NOW accounts were highly desirable to both consumers and banks.101 In the case of interstate acquisitions of healthy banks by bank holding companies, the states acted while Congress was unable to adopt legislation due to a stalemate among competing segments of the banking industry. As a result, interstate acquisitions have been accomplished under state law instead of by federal preemption.102

Thus, under the dual banking system the states have conferred substantial benefits on our banking industry by acting as "laborator[ies]" for "experimentation" in the manner envisioned by Justice Brandeis in his well-known dissent in New State Ice Co. v. Liebmann.103 As explained below, this experimental role of the states has become increasingly significant in expanding the powers of state banks in the areas of securities, insurance and real estate.104 It seems likely that these state experiments will provide useful practical experience that will assist in fashioning a new federal policy on bank powers.

Moreover, regulatory innovation has not been absent on the federal side of the dual banking system. From 1961 to 1966, James J. Saxon, as Comptroller of the Currency, took steps to increase the attractiveness of national bank franchises. He significantly liberalized chartering policies and lending powers for national banks and issued rulings authorizing national banks to establish and operate collective investment funds, underwrite revenue bonds, operate insurance and travel agencies, establish operations subsidiaries, open loan production offices without regard to

---

100. For discussion of state laws authorizing interstate bank acquisitions, see supra notes 38-40 and accompanying text.


102. For a discussion of state laws authorizing interstate bank acquisitions and the inability of Congress to act in that area, see R. Litan, supra note 15, at 38; supra notes 38-40 & 87 and accompanying text.

103. 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("[i]t is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country").

104. See infra Part II(D).
state branching laws, and offer personal property leasing and data processing services.\textsuperscript{105} Although most of Saxon’s rulings were ultimately reversed by court decisions,\textsuperscript{106} his initiatives caused a substantial number of state banks to convert to national charters and thereby placed pressure on the states and other federal agencies to respond with their own innovations.\textsuperscript{107} In addition, Saxon’s initiatives established a precedent for later rulings by his successors that have successfully enhanced the operating powers of national banks with respect to securities and insurance activities.\textsuperscript{108}

Another example of federal innovation has been the consistent efforts by recent Comptrollers of the Currency, especially Saxon and his successors, to expand the branching powers of national banks beyond those permitted by state law to state commercial banks, notwithstanding the restrictions contained in the McFadden Act\textsuperscript{109} While many of the earlier attempts of the Comptrollers to expand the branching powers of national banks were struck down under the policy of “competitive equality,” which the Supreme Court found to be inherent in the McFadden Act with regard to branching,\textsuperscript{110} several of the Comptroller’s more

\textsuperscript{105} See W. Brown, supra note 90, at 33-35; R. Litan, supra note 15, at 31; Scott, supra note 8, at 23-32.


\textsuperscript{107} See Scott, supra note 8, at 23-32. For example, state regulators put pressure on the FRB to change its prior position and conform to Saxon’s rulings by allowing state member banks to establish operations subsidiaries and to open loan production offices without obtaining branching approval. See id. at 31. In addition, as a means of providing equal competitive opportunity for state banks, many states revised and modernized their banking codes. See W. Brown, supra note 90, at 35, 38. For example, a number of states adopted “wild card” statutes that would permit state banks, under specified circumstances, to exercise new powers granted to national banks. See Scott, supra note 8, at 36. As of December 31, 1987, 38 states had enacted some type of wild card statute. Twenty-six of these laws are unlimited wild card statutes (although 21 of these laws can be triggered only with the approval of the supervisory authority for state banks), while the remaining twelve apply only to limited matters (of which six can be triggered only with supervisory discretion). See State Banking Profile, supra note 98, at 87-88.

\textsuperscript{108} For discussion of subsequent OCC initiatives, see infra notes 130-32, 137-39 & 153-57 and accompanying text.

\textsuperscript{109} As discussed supra at note 14, the McFadden Act, 12 U.S.C. § 36 (1988), permits a national bank to establish branches only in its home state and only to the degree expressly permitted to state banks under state statutory law.

\textsuperscript{110} See, e.g., First Nat'l Bank in Plant City v. Dickinson, 396 U.S. 122, 131 (1969) (holding that, in view of the McFadden Act’s principle of “competitive equality,” the
recent efforts have been successful. In some of these cases, the Comptroller has persuaded the courts that certain off-premises facilities operated by national banks should not be treated as "branches" for purposes of the McFadden Act under 12 U.S.C. § 36(f) (1988). In another recent decision, the Comptroller successfully argued that national banks should be given the same branching powers as state-chartered thrift institutions based on a finding that such thrifts are "State banks" for purposes of the McFadden Act under 12 U.S.C. § 36(h) (1988). These recent successes by the Comptroller have pressured a number of states to liberalize their branching laws in order to maintain a basic competitive parity between national and state commercial banks.

3. The Current Regulatory Structure

The structure of regulation in the U.S. banking industry is not one of perfect duality between state and federal regulators. For nearly six decades, Congress has invested both the FRB and the FDIC with supervisory powers over banks. The Comptroller could not permit a national bank to operate an armored car service and an off-premises depository, because these facilities were "branches" within the meaning of 12 U.S.C. § 36(f) (1988) that were not permissible for state banks under state law; First Nat'l Bank of Logan v. Walker Bank & Trust Co., 385 U.S. 252, 261-62 (1966) (holding that, under the policy of "competitive equality," the Comptroller could not permit national banks to branch by any method where state law permitted state banks to branch only by merger with another bank); see also Independent Banker's Ass'n of Am. v. Smith, 534 F.2d 921 (D.C. Cir.) (holding that ATM terminals established by national banks were "branches" within the meaning of Section 36(f) and therefore, as a matter of competitive equality, could be established only in accordance with state branching laws), cert. denied, 429 U.S. 862 (1976).

111. See, e.g., Clarke v. Securities Indus. Ass'n, 479 U.S. 388, 404-09 (1987) (upholding Comptroller's rulings permitting national banks to establish discount brokerage offices or subsidiaries without regard to the branching restrictions of the McFadden Act, because such entities do not engage in "core banking functions," and therefore are not "branches" within the meaning of Section 36(f)); Independent Bankers Ass'n of New York State, Inc. v. Marine Midland Bank, 757 F.2d 453 (2d Cir. 1985) (upholding Comptroller's regulation allowing national bank to contract with a supermarket to provide ATM services to the bank's customers without regard to state branching law, so long as the bank does not own or rent the ATM, and holding that supermarket's ATM was not a "branch" of the bank within the meaning of Section 36(f)), cert. denied, 476 U.S. 1186 (1986); Independent Bankers Ass'n of Am. v. Heimann, 627 F.2d 486 (D.C. Cir. 1980) (upholding the Comptroller's ruling that national banks to establish loan production offices without regard to state branching law, and indicating, in dicta, agreement with that ruling).

112. See Department of Banking & Consumer Fin. of Mississippi v. Clarke, 809 F.2d 266 (5th Cir.) ("Deposit Guaranty") (upholding Comptroller's ruling that state-chartered thrift institutions with statewide branching privileges and bank-like powers were "State banks" within the meaning of 12 U.S.C. § 36(h), so that national banks could also branch statewide even though state law allowed state-chartered commercial banks to branch only within 100 miles of their home offices), cert. denied, 483 U.S. 1010 (1987).

sory powers over banks that overlap with the respective jurisdictions of the state bank supervisors and the OCC. Under the Federal Reserve Act of 1913, Congress has empowered the FRB to manage the nation’s money supply and to exercise supervisory authority over both national banks (which are required to be members of the Federal Reserve System) and those state banks that choose to become members of the System.

In 1933 Congress established the FDIC to provide deposit insurance for the nation's banks. Under the Federal Deposit Insurance Act of 1950 ("FDI Act"), the FDIC exercises a residual supervisory authority over national banks and state member banks (which are required to maintain deposit insurance) and a more direct supervisory authority over state nonmember banks that elect to obtain deposit insurance (as almost all do). Thus, the respective bank supervision powers of the FRB and the FDIC overlap with the primary authority of the OCC over national banks and the primary authority of state bank supervisors over state banks.

A further level of federal regulation resulted from enactment of the BHC Act in 1956. The BHC Act empowered the FRB to regulate bank holding companies in a number of areas, including the acquisition of banks or nonbanking entities. Congress did not, however, choose to preempt all state regulation of bank holding companies. Instead, Section 7 of the BHC Act reserves to each state “such powers and jurisdiction which it now has or may hereafter have with respect to companies, banks, bank holding companies, and subsidiaries thereof.” Thus, Con-


117. For general discussions of the creation of the FDIC and its supervisory powers over insured banks, see C. Golembe & D. Holland, supra note 115, at 9, 28-31; E. Symons & J. White, supra note 79, at 41-43; Scott, supra note 8, at 3, 5-7.


119. For general discussions of the FRB’s regulatory authority over bank holding companies under the BHC Act, see C. Golembe & D. Holland, supra note 115, at 9, 31; E. Symons & J. White, supra note 79, at 44; Aman, supra note 115, at 863-79.

120. 12 U.S.C. § 1846 (1988). The Supreme Court has indicated that Section 7 permits the states to adopt nondiscriminatory laws with respect to bank holding companies that are “more restrictive” than federal law. See Lewis v. BT Investment Managers, Inc., 447 U.S. 27, 48-49 (1980); see also Whitney Nat'l Bank v. Bank of New Orleans & Trust Co., 379 U.S. 411, 418-19 & n.5, 424-25 (1965) (FRB may not approve an acquisition of a
progress has provided for overlapping federal and state roles in the regulation of both banks and bank holding companies.

B. Federal Restrictions on Banking Powers

The competitive opportunities of national banks and bank holding companies have been significantly restricted by federal law in the areas of securities underwriting, insurance sales and underwriting, and real estate investment and development. State member banks have been similarly restricted in the areas of securities underwriting and real estate investment and development. In recent years, the OCC and the FRB have issued rulings that modestly expand bank powers in certain of these areas. However, Congress has been unable to enact any comprehensive legislation to expand banking powers, because of strong opposition from the securities, insurance, and real estate industries, and because of congressional doubts about the safety and desirability of bank involvement in these industries. It is therefore open to question whether any broad-scale expansion of banking powers under federal law will be forthcoming in the immediate future.

1. Federal Restrictions on Bank Involvement in Securities Underwriting

Sections 16, 20, 21, and 32 of the Banking Act of 1933, which are often collectively referred to as the "Glass-Steagall Act," restrict the permissible securities activities of banks and bank holding companies. Section 16 provides that national banks and state member banks may not engage in the "business of dealing in securities and stock" except for (i) purchasing and selling securities without recourse and solely on the order and for the account of their customers, (ii) purchasing investment securities in accordance with regulations of the OCC, and (iii) underwriting and dealing in United States Treasury securities, general obligation bonds of state and local governments, and certain other government-related securities. Thus, national banks and state member banks are pro-

---

1. For a discussion of the debate within the academic community, the financial services industry and Congress over the desirability and safety of expanded bank powers, see supra Part I(E) and infra Part II(C).
hibited from underwriting or dealing in securities that are not eligible for underwriting by national banks pursuant to Section 16 of the Glass-Steagall Act ("national bank-ineligible securities"). Section 21 provides that any deposit-taking institution (including a state nonmember bank) may not directly underwrite, distribute or sell securities if such activities are prohibited to national banks under Section 16.

Section 20 prohibits any national bank or state member bank from affiliating with any organization that is "engaged principally" in the underwriting or distribution of national bank-ineligible securities. Section 32 similarly prohibits any national bank or state member bank from sharing any officer, director or employee with such a securities organization. Significantly, neither Section 20 nor Section 32 applies to state nonmember banks, and these banks may therefore affiliate with companies engaged principally in securities underwriting and dealing activities.

The OCC and the FRB have issued a number of rulings in recent years that have modestly expanded the securities-related activities of national banks, state member banks and bank holding companies. For example, the OCC and the FRB have permitted national banks and bank holding companies to provide securities brokerage and investment advisory services to their customers. In addition, the OCC and the FRB have permitted national banks, state member banks and bank holding companies to engage in the private placement of bank-ineligible securities, including commercial paper and corporate equity securities.

127. See id. § 377.
128. See id. § 78.
In 1988, two federal courts of appeal upheld FRB orders authorizing bank holding companies to establish subsidiaries that engage to a limited extent in underwriting and dealing with respect to four types of national bank-ineligible securities: commercial paper, municipal revenue bonds, mortgage-backed securities, and securities backed by consumer receivables. The courts held that these subsidiaries would not be "engaged principally" in the underwriting of national bank-ineligible securities in violation of Section 20 of the Glass-Steagall Act, because the FRB's orders restricted the subsidiaries' involvement in such underwriting to not more than five percent of their gross revenues over any two-year period. The FRB subsequently amended its orders to permit such securities subsidiaries to increase their underwriting and dealing activities with respect to national bank-ineligible securities to no more than ten percent of their gross revenues during any two-year period.

Most recently, a federal court of appeals has upheld an FRB order permitting securities subsidiaries of bank holding companies to underwrite and deal in corporate debt and equity securities. However, the FRB's order, as subsequently amended, limits the amount of such activities (together with all other national bank-ineligible securities activities) to not more than ten percent of the securities subsidiary's gross revenues during any two-year period. In addition, the FRB has not yet given final approval to any bank holding company's securities subsidiary to begin underwriting or dealing in corporate equity securities. The FRB has also required bank holding companies to establish special corporate procedures and other safeguards designed to ensure that the approved activities of securities subsidiaries do not threaten the safety or soundness of the bank holding companies or their subsidiary banks.


134. Citicorp, 839 F.2d at 62-67; Chase, 847 F.2d at 895.

135. See Announcement of Modifications to Section 20 Orders, 75 Fed. Res. Bull. 751 (1989). In Citicorp, 839 F.2d at 67, the Second Circuit upheld the FRB's determination that Section 20 of the Glass-Steagall Act "allows an affiliate [of a national bank or state member bank] to engage in bank-ineligible securities activities so long as those activities do not exceed five to ten percent of the affiliate's gross revenue." Id.

For its part, the OCC has issued, and successfully defended against court challenges, rulings that allow national banks to establish subsidiaries that provide insurance for municipal bonds, and to sell mortgage pass-through certificates representing undivided interests in mortgages owned by the banks. In both cases, the courts found that the approved securities-related activities were functionally equivalent or properly incidental to the exercise of national bank powers authorized by 12 U.S.C. § 24 (Seventh) (1988).

Notwithstanding the recent successes of the OCC and the FRB in expanding the permitted securities-related activities of national banks, state member banks and bank holding companies, the Glass-Steagall Act still places substantial restrictions on the securities powers of these organizations. National banks and state member banks still may not directly (or indirectly through an affiliate) underwrite or deal in national bank-ineligible securities, except for asset-backed securities representing participation interests in assets owned by the banks themselves. And bank holding companies that control a national bank or state member bank may not establish a securities subsidiary that underwrites or deals in national bank-ineligible securities unless the subsidiary's revenues from such activities are less than ten percent of its gross revenues.

The foregoing restrictions, while representing a degree of liberalization from prior law, still appear to hinder national banks, state member banks and bank holding companies substantially in competing with securities firms in the domestic market. For example, a recent study by the U.S.

No. 9, Mar. 19, 1990, at 1, 4; see also J.P. Morgan, 75 Fed. Res. Bull. at 213 (stating that the FRB would not authorize underwriting of or dealing in corporate equity securities until completion of further review at least a year after the date of the FRB's order).


139. See Security Pacific, 885 F.2d at 1047-50 (upholding OCC's determination that a national bank's sale of mortgage pass-through certificates backed by the bank's own mortgage loans was properly incidental to the bank's express power to sell the loans themselves); AMBAC, 865 F.2d at 281-84 (upholding OCC's determination that the issuance of municipal bond insurance was functionally equivalent to the permitted bank activity of issuing standby letters of credit).

140. See, e.g., Security Pacific, 885 F.2d at 1047-48 (indicating that any involvement by national banks in securities underwriting or dealing activities would be prohibited if it could not be justified by reference to the banking powers or limited securities powers conferred by 12 U.S.C. § 24 (Seventh) (1988)); 12 U.S.C. § 335 (1988) (prohibiting state member banks from engaging in securities underwriting or dealing activities that are forbidden to national banks).

141. See, e.g., Citicorp, 839 F.2d at 67 (indicating that a bank holding company's securities subsidiary would violate the "principally engaged" limitation of Section 20 of Glass-Steagall Act if the subsidiary's involvement in bank-ineligible securities activities exceeded ten percent of its gross revenues).

142. For the adverse impact of the Glass-Steagall Act on the competitive position of U.S. banking organizations, see Isaac & Fein, supra note 130, at 293-95; supra notes 122-
General Accounting Office ("GAO") indicates that while the national bank-ineligible activities of securities subsidiaries of bank holding companies increased substantially during 1989, those activities still accounted for a relatively small share of the total underwriting and dealing activities conducted by firms in the securities industry. In addition, certain evidence cited in the GAO's study suggests that, unless the FRB's orders are further modified, the ten percent revenue limitation and the structural restraints and other prudential "firewalls" contained in those orders will prevent securities subsidiaries of bank holding companies from achieving major competitive positions with regard to national bank-ineligible securities activities.

As previously noted, state nonmember banks, unlike national banks and state member banks, are not barred by federal law from affiliating with companies that are principally engaged in underwriting or dealing in national bank-ineligible securities. Indeed, the FDIC has adopted regulations that permit an FDIC-insured state nonmember bank to establish a subsidiary, or to affiliate with another entity (e.g., through common ownership by a parent holding company), that primarily engages in national bank-ineligible securities activities. The FDIC's regulations require that any such securities subsidiary must be adequately capitalized, and that any such subsidiary or securities affiliate must be operated in a manner that clearly separates the subsidiary or affiliate from the

---

28 and accompanying text. The Glass-Steagall Act does not apply to securities activities conducted abroad by U.S. banking organizations, but foreign securities activities of U.S. banks and bank holding companies are restricted to some degree by Regulation K of the FRB. See 12 C.F.R. Part 211 (1989); S. Rep. No. 305, supra note 23, at 12; id. at 120 (additional views of Sens. Dixon, Sanford and Garn); Isaac & Fein, supra note 130, at 296, 343-46 (appendix).

143. See U.S. General Accounting Office, Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies, GAO Document No. GAO/GGD-90-48 (Mar. 1990). This study states that the underwriting and dealing activities of "Section 20" securities subsidiaries of bank holding companies are with regard to mortgage-backed securities, municipal revenue bonds and asset-backed securities represented less than two percent of the total underwriting and dealing activities of securities firms in these types of securities during the third quarter of 1989. See id. at 28. The total revenues (including those from national bank-eligible activities) and the total capital of Section 20 securities increased markedly during 1989. However, as of June 30, 1989, Section 20 subsidiaries accounted for only 7.2 percent of total securities industry revenues and 3.7 percent of total securities industry capital. See id. at 29-30.

144. See, e.g., id. at 8-10, 15-17, 41-57 (citing comments from banking industry officials criticizing the FRB's revenue limitation and other "firewalls" as substantial and inefficient restraints on Section 20 subsidiaries, but also citing comments from securities industry officials arguing that these provisions do not unduly restrict Section 20 subsidiaries and are essential to protect bank safety and assure fair competition between Section 20 subsidiaries and securities firms).

145. See supra note 129 and accompanying text.

In addition, the underwriting activities of a securities subsidiary are limited to certain types of lower-risk securities unless the subsidiary is a member in good standing of the National Association of Securities Dealers, and has been in continuous operation for at least five years with no serious violations of the securities laws. The FDIC's regulations also place strict limitations on permissible extensions of credit or other transactions by the bank that involve or affect the bank's securities subsidiary or affiliate.

Thus, the FDIC's regulations permit state nonmember banks to engage indirectly through a subsidiary or affiliate in a broad range of securities activities that are not allowed to national and state member banks. The limitations contained in the FDIC's regulations have two primary purposes. First, the regulations seek to ensure that a state nonmember bank is sufficiently separated from its securities subsidiary or affiliate so that the bank is not found to be directly engaged in the underwriting or sale of national bank-ineligible securities in violation of Section 21 of the Glass-Steagall Act. Second, the regulations are designed to protect the safety and soundness of the bank from being undermined by any losses that may be suffered by its securities subsidiary or affiliate.

2. Federal Restrictions on Bank Involvement in Insurance Activities

Federal law restricts the insurance powers of national banks and bank holding companies. Under 12 U.S.C. § 92 (1988), a national bank may

147. See 12 C.F.R. §§ 337.4(a)(2) and (b)(1)(ii) (1989). In order to be adequately separated from the bank, the securities subsidiary or affiliate must (i) maintain physically separate offices or office space, (ii) not share a majority of directors with the bank, (iii) not share with the bank any employee directly involved in customer contacts, and (iv) conduct business pursuant to independent policies designed to inform customers that the subsidiary or affiliate is a separate organization whose investment products are not bank deposits and not guaranteed by the bank or insured by the FDIC. In the case of a securities subsidiary, the bank's investment in the subsidiary is excluded in calculating the bank's capital, and the subsidiary must maintain separate accounting and other corporate records, retain and compensate separate employees, and observe separate corporate formalities such as separate board of directors' meetings. See id. §§ 337.4(a)(2), (b)(1)(ii), (b)(3) & (c).

148. Unless a securities subsidiary or affiliate shares the same or a similar name or logo with the bank, or conducts business at the same location as the bank, or participates in joint advertising with the bank, the subsidiary or affiliate must make specific disclosures to its customers stating that it is not a bank and that the securities it sells are not guaranteed by the bank or insured by the FDIC. See id. § 337.4(h).

149. See id. § 337.4(e).


151. See id. at 46711-13.
provide general insurance agency services only if it is "located and doing business" in a town having a population of 5,000 or less.\textsuperscript{152} In 1986, the OCC issued an interpretive ruling stating that Section 92 permits a national bank to act as a general insurance agent for customers resident anywhere as long as the main office or a branch of the bank is located in a town with a population of 5,000 or less.\textsuperscript{153} That ruling has recently been upheld by a federal district court,\textsuperscript{154} and the ruling appears to provide substantial insurance agency opportunities for national banks that choose to locate their main office or a branch in a small town.

Except as permitted by Section 92, national banks may act as agents only for the sale of credit-related life, disability and involuntary unemployment insurance.\textsuperscript{155} In addition, national banks may not underwrite insurance.\textsuperscript{156} However, national banks have been permitted to issue standby credits that resemble insurance in circumstances where the bank credits are functionally equivalent to the authorized issuance of standby letters of credit.\textsuperscript{157}

The insurance powers of bank holding companies are substantially constrained by Section 4(c)(8) of the BHC Act,\textsuperscript{158} as amended by Section 601 of the Garn-St Germain Depository Institutions Act of 1982 ("Garn-St Germain Act").\textsuperscript{159} Section 4(c)(8) prohibits bank holding companies from acting as underwriters, agents or brokers for insurance, with seven limited exemptions. The most significant of these exemptions, as implemented by regulations of the FRB, permit a bank holding company (i) to act as underwriter, agent or broker for credit-related life, disability and involuntary unemployment insurance, (ii) to act as insurance agent in any town of 5,000 or less in which the bank holding company or any of its subsidiaries maintains a lending office, (iii) to engage in specific insurance agency activities of national banks with offices in places of 5,000 or less.

\begin{itemize}
\item \textsuperscript{152} As explained \textit{supra} at notes 105-06 and accompanying text, the attempt of Comptroller James Saxon to permit national banks located in places having a population of more than 5,000 to act as general insurance agents was struck down in Saxon v. Georgia Ass'n of Indep. Ins. Agents, 399 F.2d 1010 (5th Cir. 1968).
\item \textsuperscript{154} \textit{See} Nat'l Ass'n of Life Underwriters v. Clarke, 736 F. Supp. 1162 (D.D.C. 1990).
\item \textsuperscript{155} \textit{See} Independent Bankers Ass'n of Am. v. Heimann, 613 F.2d 1164, 1170 (D.C. Cir. 1979), \textit{cert. denied}, 449 U.S. 823 (1980) (holding that national banks may act as agents in providing credit-related life insurance because this activity is incidental to their express power to make loans on personal security); Pace, \textit{supra} note 66, at 25-26 (discussing authority of national banks to act as agents for credit-related insurance). In addition, the OCC ruled in 1983 that national banks could lease office space to insurance agents and receive a portion of the agents' commissions under the lease agreement. \textit{See id}.
\item \textsuperscript{156} \textit{See}, e.g., AMBAC, 656 F. Supp. at 407, 408.
\item \textsuperscript{157} \textit{See id.} at 408-11, \textit{aff'd}, 865 F.2d at 281-84 (upholding OCC ruling allowing national bank to issue standby credits that served as "insurance" for payment of municipal bonds, because OCC reasonably determined that such standby credits were functionally equivalent to authorized standby letters of credit).
\item \textsuperscript{158} 12 U.S.C. § 1843(c)(8) (1988).
\item \textsuperscript{159} Pub. L. No. 97-320, § 601, 96 Stat. 1469, 1536 (1982).
\end{itemize}
ance agency activities in restricted locations that are "grandfathered" because the bank holding company or its predecessor or a subsidiary thereof had conducted or received FRB approval for such activities at nearby locations prior to May 1, 1982, and (iv) to engage in unrestricted insurance agency activities at all locations if the particular bank holding company had received FRB approval for any insurance agency activities prior to January 1, 1971. But these exemptions, even considered collectively, do not permit most bank holding companies to maintain a substantial presence in the insurance business.

As discussed below, there is an ongoing controversy over the issue of whether state banks controlled by bank holding companies, or subsidiaries of such banks, may engage in insurance activities without regard to the restrictions contained in Section 4(c)(8) of the BHC Act. It will be shown that holding company-owned state banks and their operations subsidiaries are not subject to Section 4(c)(8) and should be permitted to engage in insurance activities that are authorized under state law.

With regard to insurance activities conducted by state member banks that are not owned by bank holding companies, the FRB has claimed authority to approve or deny proposals by state member banks to commence such activities. The FRB's regulations governing state member banks provide, as a condition of membership in the Federal Reserve System, that a state member bank may not change the general character of its business or the scope of its powers after becoming a member without obtaining the FRB's prior approval. In two opinions, the FRB staff declared that a state member bank would be required to obtain the prior approval of the FRB before it could commence an insurance activity, either directly or through a subsidiary, that would result in a change in

160. See 12 C.F.R. § 225.25(b)(8)(i), (iii), (iv) and (vii) (1989) (interpreting exemptions (A), (C), (D) and (G) contained in Section 4(c)(8) of the BHC Act). For recent court decisions upholding orders and regulations of the FRB relating to insurance activities of bank holding companies, see National Ass'n of Casualty and Sur. Agents v. Board of Governors, 856 F.2d 282 (D.C. Cir. 1988) (upholding FRB orders interpreting exemption (D) under Section 4(c)(8)), cert. denied, 109 S. Ct. 2430 (1989); Independent Ins. Agents of Am., Inc. v. Board of Governors, 835 F.2d 1452 (D.C. Cir. 1987) (upholding FRB regulation interpreting exemption (C) under Section 4(c)(8)).


162. See infra Part IV(C). For example, the Second Circuit Court of Appeals has upheld an FRB order determining that Section 4(c)(8) of the BHC Act did not prohibit two state bank subsidiaries of a bank holding company from engaging in general insurance agency activities permitted by state law. See Independent Ins. Agents of Am., Inc. v. Board of Governors, 890 F.2d 1275 (2d Cir. 1989), petition for cert. filed, 58 U.S.L.W. 3695 (U.S. April 18, 1990) (No. 89-1620), aff'g Merchants National Corp., 75 Fed. Res. Bull. 388 (1989) ("Merchants National"). For a further discussion of Merchants National, see infra Part IV(C)(3).

163. See 12 C.F.R. § 208.7 (1989).
the general character of its business or the scope of its powers. As discussed below, it is highly questionable whether the FRB has authority to exert such a veto power over the state-authorized activities of state member banks.

The FDIC has not imposed any general restrictions on the insurance activities of state nonmember banks. The FDIC chose not to adopt proposed regulations, issued in 1985, that would have prohibited all FDIC-insured banks from directly engaging in the underwriting of insurance (except for the underwriting of life insurance under certain conditions). The proposed regulations would have permitted insured banks to engage in insurance underwriting only indirectly through a subsidiary that met essentially the same tests of separateness as are required by the FDIC's regulations concerning securities subsidiaries of state nonmember banks.

The FDIC withdrew these proposed regulations in December 1987, in part because the FDIC had found "no system wide problems" resulting from the direct involvement of state banks in insurance activities. The FDIC concluded that any potential supervisory problems could be adequately dealt with "on a case-by-case basis." However, the FDIC has recently stated that it will reconsider adopting similar regulations in response to a new Delaware statute that allows state banks to underwrite and sell all types of insurance except title insurance.

3. Federal Constraints on Bank Involvement in Real Estate Investment or Development

Federal statutes and regulations generally bar national banks, state member banks, and bank holding companies from engaging in real estate or investment or development activities. National banks may acquire interests in real estate only if the property is used for the bank's business premises, or has been mortgaged to the bank as security for debts previ

165. See infra Part IV(B)(1).
166. See FDIC Notice of Proposed Rulemaking, Powers Inconsistent with Purposes of Federal Deposit Insurance Law, 50 Fed. Reg. 23964-93 (1985) [hereinafter FDIC Notice of Proposed Rulemaking]. For the specific restrictions that the proposed regulations would have imposed on insurance underwriting activities, see id. at 23,980-81, 23,992. For discussion of the FDIC's requirements applicable to securities subsidiaries of insured state nonmember banks, see supra notes 146-51 and accompanying text.
ously contracted, or has been acquired in satisfaction of a debt in default.\textsuperscript{169} The FRB has applied similar restrictions upon state member banks. The FRB, under a highly questionable assertion of its authority to place conditions on banks admitted to membership in the Federal Reserve System, has generally prohibited state member banks from engaging in real estate investment or development activities.\textsuperscript{170}

The FRB has also adopted regulations that generally bar bank holding companies from involvement in real estate development and investment activities.\textsuperscript{171} As discussed below, the FRB is presently considering rulemaking proposals that might allow such activities but only under very limited and stringent conditions.\textsuperscript{172} Thus, for the time being, bank holding companies are generally excluded from real estate activities except for those activities that may be lawfully conducted by holding company-owned state nonmember banks and their operations subsidiaries.\textsuperscript{173}

The FDIC has not generally prohibited state nonmember banks from involvement in real estate investment or development. In June 1985, the FDIC proposed regulations that would have limited all FDIC-insured banks to investments not exceeding fifty percent of the investing bank’s primary capital with respect to all real estate projects and ten percent of the bank’s primary capital with regard to any single project. The proposed regulations would have required any investments exceeding these limits to be made by a separate subsidiary meeting essentially the same requirements as the FDIC imposes on securities subsidiaries of state nonmember banks.\textsuperscript{174} As noted above, the FDIC withdrew these proposed

\textsuperscript{169}. See 12 U.S.C. § 29 (1988). Real property obtained by a national bank in satisfaction of a debt previously contracted may not remain in the bank’s possession for a period of longer than five years (unless that period is extended to not more than ten years with the approval of the OCC). See id.

\textsuperscript{170}. See 1 Fed. Res. Reg. Serv. 3-447.62 (summary of FRB staff opinion dated Nov. 20, 1984). In one case, the FRB staff permitted a state member bank, whose charter expressly authorized it to engage in real estate development activities, to do so but only on a strictly limited basis. The bank was required to limit such activities to passive, nonmanagerial investments not exceeding twenty percent of its equity capital, and the bank agreed to conform its real estate activities to future regulatory actions that might be taken by the FRB. See id.; see also 1989 House Hearings, supra note 5, at 326 (letter from Vice Chairman Manuel Johnson of the FRB to Representative Leach, explaining general FRB policy of prohibiting involvement by state member banks in real estate investment or development activities).

For analysis questioning the FRB’s authority to restrict state bank powers as a condition of membership in the Federal Reserve System, see infra Part IV(B)(1).

\textsuperscript{171}. See 12 C.F.R. § 225.126(c)-(e) (1989).

\textsuperscript{172}. For a discussion of the FRB’s proposed regulations concerning real estate activities by bank holding companies, see infra notes 231-37 and accompanying text.

\textsuperscript{173}. For a discussion of the authority of holding company-owned state nonmember banks and their operations subsidiaries to engage in state-authorized activities, see infra Part IV(C).

\textsuperscript{174}. See FDIC Notice of Proposed Rulemaking, supra note 166, at 23,979-88, 23,991-22 (proposing restrictions on the involvement of FDIC-insured banks in real estate activities). For a discussion of the FDIC’s requirements for securities subsidiaries of state nonmember banks, see supra notes 146-51 and accompanying text.
regulations in December 1987. At that time, the FDIC stated that the involvement of state banks in real estate investment and development activities did not present any "system wide problems," and that potential supervisory problems could be handled "on a case-by-case basis."¹⁷⁵

C. The Failure of Congress to Expand Banking Powers

As shown by the foregoing survey of federal constraints on banking powers, national banks, state member banks, and bank holding companies are substantially (and in some cases entirely) precluded from involvement in securities underwriting and dealing, insurance underwriting and sales, and real estate investment and development. Notwithstanding the deteriorating profitability of banks during the 1980s and repeated proposals for legislative reform,¹⁷⁶ Congress has failed to expand banking powers. The most significant action taken by Congress since 1980 with regard to the asset-side powers of banks has been to restrict the insurance powers of bank holding companies. In view of entrenched opposition to increased banking powers from the securities, insurance and real estate industries, as well as doubts expressed by many members of Congress concerning the desirability and safety of such powers, it is doubtful whether a congressional expansion of bank authority will be forthcoming in the immediate future.

In the Garn-St Germain Act of 1982, Congress expanded the liability-side powers of banks and thrift institutions by empowering them to accept MMDAs that would be competitive with MMMFs offered by securities firms.¹⁷⁷ However, while the Garn-St Germain Act also expanded the asset-side powers of federally-chartered thrifts,¹⁷⁸ Congress took no action to increase the asset-related powers of banks. Indeed, the only action of Congress on bank powers was to place stringent limitations on the insurance activities that could be conducted by bank holding companies and their nonbank subsidiaries.¹⁷⁹


¹⁷⁶. For discussion of the decline in bank profitability since the 1970s and proposals for expansion of banking powers, see supra Parts I(B)-(E).

¹⁷⁷. See Garn-St Germain Act, supra note 159, § 327, 96 Stat. 1501. For a discussion of the impact of congressional authorization for bank MMDAs, see supra notes 30-31 and accompanying text.

¹⁷⁸. See Garn St-Germain Act, supra note 159, §§ 322, 325, 329 & 330, 96 Stat. 1499, 1500, 1502 (increasing authority of federally-chartered thrifts to make commercial real estate loans, commercial and consumer loans, and to engage in leases or sales of personal property).

¹⁷⁹. See id. § 601, 96 Stat. 1536 (amending Section 4(c)(8) of the BHC Act, 12 U.S.C. § 1843(c)(8) (1988)). For a discussion of this provision, see supra notes 158-61 and accompanying text.)
In September 1984, the Senate passed a bill that would have authorized bank holding companies to establish securities subsidiaries authorized to underwrite and deal in municipal revenue bonds (except for most industrial development bonds), mortgage-backed securities and commercial paper. However, this legislation failed because the House refused to consider authorizing expanded powers for banks, ostensibly due to concern about bank safety and soundness in light of the federal bailout of Continental Illinois in May 1984.

In 1987, Congress decided to place a temporary moratorium on any further expansion of securities, insurance or real estate powers by the federal banking agencies while Congress attempted to fashion comprehensive legislation on bank powers. Accordingly, the Competitive Equality Banking Act of 1987 ("CEBA") prohibited federal banking agencies, between March 6, 1987 and March 1, 1988, from permitting any FDIC-insured bank or bank holding company to engage in any securities, insurance or real estate activities that had not been legally authorized prior to March 5, 1987. However, Congress made clear that, without additional federal legislation on banking powers, the moratorium enacted by CEBA would have no effect, following its expiration, on the preexisting securities, insurance and real estate authorities of banking organizations.

Congress failed to take action on new banking powers before the CEBA moratorium expired on March 1, 1988. On March 30, 1988, the Senate did pass a bill that would have allowed bank holding companies to establish securities subsidiaries with authority to engage in most securities underwriting and dealing activities. The authority of such subsidiaries to underwrite mutual funds and corporate debt securities would have


In many respects, the Senate bill would also have restricted banking powers. For example, the bill would have (i) prohibited state banks from engaging in activities outside their home state that were not permitted to bank holding companies under Section 4(c)(8) of the BHC Act, and (ii) extended the limitations on the insurance powers of bank holding companies under Section 4(c)(8) to holding company-owned state banks and their subsidiaries. See id. at 25-26, 59.


been delayed until 180 days after enactment, and the power to underwrite corporate equity securities would have been contingent on a further congressional vote.\textsuperscript{185} The Senate bill took no action on real estate powers and would have placed restrictions on the insurance activities of national banks and holding company-owned state banks.\textsuperscript{186}

Notwithstanding the 1988 Senate bill’s phased approach to the expansion of securities authority for bank holding companies, and the absence of any expansion of bank insurance or real estate powers, the Senate bill failed to win House approval. Two House committees reported legislation with fewer securities powers for bank holding companies than those permitted by the Senate bill. In addition, the House provisions would have restricted bank insurance and real estate powers and would have imposed significant additional consumer protection requirements on banks.\textsuperscript{187} The respective chairmen of the two House committees—Representatives Dingell and St Germain—were unable to agree on a unified approach to the legislation, and the legislation died without a vote by the


\textsuperscript{186} S. 1886 would have prohibited holding company-owned state banks from engaging in insurance activities not permitted to bank holding companies under Section 4(c)(8) of the BHC Act, unless (i) a holding company-owned state bank conducted such activities pursuant to state law in the home state of both the holding company and the bank, and (ii) such activities were directed only at residents of that state. S. 1886 would also have prohibited national banks from engaging in insurance activities except for credit-related insurance, unless (i) a national bank was located in a place with a population of 5,000 or less, and (ii) the bank restricted its general insurance activities to that place and sold general insurance products only to residents of its home state. See S. 1886, supra, §§ 802 & 803, reprinted in 134 Cong. Rec. S 3378-79 (daily ed. Mar. 30, 1988).

\textsuperscript{187} See H.R. Rep. No. 822 (pt. 1), 100th Cong., 2d Sess. (1988) (text and explanation of House bill reported by House Comm. on Banking, Finance and Urban Affairs; House bill would have permitted qualified securities subsidiaries of bank holding companies to underwrite and deal in securities of any type except for corporate equity securities, and would also have restricted the insurance activities of national banks and holding company-owned state banks, placed a two-year moratorium on any new real estate activities by bank holding companies and any of their subsidiaries, and mandated significant new consumer protections); H.R. Rep. No. 822 (pt. 2), 100th Cong., 2d Sess. (1988) (text and explanation of amendments to House bill as reported by House Comm. on Energy and Commerce; these amendments would have permitted qualified securities subsidiaries of bank holding companies only to underwrite and deal in revenue bonds, commercial paper and asset-backed securities and to sell mutual funds, while prohibiting such subsidiaries from underwriting or dealing in mutual funds or corporate debt or equity securities; the amendments would also have further limited the insurance activities of holding company-owned state banks). For reports of opposition by the banking industry to the House legislation, see House Banking Approves Bill Granting Key BHC and Bank Securities Powers, 51 Banking Rep. (BNA) No. 5, at 161 (Aug. 1, 1988); Energy and Commerce, Judiciary Alter Provisions in Banking Bill, 51 Banking Rep. (BNA) No. 12, at 522 (Sept. 26, 1988).
The failure of the Senate bill to obtain House approval appears to have been due, in substantial part, to strong reservations expressed by many House members about the ability of banking organizations to exercise broader powers safely and without harmful conflicts of interest.\textsuperscript{189}

Congress did not consider the issue of bank powers in 1989 because of its preoccupation with the thrift crisis and the insolvency of the Federal Savings and Loan Insurance Corporation ("FSLIC").\textsuperscript{190} Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA")\textsuperscript{191} to address these problems. FIRREA abolished the FSLIC and transferred the responsibility for insuring the deposits of thrift institutions to a new Savings Association Insurance Fund ("SAIF") under the administration of the FDIC.\textsuperscript{192} FIRREA also authorized $50 billion in immediate and long-term funding to enable the new Resolution Trust Corporation ("RTC") to achieve an orderly disposition of the assets of failed thrifts.\textsuperscript{193}

In addition, FIRREA imposed minimum capital requirements on fed-

\begin{itemize}
  \item \textsuperscript{189} After the legislation died in the House, Representative Dingell, chairman of the House Energy and Commerce Committee, declared that the Senate bill "did not adequately protect taxpayers and bank depositors and failed to provide effective functional regulation," and therefore was properly "cashier[ed]." Letter from Representative Dingell to the Editor, Wash. Post, Nov. 12, 1988, at A21. See also H.R. Rep. No. 822 (pt. 1), supra note 187, at 136-38 (report of House Comm. on Banking, Finance and Urban Affairs, proposing two-year moratorium on bank involvement in real estate activities because of potential risks presented by such activities to bank safety and soundness); id. at 349-60 (additional views of Representatives Annunzio, Schumer et al., opposing bank involvement in underwriting corporate debt or equity securities because of the attendant risks of bank failure, conflict of interest and concentration of financial power); H.R. Rep. No. 822 (pt. 2), supra note 187, at 66-70, 73-80 (report of House Comm. on Energy and Commerce, contending that banking organizations should not be permitted to underwrite or deal in corporate debt or equity securities or to sponsor or underwrite mutual funds, because of the high risks of the attendant loss and conflict of interest inherent in these activities).
  \item \textsuperscript{191} See supra note 8.
  \item \textsuperscript{192} See FIRREA, supra note 8, § 211(3), 103 Stat. 218-20 (amending 12 U.S.C. § 1821(a) by establishing SAIF to insure deposits of thrift institutions formerly insured by FSLIC, and establishing the Bank Insurance Fund, also administered by the FDIC, to insure bank deposits formerly insured by the FDIC); id. § 401(a)(1), 103 Stat. 354 (abolishing FSLIC).
  \item \textsuperscript{193} See id. §§ 501(a), 103 Stat. 364-93 (establishing and defining powers of RTC and providing $20 billion of current funds, see id., 103 Stat. 375-76, for use by the RTC); id. § 511(a), 103 Stat. 394-406 (establishing the Resolution Funding Corporation to provide up to $30 billion of additional long-term financing, see id., 103 Stat. 400, for use by the RTC).
\end{itemize}
erally-insured thrift institutions and authorized the FDIC to prohibit
thrifts from exercising any powers found by the FDIC to present a sig-
ificant risk to SAIF or the Bank Insurance Fund ("BIF").194 FIRREA
also reduced the commercial real estate lending authority of federally-
chartered thrifts.195 In view of the extensive legislative reforms needed
to address the thrift crisis, it is not surprising that FIRREA did not deal
with the powers of banks insured by BIF. FIRREA did, however,
strengthen the enforcement authorities of the FDIC, FRB, and OCC
with respect to banks.196

It now appears unlikely that Congress will adopt legislation on bank
powers during 1990. The Bush administration recently acknowledged
that the funding provided by FIRREA is far short of the amount needed
to resolve all of the thrift insolvency problems, and that congressional
action to provide additional funds will be needed.197 These funding con-

194. See id. § 301, 103 Stat. 303-10 (amending 12 U.S.C. § 1464(t) by establishing min-
imum capital standards for federally-chartered or insured thrifts); id. § 221, 103 Stat. 268
(adding new section 18(m)(3) of the FDI Act, which authorizes the FDIC, by regulation,
to prohibit insured state-chartered thrifts or their subsidiaries from engaging in any spe-
cific activity determined by the FDIC to pose a serious threat to SAIF); id. § 222, 103 Stat.
269-73 (adding new section 28 of the FDI Act, which prohibits insured state-
chartered thrifts from (i) engaging in any activity not authorized to federally-chartered
thrifts, unless the FDIC determines that the activity does not pose any significant risk to
SAIF or BIF, or (ii) engaging in any activity permitted to federal thrifts but in an amount
greater than the amount permitted to federal thrifts, if the FDIC has determined that
engaging in that amount of the activity poses a significant risk to SAIF or BIF, or (iii)
acquiring or retaining any equity investment not permitted to federal thrifts, except for
shares of a service corporation determined by the FDIC not to pose a significant risk to
SAIF or BIF).

195. See id. § 301, 103 Stat. 286 (amending 12 U.S.C. § 1464(c)(2)(B)) (reducing com-
mercial real estate lending authority of federal thrifts from a maximum of 40 percent of
assets to a maximum of four times capital). For explanation of this restriction on the
prior authority of federal thrifts, see H.R. Rep. No. 222, 101st Cong., 1st Sess. 408 (Con-

196. See FIRREA, supra note 8, §§ 901-914, 103 Stat. 446-86 (increasing enforcement
authorities of FDIC, FRB, OCC and Office of Thrift Supervision with respect to feder-
ally-chartered or insured banks and thrifts). For discussion of certain supervisory and
enforcement authorities of the FDIC and FRB with regard to state banks and bank hold-
ing companies, see infra Part IV(B). For a general discussion of FIRREA’s expansion of
civil enforcement authorities for federal bank regulatory agencies, see McSpadden &
Byrne, FIRREA Expands Civil Enforcement Powers of Regulators, Increases Penalties Al-

197. See, e.g., Thomas, Brady Says Cost of S & L Bailout Could Double, Wall St. J.,
May 24, 1990, at A3, col. 1 (reporting testimony by Treasury Secretary Nicholas Brady
stating that total thrift bailout costs are estimated at between $90 billion and $130 billion,
exclusive of interest, compared with $73 billion of total funding to be provided by FIR-
REA, and that costs with interest over 10 years could approach $300 billion compared
with the Bush Administration’s original estimate of $166 billion); Thomas, Brady Says S
& L Bailout Cost Expected to Increase By as Much as $50 Billion, Wall St. J., June 15,
1990, at A4, col. 2 (reporting testimony by Treasury Secretary Brady indicating that an
additional $30 to $50 billion in funds will be needed to meet projected thrift bailout costs
in 1991). [Editors’ Note: On July 30, 1990, FDIC Chairman L. William Seidman esti-
mated that the RTC would need $80 to $100 billion of additional funds to meet its likely
thrift bailout costs during fiscal 1991, including $50 to $60 billion of working capital to
cerns are likely to preclude action on new bank powers during 1990. In addition, the imprudent use by thrift institutions of expanded powers under federal and state law may well discourage Congress from taking any immediate action to increase bank powers.

In view of these disincentives to congressional action, and the entrenched opposition of the insurance and real estate industries, it is doubtful whether Congress will take any action in the near future to expand bank powers in the insurance or real estate areas. However, two major securities industry groups have recently indicated their willingness to support a repeal of the Glass-Steagall Act under circumstances that would allow bank holding companies to own securities subsidiaries and securities firms to own banks, provided that a strict separation is maintained between subsidiaries conducting a traditional banking business and those engaged in the securities business. This sudden change in

finance the retention of failed thrift assets until they are sold. See RTC May Need Up to $100 Billion in FY 1991, Seidman, Glauber Say, 55 Banking Rep. (BNA) No. 6, at 221 (Aug. 6, 1990).


200. See, e.g., Insurers, Lawmakers Raise Concerns About Implications of Merchants National Ruling, 54 Banking Rep. (BNA) 611, 611-12 (April 9, 1990) (reporting testimony by insurance industry representatives urging Congress to adopt legislation prohibiting state banks from engaging in insurance activities); 1987 Senate Hearings, supra note 63, at 546-48 (testimony of Kent W. Colton on behalf of Nat'l Ass'n of Home Builders, opposing involvement of banks in real estate investment or development); id. at 560-62 (statement of Robert R. Googins on behalf of American Council of Life Ins., opposing entry by banks into the securities or general insurance businesses); id. at 569-70 (statement by Norman D. Flynn on behalf of Nat'l Ass'n of Realtors, opposing involvement of banks in real estate brokerage, management, investment or development).

201. In December 1989, the Securities Industry Association ("SIA") announced that it was willing for the first time to support a reform of the Glass-Steagall Act that would broaden bank securities powers, if bank securities activities were strictly separated from traditional banking activities and if securities firms were permitted to acquire "consumer financing banks." The SIA conditioned its proposal for legislative reform on an immediate moratorium on further regulatory actions expanding bank securities powers. See Meyer, supra note 199, at 2-5.

The Investment Company Institute ("ICI") announced a similar change of position in April 1990. The ICI's proposal would allow holding companies to own both bank and securities subsidiaries, but only if such subsidiaries were strictly separated and the bank's assets were invested in a narrow range of safe, liquid investments. See ICI Urges Glass-Steagall Repeal, BHC Act Amendments, Narrow Banks, 54 Banking Rep. (BNA) 722 (April 30, 1990).
the securities industry's position may provide the basis for repeal of the Glass-Steagall Act in 1991.

D. State Initiatives to Expand State Bank Powers

While Congress has been unable to act on proposals to expand banking powers, several states have enacted laws authorizing state banks to engage in securities underwriting, insurance agency and underwriting, and real estate investment and development activities that are not permissible for national banks or bank holding companies. This expansion of state bank powers in the context of congressional paralysis has been very similar to the interstate banking movement, where Congress was unable to enact legislation and the states took the lead in liberalizing geographic restraints on interstate acquisitions of banks.\(^\text{202}\)

With respect to securities powers, recent surveys prepared by the Conference of State Bank Supervisors ("CSBS")\(^\text{203}\) and the FDIC\(^\text{204}\) together indicate that twenty-six states allow state banks, directly or indirectly, to underwrite at least some types of national bank-ineligible securities.\(^\text{205}\)

---

\(^{202}\) For a discussion of congressional inaction and state laws authorizing interstate acquisitions of banks by bank holding companies, see supra notes 38-40, 87, 100 & 102 and accompanying text.

\(^{203}\) CSBS prepared a detailed survey describing state laws which, as of March 1989, provided expanded securities, insurance, and real estate powers for banks. CSBS' detailed survey was attached as Appendices 1-4 to a comment letter dated April 28, 1989, from Lawrence E. Kreider of CSBS to William W. Wiles of the FRB. This comment letter was filed in FRB Docket No. R-0652, Solicitation of Public Comment, Bank Holding Companies and Change in Bank Control: Rescission of Existing Regulation Regarding Investments in Voting Shares of Nonbanking Companies by State Banks Owned by Bank Holding Companies, 53 Fed. Reg. 48915 (1988). A copy of the CSBS comment letter and detailed survey [hereinafter CSBS Detailed Survey] is on file with the Fordham Law Review.

CSBS subsequently prepared a summary of state laws granting expanded securities, insurance, and real estate powers to state banks as of March 1990. This summary survey is printed in State of the State Banking System, supra note 39, at 9-10 [hereinafter CSBS Summary Survey].

\(^{204}\) See Saulsbury, State Banking Powers: Where Are We Now?, Regulatory Review (FDIC), April/March 1987, at 1-16 (containing FDIC staff survey of state laws permitting state banks to engage in securities, insurance, and real estate activities as of April 8, 1987).

\(^{205}\) See CSBS Detailed Survey, supra note 203, at Appendix 3 (indicating that laws in Arizona, California, Delaware, Indiana, Iowa, Kansas, Michigan, Missouri, Montana, New Jersey, North Carolina, Pennsylvania, Washington, and West Virginia would authorize banks to underwrite at least some types of securities not eligible for underwriting by national banks). For description of national bank-ineligible securities, see supra notes 123-25 and accompanying text.

In addition to the states identified in the CSBS Detailed Survey, the CSBS Summary Survey identifies Florida, Maine, and Massachusetts, and Saulsbury's FDIC staff survey identifies Alabama, Arkansas, Florida, Georgia, Illinois, Mississippi, New York, Rhode Island, and Vermont as states permitting state banks to engage directly or indirectly in underwriting at least some types of national bank-ineligible securities. See CSBS Detailed Survey, supra note 203; Saulsbury, supra note 204, at 7-9, 11-12. With regard to New York, the New York State Banking Department issued a ruling in December 1986 (noted by Saulsbury) that permits state banks to affiliate with a securities firm if the firm's under-
Of these states, at least nine limit the types of national bank-ineligible securities that may be underwritten, at least nine require such underwriting to be conducted through a subsidiary or affiliate of the bank, and at least eight limit the amount of a single issuance or all issuances of securities to a specified percentage of bank capital.

With regard to insurance powers, the CSBS and FDIC surveys indicate that six states allow banks to engage in insurance underwriting activities not permitted to national banks and bank holding companies, and sixteen states permit state banks to engage in insurance agency activities that would be prohibited to national banks and bank holding companies. Of these states, at least six require that the insurance underwriting activities with respect to national bank-ineligible securities do not exceed 25 percent of the firm's total business activities. See N.Y. State Banking Dept. Ruling dated Dec. 23, 1986, reprinted in 1987 Fed. Banking L. Rep. (CCH) ¶ 86,771.

206. See CSBS Detailed Survey, supra note 203, at Appendix 3 (indicating that (i) Indiana limits state banks to underwriting of municipal bonds, (ii) Kansas limits state banks to underwriting of municipal bonds and mutual funds, and (iii) Pennsylvania limits state banks to underwriting of municipal bonds and mortgage-related securities); Saulsbury, supra note 204, at 11-12 (indicating that, in addition to the states identified in the CSBS Detailed Survey, Alabama, Arkansas, Georgia, Illinois, Mississippi and Vermont limit state bank underwriting of national bank-ineligible securities to municipal revenue bonds).

207. See CSBS Detailed Survey, supra note 203, at Appendix 3 (indicating that underwriting of national bank-ineligible securities by state banks in Arizona, Indiana, Kansas, and North Carolina may be conducted only through a subsidiary of the bank); Saulsbury, supra note 204, at 11-12 (indicating that, in addition to the states listed in the CSBS Detailed Survey, the following states allow bank underwriting of such securities only through a subsidiary or affiliate: California, Massachusetts, New Jersey, Rhode Island, and Texas).

208. See CSBS Detailed Survey, supra note 203, at Appendix 3 (indicating that California, Kansas, New Jersey, and West Virginia limit state bank underwriting of either a single issue of securities or all issues to a specified percentage of bank capital); Saulsbury, supra note 204, at 8-9, 11-12 (stating that, in addition to the states identified in the CSBS Detailed Survey, the following states limit state bank involvement in securities underwriting activities to a specified percentage of bank capital: Arkansas, Massachusetts, North Carolina, and Rhode Island).

209. See CSBS Detailed Survey, supra note 203, at Appendix 4 (indicating that North Carolina, South Carolina, and South Dakota permit state banks to engage in insurance underwriting); Saulsbury, supra note 204, at 7-8, 15-16 (stating that, in addition to the states listed in the CSBS Detailed Survey, Florida, Massachusetts, and New Jersey permit banks, directly or indirectly, to engage in insurance underwriting). For discussion of the federal limitations on insurance underwriting by national banks and bank holding companies, see supra Part II(B)(2).

210. See CSBS Detailed Survey, supra note 203, at Appendix 4, and CSBS Summary Survey, supra note 203 (together indicating that Alabama, California, Indiana (except for life insurance sales), Iowa (limited to property and casualty insurance sales), Nebraska (except in towns of 200,000 or more), New Jersey, North Carolina, Oregon, South Carolina, South Dakota, Wisconsin, and Wyoming permit state banks to engage, directly or indirectly, in general insurance agency activities not permitted to national banks); Saulsbury, supra note 204, at 8, 15-16 (stating that, in addition to the states identified in the CSBS surveys, the following states permit state banks to engage, directly or indirectly, in such agency activities: Hawaii, Massachusetts, Minnesota, and North Dakota). For discussion of the federal limitations on insurance sales by national banks and bank holding companies, see supra Part II(B)(2).
underwriting or agency activities must be conducted through a subsidiary or affiliate, and at least four limit such activities to a specified percentage of bank capital.

In May 1990, Delaware enacted a law that permits Delaware state banks to underwrite and sell all types of insurance except title insurance. The Delaware statute requires that any insurance business must be conducted in a separate subsidiary or department of the bank with separate assets, capital, officers and records. In addition, a Delaware state bank may not invest more than twenty-five percent of its total capital, surplus and individual profits in an insurance subsidiary, department or affiliate. A companion law prohibits Delaware state banks controlled by out-of-state bank holding companies from marketing most insurance products (except for credit-related insurance) to Delaware residents. However, such banks would not be limited in the types of insurance they may sell to out-of-state residents.

Citicorp and other large bank holding companies announced plans to establish nationwide insurance underwriting and agency operations through Delaware state banks. However, insurance industry groups have petitioned the FRB to prevent Citicorp and other bank holding companies from commencing an insurance business through Delaware banks. In addition, the FDIC has announced that it is likely to adopt regulations that would restrict the ability of FDIC-insured banks to underwrite insurance, because of safety and soundness concerns.

Finally, with regard to real estate powers, the CSBS and FDIC surveys indicate that twenty-seven states permit state banks to participate ac-

211. See CSBS Detailed Survey, supra note 203, at Appendix 4 (indicating that Oregon requires general insurance agency activities to be conducted by a subsidiary that is physically separated from the state bank and that has a name and employees that are separate from the bank, and that state banks in South Carolina may engage in general insurance agency or underwriting activities only through a subsidiary or affiliate); Saulsbury, supra note 204, at 8-9, 15-16 (stating that state banks in Alabama may engage in general insurance agency activities only through a subsidiary, and that state banks in Massachusetts, New Jersey, and North Carolina may engage in general insurance agency or underwriting activities only through a subsidiary or affiliate).

212. See CSBS Detailed Survey, supra note 203, at Appendix 4 (indicating that state bank involvement in general insurance agency or underwriting activities in New Jersey and South Carolina is limited to a specified percentage of bank capital); Saulsbury, supra note 204, at 8-9, 15-16 (indicating that state bank involvement in general insurance agency or underwriting activities in Massachusetts and North Carolina is limited to a specified percentage of bank capital).


214. See, e.g., Garcia, supra note 213.

215. See, e.g., id.; Insurance Groups Urge Fed, supra note 213. For a discussion of the possible response of the FRB to these petitions, see infra note 456.

216. See, e.g., Thomas supra note 168.
tively in real estate development ventures or to make passive investments in such ventures.\textsuperscript{217} Of these states, at least seven permit such participations or investments to be conducted only through a subsidiary or affiliate,\textsuperscript{218} and at least twenty-six limit such participations or investments to a specified percentage of bank capital, deposits or assets.\textsuperscript{219}

Thus, the states have taken significant initiatives in expanding the powers of state banks in the securities, insurance, and real estate areas. It should be noted that the potential impact of state law is not as great with respect to the liberalization of bank powers as it has been in the removal of geographic barriers to interstate banking. The Douglas Amendment authorizes the states to determine the degree to which the federal barrier to interstate bank acquisitions may be lifted.\textsuperscript{220} In contrast, federal law imposes significant restraints on national banks, bank holding companies and to some degree on state member banks with respect to their involvement in securities, insurance, and real estate activities.\textsuperscript{221} These federal restraints, unlike the Douglas Amendment, are not subject to liberalization by operation of state law.\textsuperscript{222} Nevertheless, by expanding the powers

\textsuperscript{217} See Saulsbury, supra note 204, at 13-14 (stating that the following states permit state bank involvement, directly or indirectly, in active participations or passive investments in real estate development projects: Alaska (passive investments only), Arizona, Arkansas, California, Colorado, Connecticut, Florida, Kentucky, Massachusetts, Missouri (passive investments only), Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Rhode Island, South Dakota (passive investments only), Tennessee, Utah, Washington, and Wyoming; CSBS Detailed Survey, supra note 203, at Appendix 2 (indicating that, in addition to the states listed in Saulsbury's survey, Michigan, Virginia, and West Virginia permit state banks to make investments or take active participations in real estate projects); CSBS Summary Survey, supra note 203 (indicating that, in addition to the states listed in the CSBS Detailed Survey, Maine and Wisconsin allow banks to engage in real estate investment or development activities).

\textsuperscript{218} See Saulsbury, supra note 204, at 7-9, 13-14 (stating that state banks in Arizona, Massachusetts, Missouri, Nevada, and North Carolina may invest or participate in real estate development only through a subsidiary or affiliate); CSBS Detailed Survey, supra note 203, at Appendix 2 (indicating that, in addition to the states identified in Saulsbury's survey, Florida and New Hampshire permit state banks to participate or invest in real estate development only through a subsidiary).

\textsuperscript{219} See CSBS Detailed Survey, supra note 203, at Appendix 2 (indicating that all states permitting bank involvement in real estate investment or development, except Arizona, impose limitations based on percentage of bank capital, deposits or assets); Saulsbury, supra note 204, at 7-9, 13-14 (same); see also Felgran, supra note 66, at 65-66 (stating that all states except Arizona limit the amount of state bank involvement in real estate development ventures); CSBS Summary Survey, supra note 203, at 9 (stating that "[a]ll but one of these [states] have imposed investment limitations on [real estate] activities").

\textsuperscript{220} For a discussion of the authority granted to the states under the Douglas Amendment, see supra notes 14 & 37-40 and accompanying text.

\textsuperscript{221} For a discussion of the federal restraints on the securities, insurance and real estate powers of national banks, bank holding companies and state member banks, see supra Part II(B).

\textsuperscript{222} See, e.g., Northwest Cent. Pipeline Corp. v. State Corp. Comm'n, 109 S. Ct. 1262, 1271-79 (1989) (distinguishing between provisions of the Natural Gas Act which establish exclusive federal control over the interstate transportation and sale of natural gas, thereby preempting any inconsistent state laws, and another provision of the Act that
of state nonmember banks, which are less constrained by federal law,\textsuperscript{223} the states are exerting substantial pressure on the federal regulators, and ultimately Congress, to increase the powers of banking organizations generally.\textsuperscript{224}

III. THE RESPONSE OF THE FEDERAL AGENCIES AND CONGRESS TO THE EXPANSION OF STATE BANK POWERS

The widespread state initiatives to expand the powers of state banks have not occurred without resistance from federal authorities. The FRB has been particularly hostile and has issued proposed regulations that would substantially diminish the ability of holding company-owned state banks and their operations subsidiaries to exercise expanded state powers. The FDIC has been more accommodating, but it too has asserted authority to take action that might restrict the newly-expanded powers of FDIC-insured state banks.

As demonstrated below, the broad claims of authority made by the FRB and FDIC are based on highly questionable grounds.\textsuperscript{225} Moreover, Congress has failed to override state laws expanding bank powers, despite numerous calls for such action by the FRB and by nonbank competitors. In the absence of further legislation by Congress, it appears that the states will probably be able to continue their efforts to increase the operating authorities of state banks.

A. The Responses of the FRB and the FDIC to the Expansion of State Bank Powers

1. The Response of the FRB

The FRB has generally been critical of the state initiatives in expanding bank powers. The FRB has argued that increased state powers, especially in the areas of real estate investment and development, are inherently risky and potentially threaten the safety and soundness of the banking industry. The FRB has also suggested that expanded state powers, when exercised by holding company-owned state banks, undermine the effectiveness of the BHC Act’s regulation of the nonbanking activities of bank holding companies.\textsuperscript{226}

\textsuperscript{223} For a discussion of relative absence of federal restraints on the securities, insurance and real estate powers of state nonmember banks, see supra Part II(B).

\textsuperscript{224} See, e.g., R. Litan, supra note 15, at 57-58 (expressing the view that state liberalization of bank powers will continue and will “place increasing pressure on Congress to liberalize activity authority for national banks or bank holding companies, or both, to level the federal-state playing field”) (quote at 58); Saulsbury, supra note 204, at 1, 4 (indicating the competitive impact of state initiatives in expanding state bank powers).

\textsuperscript{225} See infra Part V.

\textsuperscript{226} See, e.g., FRB Proposed Rule: Bank Holding Companies and Change in Bank Control; Permissibility of Real Estate Investment Activities for Bank Holding Companies and Their Direct and Indirect Nonbank Subsidiaries, 52 Fed. Reg. 543 (1987) [hereinafter

expressly reserves to the states the authority to regulate the intrastate transportation, distribution and production of natural gas).
In view of these concerns, the FRB has asserted authority to restrict the state-authorized activities of state member banks and holding company-owned state banks. First, as previously noted, the FRB has adopted a regulation prescribing conditions for membership of state banks in the Federal Reserve System. One of the conditions specified in the regulation requires prior FRB approval before a state member bank may change the general character of its business or the scope of its corporate powers. The FRB staff has taken the position that this condition requires state member banks to obtain FRB approval before commencing any new insurance or real estate activities authorized under state law. As a general policy, the FRB has not permitted state member banks to engage in real estate development activities.

With respect to bank holding companies, the FRB has issued proposed regulations that, if adopted, would allow bank holding companies, under Section 4(c)(8) of the BHC Act, to engage in real estate investment and development activities but only under stringent limitations. The FRB's proposed regulations would (i) allow a bank holding company to make only passive noncontrolling investments in real estate ventures through a nonbank subsidiary of the holding company, (ii) limit the amount of such investments both in any single real estate venture and in all such ventures, and (iii) exclude part or all of the real estate investments made by the holding company or any of its subsidiary banks in determining whether the holding company's capital would satisfy the FRB's capital adequacy requirements.

The FRB has made several additional proposals that, if adopted, would place direct restrictions on the real estate activities of banks as

---

227. See 12 C.F.R. § 208.7 (1989), discussed supra at note 163 and accompanying text.
228. See id.
229. For discussion of the FRB staff's reliance on 12 C.F.R. § 208.7 (1989) to restrict the ability of state member banks to engage in insurance or real estate activities authorized under state law, see supra notes 164 & 170 and accompanying text.
231. As previously discussed supra at note 171 and accompanying text, the FRB's current regulations under Section 4(c)(8) of the BHC Act, 12 U.S.C. § 1843(c)(8) (1988), prohibit bank holding companies from engaging in real estate investment or development.
232. See FRB Real Estate Proposal I, supra note 226, passim.
well as bank holding companies. One of the FRB's proposals, for example, would prohibit any holding company-owned state bank from engaging in real estate investment or development activities through a subsidiary of the bank, even if such activities were permitted by state law. A second proposal would require a bank holding company acquiring a state bank, as a condition of the FRB's approval of the acquisition, to transfer real estate investment or development activities conducted by the bank or a subsidiary of the bank to a separate nonbank subsidiary of the holding company. A third proposal would apply the restrictions on affiliate transactions under Sections 23A and 23B of the Federal Reserve Act to transactions between any FDIC-insured bank and any subsidiary of the bank engaged in real estate investment or development activities. A fourth proposal would impose special capital requirements directly on real estate subsidiaries of holding company-owned banks.

The most far-reaching FRB proposal would rescind the FRB's current regulation concerning subsidiaries of holding company-owned state banks. The current regulation provides that Section 4 of the BHC Act, which restricts the nonbanking activities of bank holding companies, does not apply to a wholly-owned subsidiary of a holding company-owned state bank if the subsidiary engages solely in activities that the parent bank may conduct at locations at which the bank is authorized to carry on such activities. The rescission proposal reflects the FRB's concerns about the expanded powers that have been granted to state banks but are not permissible for bank holding companies.

If the rescission proposal is adopted, the FRB would permit a holding company-owned state bank to engage directly in state-authorized activities that are not permissible for bank holding companies, but would not

233. See id. at 545.
237. See FRB Real Estate Proposal II, supra note 234, at 42303.
238. See 12 C.F.R. § 225.22(d)(2)(ii) (1989). For additional discussion of this regulation and the FRB's rescission proposal, see infra notes 481-85 and accompanying text.
allow the bank to conduct such activities indirectly through an operations subsidiary.\textsuperscript{240} As discussed below, it appears that any assertion by the FRB of regulatory authority over operations subsidiaries of holding company-owned state banks would be contrary to the clear intent of the BHC Act.\textsuperscript{241}

2. The Response of the FDIC

In contrast to the FRB, the FDIC has generally supported the expansion of securities, insurance, and real estate powers for state banks. The FDIC has stated that expanded state powers are responsive to the need of banks to meet competition from nonbank firms and the need of consumers for expanded services. In addition, the FDIC has said that the new state powers have not presented any generalized threat to bank safety and soundness.\textsuperscript{242} As noted previously, however, the FDIC has recently indicated that it may take action to restrict the exercise of nationwide insurance underwriting powers granted by a new Delaware statute to Delaware state banks.\textsuperscript{243}

In addition, the FDIC has asserted broad authority to condition or prohibit the exercise of new state powers in order to preserve bank safety and soundness. As previously discussed, the FDIC has issued final regulations that require any state nonmember bank engaged in national bank-ineligible securities activities to do so only through a subsidiary or affiliate that is adequately separated from the bank and meets certain other conditions.\textsuperscript{244} In addition, the FDIC proposed in 1985, but withdrew in late 1987, regulations imposing similar requirements on FDIC-insured banks that engage in insurance underwriting or real estate investment or development.\textsuperscript{245} In these rulemaking proceedings, the FDIC claimed authority to place restrictions or conditions on the exercise of expanded state banking powers pursuant to Sections 6, 8(a), 8(b) and 9 of the FDIC Act.\textsuperscript{246} However, as shown below, these statutory provisions do not authorize the FDIC to impose sweeping prohibitions on the activities of

\textsuperscript{240.} See \textit{id.} at 48,917, 48,919.
\textsuperscript{241.} See infra Part IV(C).
\textsuperscript{242.} See, e.g., 1987 \textit{House Hearings}, \textit{supra} note 17, at 430-31 (letter dated Nov. 13, 1987, from Chairman L. William Seidman of the FDIC to Representative St Germain); 1987 \textit{Senate Safety and Soundness Hearings}, \textit{supra} note 226, at 582 (written response of Chairman Seidman to written question of Senator Proxmire). For further expressions of the FDIC's view that expanded state powers do not present a generalized threat to bank safety or soundness, see \textit{supra} notes 167 & 175 and accompanying text.
\textsuperscript{243.} See \textit{supra} notes 168, 213-216 and accompanying text.
\textsuperscript{244.} For a discussion of the FDIC's regulations concerning securities subsidiaries of state nonmember banks, see \textit{supra} notes 146-51 and accompanying text.
\textsuperscript{245.} For a discussion of the FDIC's proposed regulations with respect to insurance and real estate activities of FDIC-insured banks, see \textit{supra} notes 166-67 & 174-75 and accompanying text.
state banks.247

B. The Response of Congress to Expanded State Bank Powers

As discussed above, Congress has largely failed to take action on proposals to expand or restrict bank powers.248 With the exception of the temporary moratorium enacted by CEBA, which expired on March 1, 1988,249 Congress has not acted since 1982 to restrict the powers of state banks. For example, Congress failed in 1984 and again in 1988 to adopt proposed legislation that would have restricted the powers of state banks.250 The inaction of Congress is particularly significant in view of repeated requests by the FRB and insurance industry groups for legislation that would prevent holding company-owned state banks and their operations subsidiaries from engaging in activities not permitted to bank holding companies under the BHC Act.251

Moreover, Congress has adopted two recent pieces of legislation that indicate a congressional intent not to impose any generalized restrictions on the powers of state banks or their operations subsidiaries. First, in 1982, Congress amended the Bank Service Corporation Act ("BSC Act")252 to allow one or more national or state banks to establish a wholly-owned or partly-owned subsidiary, known as a bank service corporation ("BSC"), to provide banking services to any person.253 Section 4 of the BSC Act, as amended, authorizes a BSC that is owned by one or

---

247. See infra Parts IV(B)(2)-(4).
248. See supra Part II(C).
249. For a discussion of the temporary restrictions placed on securities, insurance, and real estate activities of state banks under CEBA's moratorium, see supra notes 182-84 and accompanying text.
250. For a discussion of the proposed 1984 and 1988 legislation, see supra notes 180-81 & 185-89 and accompanying text.
253. Prior to 1982, a BSC could be established only by two or more banks and could provide services only to the shareholding banks. See Act of Oct. 23, 1962, supra note 252, §§ 1(c) & 4, 76 Stat. 1132 (codified at 12 U.S.C. §§ 1861(c) and 1864 (1982)). The 1982 amendments to the BSC Act allowed a single FDIC-insured bank to organize a wholly-owned BSC, and also permitted BSCs to provide nondeposit banking services to persons other than banks. The 1982 amendments retained the existing authority of two or more banks to establish a jointly-owned BSC. See Garn-St Germain Act, supra note 159, § 709, 96 Stat. 1540-42, amending 12 U.S.C. §§ 1861(b)(2) & 1864 (1988).
more state banks to provide any nondeposit banking services that the parent banks are authorized to provide under state law, as long as the BSC provides these services at locations within the parent banks' home state where the parent banks could offer such services under state law.\textsuperscript{254} In addition to these state-authorized services, a BSC may provide, with the approval of the FRB, nondeposit services that are authorized for bank holding companies under Section 4(c)(8) of the BHC Act.\textsuperscript{255}

Thus, the 1982 amendments to the BSC Act empower one or more state banks to establish a BSC to perform any of the nondeposit services which the parent banks may offer under state law.\textsuperscript{256} The authority granted to a BSC owned by a state bank is identical to the powers of an operations subsidiary of a holding company-owned state bank as recognized by the FRB's regulations under the BHC Act.\textsuperscript{257} The BSC Act strongly indicates that the powers of a BSC (\textit{i.e.}, an operations subsidiary) established by a holding company-owned state bank are not subject to the activity limitations imposed on bank holding companies under Section 4 of the BHC Act, as long as the BSC performs nondeposit services that the parent bank may provide under state law.\textsuperscript{258}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{254} See 12 U.S.C. §§ 1864(b)(1) & (c) (1988).
\item The 1982 amendments to the BSC Act were introduced during the Senate debates on the Garn-St Germain Act by Senator Garn, who was Senate floor manager for the legislation. Senator Garn explained that the 1982 amendments would "expand[] the types of activities that a bank service corporation can perform so as to include all those activities and services that can be performed by a State-chartered bank in any given State." 128 Cong. Rec. 25,131 (1982). After adoption by the Senate, the amendments were accepted by the conference committee on the Garn-St Germain Act. \textit{See} S. Conf. Rep. No. 641, \textit{supra} note 161, at 92 (stating that a BSC "can engage in the same activities as its parent banks"), \textit{reprinted in} 1982 U.S. Cong. Code & Admin. News at 3135.
\item \textsuperscript{255} See 12 U.S.C. §§ 1864(b), 1864(f) & 1865(b) (1988).
\item \textsuperscript{256} The only precondition to state bank establishment of a BSC is that the bank receive prior approval from its appropriate federal regulator (the FRB in the case of a state member bank and the FDIC in the case of a state nonmember bank) before investing in the capital stock of the BSC. \textit{See} 12 U.S.C. § 1865(a) (1988).
\item \textsuperscript{257} As discussed \textit{supra} at note 238 and accompanying text, the FRB's regulations permit an operations subsidiary of a holding company-owned state bank to engage in all of the activities in which the parent bank may engage under state law at the same locations, without regard to the restrictions of Section 4 of the BHC Act. \textit{See} 12 C.F.R. § 225.22(d)(2)(ii) (1989).
\item \textsuperscript{258} The express terms of the BSC Act allow any state or national bank to establish a BSC and do not deny this privilege to holding company-owned banks. \textit{See} 12 U.S.C. §§ 1861(b)(2), 1862, 1863 & 1865 (1988). Moreover, a BSC owned by a state bank may perform any nondeposit services that its parent bank is authorized to provide under state law, even if those services are not permissible for nonbank subsidiaries of a bank holding company under Section 4(c)(8) of the BHC Act. \textit{See} 12 U.S.C. §§ 1864(b)(1), (c) & (f) (1988); \textit{see also} 128 Cong. Rec. 25,131 (1982) (remarks of Senator Garn, explaining that 1982 amendments to BSC Act authorize BSCs owned by State banks to perform "all those activities and services that can be performed by a state-chartered bank in any given State, as \textit{well as} most of the activities and services that can be engaged in by a bank holding company subsidiary") (emphasis added).
\item For further discussion of the FRB's lack of authority under the BHC Act to regulate the activities of operations subsidiaries of holding company-owned state banks, in view of the provisions of the BSC Act, \textit{see infra} Part IV(C). The relevance of the BSC Act to the
\end{itemize}
\end{footnotesize}
The 1982 amendments to the BSC Act are especially significant in view of their concurrent adoption with the amendments limiting the insurance powers of bank holding companies under Section 4(c)(8) of the BHC Act. At the same time that Section 601 of the Garn-St Germain Act restricted the insurance activities of nonbank subsidiaries of bank holding companies under Section 4(c)(8) of the BHC Act,259 Section 709 of the Garn-St Germain Act amended the BSC Act to authorize BSCs owned by state banks to engage in all nondeposit activities that are lawful for the parent banks under state law.260 The simultaneous enactment of Sections 601 and 709 of the Garn-St Germain Act provides compelling evidence that Congress did not intend to subject BSCs established by holding company-owned state banks to the activity restrictions imposed on bank holding companies and their nonbank subsidiaries under Section 4 of the BHC Act.261

The second recent statute indicating that Congress has not authorized any generalized restriction on the powers of state banks or their operations subsidiaries is FIRREA. As discussed above, FIRREA authorizes the FDIC to adopt regulations generally prohibiting insured thrift insti-

259. For a discussion of the restrictions placed on the insurance activities of bank holding companies under Section 601 of the Garn-St Germain Act, see supra notes 158-61 and accompanying text.

260. For a discussion of the amendments to the BSC Act enacted by Section 709 of the Garn-St Germain Act, see supra notes 252-258 and accompanying text.

261. See, e.g., INS v. Cardoza-Fonseca, 480 U.S. 421, 432 (1987) (where Congress includes particular language in one section of a statute and excludes it from another, it is generally presumed that Congress did so intentionally to create different legal standards); Board of Governors v. Investment Co. Inst., 450 U.S. 46, 60-61 n.26, 64-65 (1981) ("FRB v. ICF") (fact that Sections 16 and 21 of Glass-Steagall Act prohibit all direct bank involvement in specified securities activities, while Section 20 permits a bank affiliate to offer such activities if not "engaged principally" therein, demonstrates that Section 20 allows bank affiliates to engage in some securities activities that are prohibited to banks).

Moreover, to argue that a holding company-owned state bank cannot establish a BSC under Section 4 of the BSC Act, if the BSC intends to engage in activities forbidden to bank holding companies under Section 4 of the BHC Act, would be to contend that a portion of the 1982 amendments to the BSC Act was repealed by implication by the simultaneous enactment of the 1982 amendments to Section 4(c)(8) of the BHC Act. Such a strange construction is unsupported by any expression of congressional intent and is also contrary to the general principle that repeals of statutes by implication are not favored. See, e.g., Watt v. Alaska, 451 U.S. 259, 267 (1981).
tutions from conducting any activity that the FDIC has determined to
present a serious threat to the SAIF insurance fund. FIRREA also gen-
erally prohibits state-chartered thrift institutions from engaging in any
activity or making any investment that would not be permissible for fed-
erally-chartered thrifts, unless the state institution maintains adequate
capital and the FDIC determines that the activity or investment poses no
significant risk to the affected insurance fund. \[262\]

In contrast to these broad provisions authorizing the FDIC to impose
general prohibitions on activities by insured thrifts, FIRREA contains
only a single limited provision, Section 902, that authorizes the responsi-
ble federal regulator\[263\] to restrict unsafe or unsound activities by individ-
ual national or state banks. Section 902 amends Section 8(b) of the FDI
Act by providing that a cease and desist order issued by the responsible
federal regulator may "place limitations on the activities or functions of
an insured depository institution."\[264\] Thus, Section 902 indicates that
Congress has only authorized the federal banking agencies to impose ac-
tivity restrictions that insure the safety and soundness of individual
banks on a basis that takes appropriate account of the particular finan-
cial circumstances of each bank.\[265\]

Additionally, as discussed below, the provisions of FIRREA establish-
ing general restrictions on the powers of state-chartered thrifts were en-
acted in response to Congress' perception that overly generous powers
for state thrifts and inadequate regulation of state thrifts had contributed
significantly to the thrift bailout crisis. In contrast, the record of the
states with regard to the regulation of banks has not revealed any serious
systemic risk to the FDIC insurance fund. Thus, there has not been any
demonstrated need for preemptive federal legislation with respect to the
powers of state banks.\[266\]

---

262. For a discussion of the FDIC's authority under FIRREA to prohibit particular
activities of insured thrift institutions, see supra note 194 and accompanying text.

263. The responsible federal regulator, for purposes of enforcing the provisions of the
FDI Act, is the OCC with respect to national banks, the FRB with respect to state mem-
ber banks, and the FDIC with respect to state nonmember banks. See 12 U.S.C.
§ 1813(q) (1988), as amended by FIRREA, supra note 8, § 204(f), 103 Stat. 192.

§ 1818(b) (1988) (emphasis added).

265. As explained infra in Parts IV(B)(3) and (4), Sections 8(a) and 8(b) of the FDI
Act authorize the FDIC and the FRB, in general, to restrict unsafe or unsound activities
of state banks only with appropriate regard to the financial and managerial resources and
profile of each individual bank. Moreover, as discussed infra at notes 342-44 and accom-
panying text, the BSC Act indicates that an operations subsidiary of a state bank is to be
treated in the same manner as its parent bank for purposes of Sections 8(a) and 8(b).

266. For a discussion of the significant contrast between the past regulation of state
thrifts and the regulation of state banks, see infra notes 566-86 and accompanying text.
IV. The Limited Authority of the Federal Reserve Board and the FDIC to Restrict the Powers of State Banks

The FRB and the FDIC, as shown above, have each asserted broad authority to limit the powers that may be exercised by state banks and their operations subsidiaries under state law. The FRB and the FDIC have not yet attempted to exercise the full extent of their claimed authority, perhaps because of the failure of Congress to mandate any general restriction on state bank powers. This Part shows that, in general, neither the FRB nor the FDIC has power to adopt sweeping regulations that would prohibit state banks or their operations subsidiaries from engaging in state-authorized activities. It seems likely, therefore, that the states will be able to continue their expansion of state bank powers absent preemptive action by Congress.

Part IV(A) discusses the relevant legal standards to be applied in determining the validity of the FRB's and the FDIC's interpretations of their authority under the governing statutes. Part IV(B) considers the authority of the FRB and the FDIC to regulate the activities of state banks and their operations subsidiaries under the Federal Reserve Act and the FDI Act. Finally, Part IV(C) analyzes the FRB's authority under the BHC Act to regulate holding company-owned state banks and their operations subsidiaries.

A. Standards for Reviewing Claims of Statutory Authority By the FRB and the FDIC

The basic criteria for judicial review of agency claims of statutory authority are set forth in the Supreme Court's *Chevron* and *Cardoza-Fonseca* decisions. *Chevron* and *Cardoza-Fonseca* establish a two-part test for determining whether an agency has properly construed its authority under the governing statute. First, the reviewing court must determine "whether Congress has directly spoken to the precise question at issue." If Congress has clearly indicated its intent with regard to that question, "that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." If Congress has not clearly expressed its intent, the court must determine whether the agency's interpretation is a reasonable one.

Second, if the intent of Congress on the relevant question is not clear because the governing statute is "silent or ambiguous with respect to the specific issue," the court must determine whether the agency's inter-

---

267. See supra Part III(A).
pretation of the statute is "reasonable." Thus, in the case of statutory ambiguity on the relevant issue, an agency ruling will be upheld unless it is "arbitrary, capricious, or manifestly contrary to the statute."

Both *Chevron* and *Cardoza-Fonseca* make clear that reviewing courts "must reject administrative constructions which are contrary to clear congressional intent." In determining whether Congress has expressed a clear intention on the specific question at issue, the courts should use "traditional tools of statutory construction." The court should first look to the plain meaning of the relevant statutory language as the best evidence of congressional intent. In many cases, however, it is not sufficient to rely on the literal meaning of a single statutory provision, and the reviewing court must ascertain the actual intent of Congress by construing that provision in the context of the entire statute and related statutes on the same subject.

Moreover, the plain language of a statutory provision is not conclusive where the legislative history demonstrates a "clearly expressed legislative intention" contrary to that language. In such a case, the clear intent of Congress manifested in the legislative history of the entire statute will overcome a single provision's apparent literal meaning. In addition, if the terms of a statute are silent or ambiguous on the relevant

275. *Chevron*, 467 U.S. at 843 n.9, quoted in *Cardoza-Fonseca*, 480 U.S. at 447-48; accord Federal Election Comm'n v. Democratic Senatorial Campaign Comm., 454 U.S. 27, 32 (1981) (a reviewing court "must reject administrative constructions of [a] statute . . . that are inconsistent with the statutory mandate or that frustrate the policy that Congress sought to implement").
276. *Chevron*, 467 U.S. at 843 n.9, quoted in *Cardoza-Fonseca*, 480 U.S. at 448.

It must be noted that the Supreme Court in recent years has not followed a consistent line in its approach to construing legislative history. In some cases the Court has readily adhered to a congressional intent discerned in the legislative history even where that intent conflicts with the literal meaning of the statute. *See, e.g., Philadelphia Gear*, 476 U.S. at 430-38. In other cases, the Court has refused to depart from the "plain language" of a statute even where the "plain purpose" of the statute might be different. *See, e.g., Dimension* 474 U.S. at 373-74; see also *Philadelphia Gear*, 476 U.S. at 440-41 (Marshall, Blackmun and Rehnquist, JJ., dissenting) (criticizing majority opinion for failing to adopt plain meaning approach to statutory construction as followed in *Dimension*).

For a recent discussion of the tension between textual (e.g., plain meaning) and contex-
question, the court must consult the statute's legislative history to determine whether a clear legislative intent on the issue can be ascertained. If such an intent can be identified, it is binding on the agency.

B. Limitations on the Authority of the FRB and the FDIC to Regulate the Activities of State Banks

The FRB and the FDIC have claimed authority to impose general prohibitions or restrictions on the state-authorized activities of state member banks (in the case of the FRB) and state nonmember banks (in the case of the FDIC) pursuant to various provisions of the Federal Reserve Act and the FDI Act. Analysis of these provisions, however, reveals that they grant no such general authority to the FRB and the FDIC. The FRB may regulate transactions between state banks and their affiliates. The FRB and the FDIC also may impose capital requirements on state banks and their operations subsidiaries. In addition, the FRB and the FDIC have authority under the FDI Act to take regulatory actions designed to prevent individual state banks or their operations subsidiaries from engaging in unsafe or unsound banking practices. However, absent an unusual case in which a specific activity is so inherently risky as to threaten the soundness of virtually every banking organization that might choose to engage in the activity, neither the FRB nor the FDIC has authority to prohibit all state banks or their operations subsidiaries from conducting that activity.

1. The FRB's Authority to Place Conditions on the Entry of State Banks into the Federal Reserve System

The FRB has adopted regulations placing conditions on the admission of state banks as members of the Federal Reserve System. One of these conditions, noted above, seeks to control the future powers and activities of each state member bank by prohibiting the bank, without the FRB's prior approval, from changing the general character of its business or the scope of its corporate powers after the date of its admission as a member bank. The FRB's asserted authority for this condition of membership is Section 9 of the Federal Reserve Act. In fact, however, the condition appears to be contrary to both the terms and legislative history of Section 9.

The relevant provisions of Section 9 are contained in 12 U.S.C. §§ 321,
322 and 330 (1988). Section 321 provides that a state bank may apply for membership in the Federal Reserve System "under such rules and regulations as [the FRB] may prescribe." Section 321 further states that the FRB may admit state banks to membership "subject to the provisions of the [Federal Reserve Act] and to such conditions as [the FRB] may prescribe pursuant thereto." Section 322 provides that, in acting upon a state bank's application for membership, the FRB must consider whether or not the bank's "corporate powers exercised are consistent with the purposes of the [Federal Reserve Act]." Finally, Section 330 provides:

Subject to the provisions of [the Federal Reserve Act] and to the regulations of the [FRB] made pursuant thereto, any [State] 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 . . . .

The explicit terms of Sections 322 and 330 indicate that the FRB's authority to review the powers of a state member bank is limited to the bank's powers as of the date on which the FRB acts on the bank's application for membership. Nothing in the language of Section 322 or Section 330 indicates that the FRB has discretion to veto or restrict new powers that are granted to a state member bank under state law after its admission to membership. The lack of any such discretion is further suggested by other provisions of the Federal Reserve Act that do place specific limitations in the powers of state member banks after their ad-

285. The other factors to be considered by the FRB in acting on a state bank's application for membership are the bank's financial condition and the general character of its management. See 12 U.S.C. § 322 (1988).


287. If Congress had intended to authorize the Board to restrict the powers granted by state law to state member banks after their admission to membership, Congress could have empowered the FRB, under Section 322, to place restrictions on "the corporate powers exercised or to be exercised" by a prospective state member bank. Another indication of Congress' understanding that it did not grant such power is that Congress subsequently authorized the FRB to issue cease and desist orders under Section 8(b) of the FDI Act to prevent particular state member banks from engaging in unsafe or unsound activities. For discussion of the FRB's cease and desist authority under Section 8(b), see infra Part IV(B)(4).

288. It is noteworthy that, while Section 322 requires the FRB to consider a state bank's powers as of the time of its application for membership, Section 329 requires such a bank to possess adequate capital stock and surplus at the time of its application and not to reduce its capital stock thereafter without prior approval of the FRB. See 12 U.S.C. §§ 322 & 329 (1988). The fact that a subsequent approval requirement is not included in Section 322 indicates that Congress did not intend to require FRB approval for a state member bank's exercise of state powers granted after it becomes a member bank. See INS v. Cardozo-Fonseca, 480 U.S. 421, 432 (1987) (use of condition in one section of a statute but not in another section gives rise to presumption that the condition was not intended to operate in the latter section); cf. Farley v. Albers, 112 F.2d 401, 403 (D.C. Cir.) (under Section 330, a state member bank "may continue to exercise all corporate powers granted it by the state in which it was created" subject to the limitations contained in the Federal Reserve Act; the FRB may not add to or enlarge the bank's powers beyond those authorized by state law), cert. denied, 311 U.S. 653 (1940).
mission to membership. In the absence of any express restrictions on state powers granted after admission to membership, Section 330 creates a general presumption that state member banks may exercise all such powers under state law.

Moreover, the FRB's power to adopt regulations under Sections 321 and 330, and to impose conditions of membership under Section 321, is expressly limited to such regulations or conditions as are made "pursuant to" the Federal Reserve Act. Accordingly, the FRB may not adopt regulations or conditions that extend its jurisdiction beyond the boundaries established by the terms and intent of the Federal Reserve Act.

The legislative history of Sections 321, 322 and 330 confirms that the FRB does not have a general power to veto or restrict the powers that are granted to state member banks under state law after their admission to membership. These provisions were added by a 1917 amendment to the Federal Reserve Act. The amendment was intended to encourage

---

289. See, e.g., 12 U.S.C. § 321 (1988) (restricting state member banks to the branching authority permitted to national banks); id. § 324 (requiring state member banks to meet reserve and capital requirements, and to comply with provisions applicable to national banks regulating the payment of dividends and preventing the impairment of capital); id. § 325 (requiring examination of state member banks by the FRB, subject to the FRB's discretion to accept state examinations under § 326); id. § 329 (requiring each state member bank, as a condition of initial membership, to possess adequate capital stock and surplus and not to reduce its capital stock thereafter without the prior approval of the FRB); id. § 335 (restricting state member banks to the securities activities permitted to national banks); id. § 339 (prohibiting state member banks from engaging in lotteries or related activities).

290. See 12 U.S.C. § 330 (1988), quoted supra at note 286 and accompanying text. For example, in Old Kent Bank and Trust Co. v. Martin, 281 F.2d 61 (D.C. Cir. 1960), the court held that the FRB had no authority under Section 321 to prohibit a state member bank from acquiring a national bank and its branches by merger. The court held that Section 321's explicit limitations on branching by state members banks did not apply to bank merger transactions. The court further found that no other language in the Federal Reserve Act could authorize the FRB to prohibit a state member bank from exercising its authority under state law to merge with a national bank pursuant to 12 U.S.C. §§ 214a-214c (1988).

In contrast, in Continental Bank and Trust Co. v. Woodall, 239 F.2d 707 (10th Cir.), cert. denied, 353 U.S. 909 (1957), the court upheld an FRB condition that required a state member bank to maintain adequate capital. The court pointed out that, in addition to the FRB's authority to prescribe conditions for membership under Section 321, there were explicit statutory provisions (e.g., Section 324) requiring state member banks to maintain adequate capital. Thus, the FRB's continuing authority to require adequate capital did not rest solely on its power to prescribe conditions for membership.


292. See, e.g., Board of Governors v. Dimension Fin. Corp., 474 U.S. 361, 373 n.6 (1986) (FRB's authority under Section 5(b) of the BHC Act to issue regulations to administer and carry out the purposes of the BHC Act, and to prevent evasions thereof, "only permits the [FRB] to police within the boundaries of the Act; it does not permit the [FRB] to expand its jurisdiction beyond the boundaries established by Congress"); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213 (1976) (regulations of a federal agency that exceed the authority delegated by Congress are invalid, because "[t]he rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law").

more state banks to join the Federal Reserve System by “liberaliz[ing] the terms” for admission while maintaining “reasonable safeguards.” At the suggestion of state banks, the 1917 amendment was modified on the Senate floor. This modification made clear that the FRB’s authority to prescribe rules regarding the admission of state member banks was “not intended to give the [FRB] the right to make future regulations applicable solely to State member banks which might further curtail their power as member banks after they have entered the [Federal Reserve] system.”

Thus, Congress did not intend that the FRB’s authority to prescribe rules for admission of state member banks under Section 321 would enable the FRB to restrict or veto powers that are granted to state banks under state law after they become members of the Federal Reserve System. Since the language of Section 321 authorizing the FRB to impose conditions for membership of state banks was adopted at the same time as the provision in Section 321 empowering the FRB to adopt rules governing admission to membership, both provisions should be interpreted in the same manner.

In sum, the FRB’s power under Section 321 to impose conditions on the admission of state member banks extends only to the powers of such banks as of the date of their admission, which the FRB is entitled to review under Section 322. Section 321 does not authorize the FRB to impose conditions that have the effect of vetoing or restricting the exercise of new state powers granted to state member banks after their admission to membership. The FRB’s imposition of such a condition in its current regulation clearly appears to be an invalid extension of its authority under Section 321.


296. 55 Cong. Rec. 1987 (1917) (remarks of Senator Owen, Senate floor manager for the 1917 amendments) (emphasis added). Because Senator Owen’s statement concerning this modification of the FRB’s authority to prescribe rules for state bank membership was the only statement made prior to adoption of the modification by the Senate, see id., Senator Owen’s remarks are entitled to great weight in construing 12 U.S.C. § 321 (1982), as modified by the 1917 amendment. See, e.g., Northeast Bancorp, Inc. v. Board of Governors, 472 U.S. 159, 169-70 (1985).


298. See, e.g., Securities Indus. Ass’n v. Board of Governors, 468 U.S. 137, 148-49 (1984) (concluding that Section 16 of the Glass-Steagall Act, which prohibits national banks from engaging in specified securities activities, “seek[s] to draw the same line” and should be interpreted to have the same scope as Section 21 of the same Act, which prohibits companies engaged in such securities activities from engaging in deposit banking) (quote at 149); Board of Governors v. Investment Co. Inst., 450 U.S. 46, 62-63 (1981) (same).

299. For discussion of the FRB’s imposition of this condition under 12 C.F.R. § 208.7 (1989), see supra notes 163, 227 & 283 and accompanying text. The use by the FRB of regulatory conditions to extend the scope of its statutory authority has been criticized in Aman, supra note 115, at 879-99; see also Board of Governors v. Dimension Fin. Corp.,
2. The FDIC's Authority to Review the Powers of State Nonmember Banks Applying for Deposit Insurance

Section 5(a) of the FDI Act requires the FDIC to consider seven factors set forth in Section 6 in determining whether to approve the application of a state nonmember bank for deposit insurance. The FRB must consider the same factors in determining whether to admit a state bank to membership in the Federal Reserve System, as must the OCC in deciding whether to approve a national bank charter, because state member banks and national banks are automatically insured by the FDIC. The sixth factor set forth in Section 6 is “whether or not [the applying bank’s] corporate powers are consistent with the purposes of [the FDI Act].” Based on this factor, the FDIC has claimed authority to regulate the scope of state powers that may be granted to an insured bank after it obtains deposit insurance, in order to protect the safety and soundness of the bank and preserve the deposit insurance fund. This claim, however, is unsupported by either the terms or legislative history of Section 6.

The explicit terms of Sections 4(b), 5(a) and 6 demonstrate that the factors set forth in Section 6 apply only to decisions by the OCC to grant charters for new national banks, by the FRB to admit new state member banks, and by the FDIC to approve new deposit insurance for state nonmember banks. None of these sections authorizes the FDIC to restrict or veto powers obtained by a bank after it secures deposit insurance. Moreover, the absence of such authority is strongly suggested by Sections 8(a) and 8(b), which empower the FDIC to restrict or prohibit the activities of insured banks on a case-by-case basis under carefully limited circumstances requiring prior notice and opportunity for a hearing.

474 U.S. 361, 373 n.6, 374-75 (1986) (FRB may not extend by regulation the boundaries of its jurisdiction as established by Congress).


303. The other factors to be considered under Section 6 are the bank’s financial history and condition, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the risk it presents to the deposit insurance fund, and the convenience and needs of the community it is to serve. See 12 U.S.C. § 1816 (1988), as amended by FIRREA, supra note 8, § 207, 103 Stat. 206.

304. See FDIC Notice of Proposed Rulemaking, supra note 166, 50 Fed. Reg. at 23967-68. The FDIC’s claim of authority under Section 6 to regulate the powers of insured banks is further discussed supra at note 246 and accompanying text.


306. For a discussion of the limits on the FDIC’s regulatory authority under Sections 8(a) and 8(b) of the FDI Act, see infra Parts IV(B)(3) and (4). The fact that Congress has provided carefully tailored remedies in Sections 8(a) and 8(b) to enable the FDIC to regulate the activities of insured banks, and that these remedies contain procedural safe-
The relevant legislative history confirms that the authority of the federal banking agencies to consider the factors contained in Section 6 applies only to the time period prior to a bank’s receipt of deposit insurance. In view of this limitation on the FDIC’s authority under Section 6, the FDIC cannot rely on that statute to veto or restrict powers granted to banks after they obtain deposit insurance.

3. The FDIC’s Authority to Terminate Deposit Insurance and to Issue Regulations to Protect the Deposit Insurance Fund

Section 8(a) of the FDI Act empowers the FDIC to terminate the deposit insurance of any insured bank if it determines that the bank has engaged or is engaging in any unsafe or unsound practice or violation of law or is in an unsafe or unsound condition to continue in operation. However, before the FDIC may seek to terminate a bank’s deposit insurance, it must first give notice and an opportunity for corrective action to the OCC (in the case of a national bank), the FRB (in the case of a state member bank), or the responsible state supervisory authority (in the case of a state nonmember bank). The FDIC must also provide notice and an opportunity for an adjudicatory hearing on the record to the bank whose deposit insurance is to be terminated. In addition, any bank whose deposit insurance is terminated may seek judicial review of the FDIC’s termination order.

The FDIC has claimed that Section 8(a) authorizes the FDIC to adopt guards to protect the rights of affected parties, strongly indicates that the FDIC does not possess a broad regulatory authority under Section 6. See, e.g., SEC v. Sloan, 436 U.S. 103, 112-14 (1978); Nat’l R.R. Passenger Corp. v. Nat’l Ass’n of R.R. Passengers, 414 U.S. 453, 458 (1974).

See, e.g., S. Rep. No. 1007, 74th Cong., 1st Sess. 3 (1935) (Section 6 defines the factors “which are deemed proper for consideration in determining whether the applying bank should be insured”) (emphasis added); H.R. Rep. No. 1822, 74th Cong., 1st Sess. 44 (1935) (Conference Rep.) (statement of House managers taking part in the conference committee on the 1935 legislation) (factors contained in Section 6 are to be considered by the FDIC “in connection with the admission of banks to the benefits of deposit insurance”) (emphasis added); 79 Cong. Rec. 11776 (1935) (remarks of Senator Glass, Senate floor manager for the 1935 legislation) (Section 6 authorizes the FDIC “to determine the character of banks which are to be insured”) (emphasis added); see also H.R. Rep. No. 54 (pt. 1), supra note 190, at 327, reprinted in 1989 U.S. Code Cong. & Admin. News 123 (Section 207 of FIRREA amends Section 6 of the FDI Act by adding, “as a new factor for agencies to consider when evaluating applications for deposit insurance, the risk presented to the BIF or the SAIF”) (emphasis added).


See id. § 1818(a)(2)(A), as amended at 103 Stat. 489. In the case of the OCC or the FRB, the FDIC must allow 30 days for corrective action unless a shorter period is agreed to by the OCC or the FRB. See id.

See id. § 1818(a)(2)(B), (3) & (4), as amended at 103 Stat. 489-90.

See id. § 1818(a)(5), as amended at 103 Stat. 490.
general regulations prohibiting or restricting particular activities of insured banks in order to protect the safety and soundness of those banks and to preserve the deposit insurance fund. The FDIC has also cited its general power under Section 9 of the FDI Act to issue "such rules and regulations as it may deem necessary to carry out the provisions of [the FDI Act] or of any other law which it has the responsibility of administering or enforcing." Neither Section 8(a) nor Section 9, however, provides a persuasive basis for the FDIC's claim of authority.

As already noted, the express terms of Section 8(a) only empower the FDIC to bring proceedings to terminate the deposit insurance of an individual bank based upon that particular bank's unsafe practices, unsound condition or violations of law. Moreover, the FDIC must give prior notice both to the bank's primary federal or state supervisor and to the bank itself, and must provide an opportunity for an adjudicatory hearing before issuing a termination order. The legislative history of Section 8(a), as enacted in 1935 and amended in 1966 and 1989, confirms the intent of Congress that the FDIC would conduct involuntary terminations of deposit insurance on an individualized basis and only after providing extensive procedural safeguards.

The FDIC has argued that it "cannot be expected to proceed solely on a case by case basis" in defining unsafe and unsound banking practices, and that, under Sections 8(a) and 9, it has discretion to adopt general regulations identifying risky practices that "threaten the viability of the deposit insurance fund." This argument might be sustained if the FDIC prohibited by general regulation an activity so inherently unsafe that it would entail severe financial risks to virtually all banks that engaged in it, regardless of the individual financial strength of any such bank. In such a case, neither a bank engaged in such an activity nor

313. See FDIC Notice of Proposed Rulemaking, supra note 166, 50 Fed. Reg. at 23967-68. For further discussion of this claim of authority, see supra note 246 and accompanying text.


315. For an analysis concurring in the view that Section 9 does not authorize the FDIC to adopt regulations placing general restrictions on the powers of state banks, see Lyons, The FDIC's General Legislative Rulemaking Authority: Are There Limits in a Dual Banking System?, 11 Seton Hall Legis. J. 153 (1987).


318. For example, the FDIC might properly issue a regulation prohibiting insured banks from making loans, especially those secured by interests in real estate, based on oral agreements. Oral loan agreements would entail such serious problems of enforceabili-
its primary supervisor could remove the threat to the bank without completely stopping the activity.\textsuperscript{319}

In any other case, however, an activity might or might not present a serious financial risk to a bank based upon that particular bank’s financial strength or other circumstances. In such a case, the FDIC’s promulgation of a prohibitory regulation would be contrary to Section 8(a), unless it is carefully tailored to provide the adjudicatory procedures and the prior opportunity for state corrective action mandated by Section 8(a).\textsuperscript{320} In other words, the FDIC may not rely on Section 8(a) to issue a blanket regulation that restricts or prohibits the exercise of state-authorized powers by FDIC-insured state banks, unless the regulation provides the individualized determination procedures and other protections required by Section 8(a).\textsuperscript{321}

The FDIC’s general authority under Section 9 to adopt regulations to carry out its statutory responsibilities cannot validate any attempt by the

---

\textsuperscript{319} It is noteworthy that Congress has prohibited all FDIC-insured banks from participating in lottery-related activities. See 12 U.S.C. §§ 25a, 339 & 1829a (1988). The fact that Congress has not seen fit to impose a similar general prohibition on other activities of state nonmember banks places a heavy burden of justification on the FDIC in adopting any blanket prohibition on such activities. See Lyons, supra note 315, at 167 n.100.

\textsuperscript{320} For discussion of these procedures and the prerogative of the primary supervisor, see supra notes 310-12 & 316 and accompanying text; see also SEC v. Sloan, 436 U.S. 103, 117 (1978) (SEC’s power to order a 10-day suspension in the trading of a company’s securities provides the SEC with “a powerful weapon for dealing with certain problems,” but this power may not be “administratively extended” beyond the limits established by Congress).

\textsuperscript{321} See Lyons, supra note 315, at 167-68; see also Investment Co. Inst. v. FDIC, 728 F.2d 518, 524 (D.C. Cir. 1984) (“Boston Five Cents”) (Section 8 of the FDI Act “surrounds the power it grants to the FDIC over federally insured banks with procedural safeguards of the banks’ rights”); FAIC Securities, 595 F. Supp. 73, 78 n.7 (D.D.C. 1984) (FDIC’s authority to prevent unsafe and unsound banking practices under Section 8 of the FDI Act “relate[s] to specific enforcement actions brought against individual banks”).

One decision that might arguably be read to support the FDIC’s broad assertion of rulemaking power under Section 8(a) is Lincoln Savings & Loan Ass’n v. FHLBB, 856 F.2d 1558 (D.C. Cir. 1988). However, as explained infra at notes 369-79 and accompanying text, Lincoln actually is consistent with the more limited interpretation of the FDIC’s authority advanced in this Article.
FDIC to extend its jurisdiction beyond the statutory limits established by Congress. Moreover, the general purposes of the FDI Act as a whole, and Section 8(a) in particular, contradict the FDIC's claim of a broad authority under Section 9 to prohibit or restrict state bank powers. The House debates on Section 8(a), as originally adopted in 1935, demonstrate that Congress intended to protect the soundness of insured banks and the deposit insurance system while preserving the viability of the state banking system. For example, Representative Sauthoff declared that he opposed any federal regulatory scheme under which the “supervision and regulation [of state banks] would be taken away from the State authorities and vested in Washington.” These expressions of congressional intent to preserve the dual banking system in 1935 were consistent with statements made by supporters of the original legislation creating the FDIC in 1933.

In 1950, when Congress readopted the provisions establishing the FDIC and incorporated those provisions in the new FDI Act, it was again understood that the Act would preserve a strong state banking system. In accordance with that understanding, the Senate committee report on a 1960 amendment to the FDI Act stated that the FDIC's supervisory authority over FDIC-insured banks was limited to “specific types of actions which have a direct bearing upon its role as insurer.” The committee report further declared that, while the FDIC's supervisory powers were designed “to supplement and strengthen the supervision of banks by the older State and Federal banking agencies,” it was Congress' intent that “[t]he direct and primary responsibility for the supervision of banks rests with [the state banking agencies and the OCC].”


323. See, e.g., 79 Cong. Rec. 6922-24 (1935) (remarks of Representatives Igoe and Sauthoff); id. at 6927-28 (remarks of Representative Farley); id. at 6943 (remarks of Representative Spence); id. at 7263-66 (remarks of Representatives Wolcott, Dirksen and Steagall).

324. Id. at 6923.

325. See, e.g., 77 Cong. Rec. 4033 (1933) (remarks of Representative Steagall, House floor manager for 1933 legislation) (FDIC insurance is intended “to preserve independent, dual banking in the United States”); id. at 181-82, 185 (remarks of Senators Robinson and Vandenberg). For further discussion of the 1933 legislative history, see Lyons, supra note 315, at 159.

326. See FDI Act, supra note 116.

327. See, e.g., 96 Cong. Rec. 10,658 (1950) (remarks of Rep. Multer) (FDI Act is not intended to permit “a nationalization of our banking system”), quoted in Lyons, supra note 315, at 159.


As described below, the terms and legislative history of Section 8(b) provide further evidence of the intent of Congress to limit the supervisory powers of the FRB and FDIC over state banks in order to preserve the primary supervisory authority of the state agencies.\footnote{330} Thus, Congress has mandated in the FDI Act that the FDIC “must take care not to usurp . . . the primary role Congress intended state agencies to play in the regulation of state banks.”\footnote{331} In view of this clear congressional mandate, it would not be proper for the FDIC to rely on Sections 8(a) and 9 to issue regulations imposing a blanket restriction or prohibition on banking activities authorized by state law, unless those activities presented serious risks to the safety and soundness of virtually every state bank that chose to engage in them.\footnote{332} It does not appear that any of the recently expanded powers of state banks presents risks to bank safety that cannot be adequately dealt with on a case-by-case basis.\footnote{333} Accordingly, the FDIC may not properly rely on Section 8(a) or Section 9 to impose general restrictions or prohibitions on these state powers.

4. The Authority of the FRB and the FDIC to Require State Banks to Terminate Unsafe or Unsound Activities

   a. Statutory Provisions of Section 8(b) of the FDI Act

Section 8(b) of the FDI Act empowers the FDIC (with respect to state nonmember banks) and the FRB (with respect to state member banks) to issue orders requiring state banks to cease and desist from engaging in unsafe or unsound business practices or committing violations of law.\footnote{334} Section 8(b) was amended in 1989 by FIRREA to make clear that the FDIC’s or FRB’s power to issue cease and desist orders includes “the authority to place limitations on the activities or functions of an insured [state bank].”\footnote{335}

Like Section 8(a), Section 8(b) contains detailed procedures to safeguard the rights of state banks that become the subject of cease and desist proceedings.\footnote{336} Before commencing a cease and desist proceeding

\footnote{330} See infra Part IV(B)(4).
\footnote{331} Boston Five Cents, 728 F.2d at 525 (construing the FDIC’s enforcement powers under Section 8 of the FDI Act).
\footnote{332} For a discussion of the FDIC’s authority to issue regulations under Section 8(a) in such a situation, see supra notes 318-19 and accompanying text.
\footnote{333} For the FDIC’s view that expanded state bank powers have not resulted in widespread risks to bank safety, see supra notes 167, 175 & 242 and accompanying text.
\footnote{334} See 12 U.S.C. § 1818(b) (1988), as amended by FIRREA, supra note 8, § 902(a)(1), 103 Stat. 450-51. In the case of national banks, the OCC is authorized to issue cease and desist orders. See id. For the allocation of supervisory and enforcement responsibilities among the federal regulators with respect to FDIC-insured banks, see id. § 1813(q) (1988), as amended by FIRREA, supra note 8, § 204(f)(4), 103 Stat. 192.
\footnote{335} Id. § 1813(b)(7), added by FIRREA, supra note 8, § 902(a)(1), 103 Stat. 450. For further discussion of this provision see supra notes 263-65 and accompanying text; infra notes 357-59 and accompanying text.
\footnote{336} For a discussion of the procedural safeguards under Section 8(a), see supra notes 310-12 and accompanying text.
against a state bank, the FDIC or FRB must first provide, in accordance with Section 8(m), a notice of the grounds for its action to the responsible state supervisory agency and permit that agency to take corrective action.\textsuperscript{337} If the state agency fails to take satisfactory corrective action within the time permitted by the FDIC or FRB, the federal agency may commence a cease and desist proceeding by delivering a notice of charges to the state bank.\textsuperscript{338} The FDIC or FRB must provide the bank with at least thirty days’ prior notice of its intention to hold an evidentiary hearing on the charges. Any cease and desist order (unless entered with the actual or implied consent of the bank) must be made on the record after the hearing and is subject to judicial review.\textsuperscript{339}

Under Section 8(b)(3), the FRB has authority to issue a cease and desist order to a bank holding company or any of its subsidiaries "other than a bank."\textsuperscript{340} Based on the plain language of Section 8(b)(3), the FRB would not have authority to issue a cease and desist order to a holding company-owned state nonmember bank.\textsuperscript{341}

It further appears that the FRB does not have authority to issue a cease and desist order to an operations subsidiary of a holding company-owned state nonmember bank. The BSC Act provides that, for purposes of Section 8 of the FDI Act, a BSC is to be treated “as if [it] were an insured bank” regulated by the primary federal supervisor of its principal investor bank.\textsuperscript{342} Thus, the FDIC would have sole authority to bring a cease and desist proceeding against a BSC established by a holding company-owned state nonmember bank, and such a BSC would not be treated as a “nonbank subsidiary” of the parent bank holding company subject to FRB supervision under Section 8(b)(3).\textsuperscript{343} Because an operations subsidiary is identical to a wholly-owned BSC, the BSC Act strongly indicates that an operations subsidiary of a holding company-owned state nonmember bank, like a BSC of such a bank, is not subject to the FRB’s supervisory authority over bank holding companies under Section 8(b)(3).\textsuperscript{344}

\textsuperscript{338} See id.; id. § 1818(b)(1), as amended by FIRREA, supra note 8, § 902(a)(1), 103 Stat. 450.
\textsuperscript{339} See id. §§ 1818(b)(1) & 1818(b)(2), as amended by FIRREA, supra note 8, §§ 902(a)(1) & 920(a), 103 Stat. 450, 488.
\textsuperscript{340} Id. § 1818(b)(3) (1988) (emphasis added), as amended by FIRREA, supra note 8, § 902(a)(1), 103 Stat. 450.
\textsuperscript{341} See id. Of course, as indicated \textit{supra} at note 334 and accompanying text, the FRB has direct authority under Section 8(b)(1) to issue a cease and desist order to a state member bank.
\textsuperscript{343} Id. §§ 1813(q), 1818(b)(1) & 1818(b)(3) (1988) (emphasis added), as amended by FIRREA, supra note 8, §§ 204(f)(4) & 902(a)(1), 103 Stat. 192, 450. The FRB would have sole authority to bring a cease and desist proceeding against an operations subsidiary established by a state member bank. See id.
\textsuperscript{344} As described \textit{supra} at notes 10 & 256-58 and accompanying text, an “operations subsidiary” and a wholly-owned BSC are identical in that each is a subsidiary of a bank engaged in providing banking services authorized by the bank’s chartering authority.
The FDIC and the FRB have claimed that Section 8(b) authorizes them to issue general regulations prohibiting activities of state nonmember banks (in the case of the FDIC) and state member banks (in the case of the FRB) that are deemed by the FDIC or the FRB to be unsafe, unsound or violations of law.\textsuperscript{345} However, as in the case of Section 8(a),\textsuperscript{346} the explicit terms of Sections 8(b) and 8(m) contemplate that unsafe or unsound banking practices of state banks will be defined in the context of individual adjudicatory proceedings and only after the state supervisory agencies have been afforded an opportunity to take corrective action.\textsuperscript{347}

This statutory scheme indicates that the FDIC or FRB can properly adopt general regulations defining a state bank activity as unsafe or unsound if the activity is so inherently risky, or entails such a high probability of legal violations, that the activity would present a severe threat to the financial soundness or operational legitimacy of virtually every bank that engaged it.\textsuperscript{348} In such a case, neither a state bank nor its supervisor could remove the danger of the activity without terminating it. In the alternative, an FDIC or FRB general regulation could be defended as legitimate if it is framed in a manner that takes appropriate account of the individual financial condition of each affected state bank, provides the procedural safeguards contemplated by Section 8(b), and requires prior consultation with the responsible state supervisor before enforcement action is taken against the bank.\textsuperscript{349}

The FDIC and FRB have issued certain regulations in reliance on their authority to prevent unsafe, unsound or illegal banking practices. For example, the FDIC and FRB have each issued regulations prohibiting any insured state bank from issuing standby letters of credit or similar credit-related instruments if such instruments, when combined with

\textsuperscript{345} For the FDIC’s claim of authority to issue general regulations defining unsafe, unsound or illegal practices of state nonmember banks under Section 8(b), see, e.g., 49 Fed. Reg. at 46,709, 46,710 (1984) (FDIC interpretive statement accompanying original adoption of 12 C.F.R. § 337.4); 12 C.F.R. § 337.1 (1989). For an exercise of similar claimed authority by the FRB, see 12 C.F.R. § 208.8(a) (1989).

\textsuperscript{346} For a discussion of the case-by-case decisionmaking and the procedural safeguards contemplated by Section 8(a), see supra Part IV(B)(3).

\textsuperscript{347} For discussion of the adjudicatory proceedings and opportunity for state corrective action contemplated by Sections 8(b) and 8(m), see supra notes 336-39 and accompanying text. See Boston Five Cents, 728 F.2d at 525 (Section 8 provides “procedural safeguards of the banks’ rights” in enforcement proceedings, and Section 8(m) ensures that the federal agencies cannot “usurp” the prior right of the state supervisory authorities “to take corrective action”); FAIC Securities, 595 F. Supp. 73, 78 n.7 (D.D.C. 1984) (provisions of Section 8 authorizing federal banking agencies to prevent unsafe or unsound banking practices “relate to specific enforcement actions brought against individual banks”).

\textsuperscript{348} As discussed supra in note 318, an example of a universally risky banking practice would be the making of loans under oral agreements.

\textsuperscript{349} For an example of a regulation that could pass muster under Section 8(b), see the regulation of the former Federal Home Loan Bank Board (“FHLBB”) regarding “direct investments” of federally-insured, state-chartered thrifts, discussed infra at notes 370-79.
all other extensions of credit by the bank, would violate either the bank's legal lending limits or legal restrictions on transactions between the bank and its affiliates.\textsuperscript{350} Since standby letters of credit and similar instruments have been recognized as the functional equivalent of extensions of credit,\textsuperscript{351} these regulations are properly designed to prevent state banks from engaging in excessive credit-granting activities that would result in violations of law.\textsuperscript{352}

As discussed above, the FDIC has also issued, in reliance on its authority under Section 8(b), a regulation governing any state nonmember bank that has a subsidiary or affiliate engaged in underwriting or dealing in national bank-ineligible securities.\textsuperscript{353} These regulations are primarily designed to maintain an adequate legal separation between the bank and the securities subsidiary or affiliate.\textsuperscript{354} This legal separation is needed to prevent state nonmember banks from being found to have engaged \textit{directly} in securities underwriting or dealing activities. Such a direct involvement of banks in the securities business would violate Section 21 of the Glass-Steagall Act.\textsuperscript{355} Thus, the FDIC's securities regulations, in accordance with the FDIC's authority under Section 8(b) of the FDI Act, prescribe general prohibitions and restrictions that are needed to prevent violations of law by state nonmember banks.\textsuperscript{356}

\begin{footnotes}
\item[350] See 12 C.F.R. § 208.8(d) (1989) (FRB regulation applicable to state member banks); \textit{id.} § 337.2 (FDIC regulation applicable to state nonmember banks).
\item[351] See, e.g., \textit{AMBAC}, 865 F.2d at 281-83.
\item[352] The FRB and the FDIC have adopted other general regulations under Section 8(b) that are designed to prevent state banks from committing hazardous banking practices or violations of law. \textit{See}, e.g., 12 C.F.R. §§ 208.8(e)-(g), (j) & (k) (1989) (FRB rules prohibiting state member banks from making loans in federally-declared flood hazard areas on properties not covered by flood insurance; regulating state member banks that act as securities transfer agents, clearing agents or municipal securities dealers; and prescribing recordkeeping requirements for securities transactions effected on behalf of customers); \textit{id.} § 337.3 (FDIC rule requiring state nonmember banks to comply with FRB regulations implementing federal statutory limitations on bank extensions of credit to executive officers, directors and principal shareholders).
\item[353] For a discussion of 12 C.F.R. § 337.4 (1989), governing the affiliation of state nonmember banks with securities subsidiaries or affiliates, see \textit{supra} notes 146-151 and accompanying text.
\item[356] The FDIC has also stated that the legal separation requirements contained in its securities regulation are designed to protect the safety and soundness of the bank from losses that may be insured by its securities subsidiary or affiliate. \textit{See} 49 Fed. Reg. 46,709, 46,711-13 (1984) (FDIC interpretive statement accompanying adoption of 12 C.F.R. § 337.4). For discussion of these requirements, see \textit{supra} notes 146-151. These requirements do not prohibit state nonmember banks from affiliating with securities firms. Instead, the requirements appear to be proper responses by the FDIC to generic safety and soundness concerns resulting from the higher potential risks posed by bank affiliation with securities firms. \textit{See Investment Co. Inst.}, 815 F.2d at 1550.
\end{footnotes}
In other circumstances, where the risks presented by an activity to the safety, soundness or legality of a state bank’s operation would vary depending on the bank’s particular financial strength and other circumstances, as well as the state regulatory scheme to which the bank is subject, Section 8(b) does not authorize the FDIC or the FRB to impose general prohibitions or restrictions on the activity. This conclusion finds additional support in the decision of Congress in FIRREA to clarify the authority of the federal banking agencies under Section 8(b) by providing that the agencies may issue cease and desist orders requiring particular banks to refrain from particular activities. In contrast, as discussed above, FIRREA granted to the FDIC authority to issue regulations prohibiting all federally-insured thrifts from engaging in activities determined to be unsafe by the FDIC. Thus, a clear distinction can be drawn between FIRREA’s limited amendment of Section 8(b) with respect to bank activities and its sweeping grant of authority to the FDIC over thrift activities. This distinction strongly indicates that Congress has not given the FDIC and the FRB a general authority to prohibit state banks from engaging in activities authorized by state law.

b. Judicial Interpretations of Section 8(b)

The courts have recognized that Section 8(b) provides broad discretion to the federal banking agencies in determining whether specific bank activities should be prohibited as unsafe or unsound banking practices. However, the courts have also made clear that such discretion is not unbounded. First, the term “unsafe or unsound practice” as used in Section 8(b) has been held to apply only to an activity which has “a reasonably direct effect on a bank’s financial stability.” Thus, the federal banking agencies may not prohibit, under Section 8(b), a lawful banking activity that bears “only the most remote relationship to [the bank’s] financial integrity and the government’s insurance risk.”

357. See FIRREA, supra note 8, § 902(a)(1), adding provision to be codified at 12 U.S.C. § 1818(b)(7). For further discussion of this provision, see supra notes 263-65 & 335 and accompanying text.

358. For a discussion of the authority granted by FIRREA to the FDIC over the activities of thrift institutions, see supra notes 194 & 262 and accompanying text.

359. See, e.g., INS v. Cardoza-Fonseca, 480 U.S. 421, 432 (1987) (use by Congress of particular language in one section of a statute and use of different language in another section leads to a general presumption that the two sections are intended to provide different legal standards); Board of Governors v. Investment Co. Inst., 450 U.S. 46, 58-59 n.24, 64 (1981) (use of different language in Sections 20 and 21 of Glass-Steagall Act indicates that the two sections establish different restrictions on the permissible degree of bank involvement in securities activities).


362. Gulf Federal, 651 F.2d at 264.
Second, the courts have generally agreed that the federal banking agencies may bring action under Section 8(b) to prevent a bank from committing violations of law, even if those violations do not threaten the bank's financial soundness. However, in redressing such a violation, an agency has no authority to fashion remedial policies that extend beyond the statutory powers granted to the agency.

Third, the courts have emphasized that Section 8(b) does not give the federal banking agencies "a 'blank check' authority" and instead empowers them to act only "within carefully guarded limits." Thus, for example, the courts have pointed to the "procedural safeguards" provided by Section 8(b), such as the requirement that the federal agency must commence a cease and desist proceeding by giving the bank a notice of charges and an opportunity to appear at an adjudicatory hearing.

363. See, e.g., Saratoga Sav. & Loan Ass'n v. FHLBB, 879 F.2d 689, 693 (9th Cir. 1989) (interpreting FHLBB's former cease and desist authority with respect to federally-insured, state-chartered thrifts); Otero Sav. & Loan Ass'n v. FHLBB, 665 F.2d 279, 286, 291 (10th Cir. 1981) (opinions of Holloway and McKay, JJ.) (same); Nat'l State Bank v. Long, 630 F.2d 981, 988 (3d Cir. 1980) (holding that Section 8(b) is applicable to a violation of state law that "directly implicates concerns in the banking field"). But see Bellaire, 697 F.2d at 681 (Section 8(b) applies only to violations of law "with a reasonably direct effect on a bank's financial stability").

364. See, e.g., MCorp Financial, Inc. v. Board of Governors, 900 F.2d 852, 862-64 (5th Cir. 1990) (FRB does not have authority under Section 8(b) to require a bank holding company to transfer its own funds to replenish the capital of a failing subsidiary bank); Larimore v. Comptroller of the Currency, 789 F.2d 1244, 1248-56 (7th Cir. 1986) (en banc) (OCC lacked authority under pre-FIRREA version of Section 8(b) to require bank directors to reimburse the bank for losses resulting from violations of national bank lending limits under 12 U.S.C. § 84); Citizens State Bank of Marshfield v. FDIC, 751 F.2d 209, 216-19 (8th Cir. 1984) (FDIC lacked authority under pre-FIRREA version of Section 8(b) to require bank directors to reimburse consumers for bank violations of federal Truth in Lending Act); Otero, 665 F.2d at 286-92 (opinions of Holloway and McKay, JJ.) (FHLBB lacked authority under pre-FIRREA statute to require thrift institution to cease and desist from offering lawful NOW accounts as penalty for past offering of illegal interest-bearing checking accounts).

In response to Larimore, Congress added Section 8(b)(6) to the FDI Act in 1989 to authorize the federal banking agencies to require bank insiders to make reimbursement or restitution in cases involving unjust enrichment or reckless disregard of the law. See FIRREA, supra note 8, § 902(a)(1), 103 Stat. 450; H.R. Rep. No. 54 (pt. 1), supra note 190, at 392, 467-68, reprinted in 1989 U.S. Code Cong. & Admin. News at 188, 263-64 (discussing Section 8(b)(6)).

In addition, as discussed supra at notes 263-65 & 357-59, FIRREA added Section 8(b)(7) of the FDI Act to empower the federal banking agencies to issue cease and desist orders requiring individual banks to limit or halt particular activities. See FIRREA, supra note 8, § 902 (a)(1), 103 Stat. 450; H.R. Rep. No. 54 (pt.1), supra note 190, reprinted in 1989 U.S. Code Cong. & Admin. News at 392 (discussing Section 8(b)(7)). But neither Section 8(b)(6) nor Section 8(b)(7) authorizes the FDIC or the FRB to impose blanket restrictions or prohibitions on the powers of state banks.

365. Larimore, 789 F.2d at 1253; see also [Anonymous] v. FDIC, 619 F. Supp. 866, 869-73 (D.D.C. 1985) (reaching similar conclusion as to FDIC's authority to suspend bank officers under Section 8(e) of the FDI Act).


367. See Boston Five Cents, 728 F.2d at 524, 527 n.8 (D.C. Cir. 1984); see also [Anony-
Moreover, in the case of a state bank, the courts have highlighted the prior notice and opportunity for corrective action that must be provided to the state supervisory agency, so that the federal agency does not "usurp state banking agencies' regulatory authority over state banks."

The broadest judicial interpretation of the language of Section 8(b) appears in *Lincoln Savings & Loan Ass'n v. FHLBB.* Lincoln held that the former FHLBB had authority, under the parallel cease and desist statute applicable to federally-insured, state-chartered thrifts, to adopt a general regulation limiting high-risk "direct investments" made by such thrifts under state law. In upholding the FHLBB's regulation, *Lincoln* specifically rejected the contention that the FHLBB could act only on a case-by-case basis against individual thrifts under its cease-and-desist authority.

The *Lincoln* decision is subject to criticism on the ground that it fails to give due recognition to the statutory prerogatives of state thrift regulators with regard to state-chartered thrifts. More importantly, however, the FHLBB's regulation upheld in *Lincoln* was substantially consistent with the standards articulated in this Article. First, the FHLBB had adopted the regulation only after it reviewed "extensive studies by experts" and performed "additional studies" establishing that excessive levels of state-authorized direct investments were contributing...
to a large number of thrift failures. Second, the regulation was not a blanket rule barring all direct investments. Instead, it restricted direct investments according to a sliding scale that took into account each thrift's capital position. Third, a state-chartered thrift could apply for FHLBB permission to exceed the level of direct investments allowed by the regulation, and the FHLBB was required to consult with the responsible state thrift supervisor before denying such an application.

Thus, in accordance with the interpretation of Section 8(b) set forth in this Article, the FHLBB regulation in *Lincoln* (i) was based on extensive evidence showing that particular state-authorized activities of thrifts posed a serious risk to the financial health of a large number of state-chartered thrifts, (ii) took into account the individual financial position of each affected state-chartered thrift, and (iii) required prior consultation with the responsible state authority before a state-chartered thrift would actually be prohibited from engaging in a state-authorized activity. Viewed in this context, *Lincoln* did not uphold a broader scope of federal rulemaking authority over state-chartered institutions than is warranted by the terms of Section 8(b).

c. *Legislative History of Section 8(b)*

The legislative history of Section 8(b), as originally enacted in 1966,
demonstrates that the provision was intended to provide federal banking agencies with "additional flexible and effective supervisory powers . . . within carefully guarded limits."\textsuperscript{381} In adopting Section 8(b), Congress attempted to balance the public interest in protecting the soundness of banks and the federal deposit insurance fund against the interest of banks and their officials "in receiving a reasonable degree of protection from . . . arbitrary, capricious, and overbearing [government] tactics."\textsuperscript{382}

To protect against arbitrary action by the federal banking agencies, Congress provided procedural safeguards in the form of prior notice, adjudicatory hearings, and judicial review.\textsuperscript{383} In addition, Congress adopted Section 8(m) to require the FDIC and the FRB to provide state supervisory authorities with prior notice and opportunity for corrective action before cease and desist proceedings could be brought against state banks. The purpose of Section 8(m) was to give additional protection to the rights of state banks\textsuperscript{384} and to ensure that the "supervisory powers of the State agencies [would] not be circumvented or diminished."\textsuperscript{385}

Finally, the legislative history indicates the clear understanding of Congress that Section 8(b) would provide authority for enforcement actions against individual banks based upon particular unsafe or unsound practices or violations of law.\textsuperscript{386} Congress recognized that the finding of an unsafe or unsound banking practice would usually depend upon the individual bank's special circumstances, because a particular banking activity would
not necessarily [be] unsafe or unsound in every instance;... what may be an acceptable practice for an institution with a strong reserve position, such as concentration in higher risk lending, may well be unsafe or unsound for a marginal operation.\footnote{387}

In sum, the relevant legislative history confirms that the FDIC’s and the FRB’s authority under Section 8(b) is to be implemented in the context of “specific enforcement actions brought against individual banks,”\footnote{388} in which the agencies comply with the “procedural safeguards of the banks’ rights.”\footnote{389} Section 8(b) generally “does not contemplate across-the-board regulations.”\footnote{390} As discussed above, therefore, Section 8(b) does not authorize the FDIC or the FRB to adopt rules imposing blanket prohibitions on the activities of state banks, unless there is substantial evidence demonstrating a serious risk to the safety of most banks involved in those activities.\footnote{391}

5. The FRB’s Authority to Regulate Bank Transactions with Affiliates

The FRB has authority to regulate transactions between national banks or state member banks and their affiliates under Sections 23A and 23B of the Federal Reserve Act.\footnote{392} The FRB’s regulations under these statutes apply to state nonmember banks and their affiliates under Section 18(j)(1) of the FDI Act.\footnote{393} The term “affiliate” is defined in Sections 23A and 23B to include, in general, any company that controls, is controlled by, or is under common control with, the bank.\footnote{394} Thus, a holding company-owned bank would be deemed to be an affiliate of its parent company and of each nonbank subsidiary of the parent company.\footnote{395}

\footnote{387. \textit{Id.} at 26,474 (remarks of Senator Robertson, quoting memorandum from FHLBB chairman). As noted by Senator Robertson, \textit{id.}, and by Representative Patman, \textit{id.} at 24,984, Congress relied upon the description of “unsafe or unsound practice” contained in the FHLBB memorandum. For further discussion of this reliance, \textit{MCorp Financial, Inc.} v. Board of Governors, 900 F.2d 852, 863 (5th Cir. 1990); Gulf Fed. Sav. & Loan Ass’n v. FHLBB, 651 F.2d 259, 264 (5th Cir. 1981) (identifying FHLBB chairman as John Home), \textit{cert. denied}, 458 U.S. 1121 (1982).}

\footnote{388. \textit{FAIC Securities}, 595 F. Supp. at 78 n.7.}

\footnote{389. \textit{Boston Five Cents}, 728 F.2d at 524.}

\footnote{390. \textit{FAIC Securities}, 595 F. Supp. at 78 n.7.}

\footnote{391. For further discussion of the interpretation of Section 8(b) advocated in this Article, see \textit{supra} notes 347-49 and accompanying text. As discussed \textit{supra} at notes 167, 175 & 242 and accompanying text, the FDIC has stated that it does not perceive any systemic risk to have resulted from the expansion of state bank securities, insurance, and real estate powers. However, as indicated \textit{supra} at note 226 and accompanying text, and \textit{infra} at note 484 and accompanying text, the FRB has argued that the involvement of banks in nontraditional activities such as real estate investment or development could pose significant risks and conflict of interest problems for participating banks.}

\footnote{392. \textit{See} 12 U.S.C. §§ 371c & 371c-1 (1988). The FRB is authorized to adopt rules to implement these statutes. \textit{See id.} §§ 371c(e) & 371c-1(e).}

\footnote{393. \textit{See id.} § 1828(j)(1).}

\footnote{394. \textit{See id.} §§ 371c(b)(1) & 371c-1(d)(1).}

\footnote{395. A bank that is a subsidiary of a bank holding company is generally \textit{not} treated as an “affiliate” of any other bank controlled by the same holding company for purposes of}
Under Section 23A, a bank may not engage in a "covered transaction" (such as an extension of credit or purchase of assets) with an affiliate unless the total amount of covered transactions involving the bank or its subsidiaries does not exceed ten percent of the bank’s capital stock and surplus as to any single affiliate and twenty percent of its capital stock and surplus as to all affiliates. 

In addition, Section 23A requires that all extensions of credit by a bank or its subsidiary to an affiliate must be secured by qualified collateral. Section 23B provides that all covered transactions and certain other dealings (such as sales of assets and contracts for services) between either a bank or its subsidiary and an affiliate of the bank must be on terms equivalent to those found in an arms’ length transaction.

Thus, Sections 23A and 23B place significant restrictions on dealings between banks and their nonbank affiliates. However, Sections 23A and 23B have a much narrower application to transactions between a bank and its own subsidiaries. Section 23A provides that a subsidiary of a bank is not an “affiliate” of the bank unless the FRB determines, by order or regulation, that covered transactions between the bank and its subsidiary may be “affected by [their] relationship to the detriment” of the bank. Section 23B includes the same general exclusion of subsidiaries of banks from treatment as affiliates in the absence of a contrary FRB determination.

As previously noted, the FRB has proposed to subject transactions between a bank and a subsidiary of the bank engaged in real estate investment or development to the requirements of Sections 23A and 23B. To adopt such a blanket rule, the FRB would be required to make a generalized determination that the relationship between any bank and its real estate subsidiaries may affect transactions between them to the detriment of the bank. The FRB's determination would be subject to judicial invalidation if it were found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

In applying the arbitrary and capricious standard, a reviewing court would assess whether the FRB had considered the relevant facts in light of the applicable statutory factors (for example, whether real estate ventures generally are so inherently risky that the relationship of virtually any bank with its real estate subsidiaries could be expected to affect

---

Section 23A. Similarly, such “sister banks” are not treated as “affiliates” of each other under Section 23B. See 12 U.S.C. §§ 371c(d)(1)(C) & 371c-1(d)(1) (1988).

397. See id. § 371c(e).
398. See id. § 371c-1(a)(1).
400. See id. § 371c-1(d)(1).
401. For a discussion of this proposal, see supra notes 235-36 and accompanying text.
transactions between them to the detriment of the bank). In addition, the court would evaluate whether the FRB had "articulate[d] a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.' "

The burden on the FRB to justify its application of Sections 23A and 23B to real estate subsidiaries of banks would be greater in the case of operations subsidiaries. Such an application of the affiliate transaction restrictions would reverse a 1970 FRB ruling which states that Section 23A does not apply to transactions between a bank and its operations subsidiaries. In issuing the 1970 ruling, the FRB found "no reason to limit transactions between the bank and [its operations] subsidiary any more than transactions between [unincorporated] departments of a bank." Congress agreed with this assessment in 1982, when it amended Section 23A to provide generally (subject to a contrary FRB determination) that subsidiaries of banks would not be treated as affiliates.

To justify an application of Sections 23A and 23B to real estate operations subsidiaries, the FRB would be "obligated to supply a reasoned analysis" for its decision to depart from its 1970 ruling, especially in view of Congress' apparent endorsement of that ruling in 1982. In presenting such an analysis, the FRB would be required to "cogently explain" why special risk factors relating to bank ownership of real estate operations subsidiaries warranted the FRB's departure from its previous position. The FRB has not yet provided such an analysis.

6. The Authority of the FRB and the FDIC to Adopt Capital Adequacy Requirements

The International Lending Supervision Act of 1983 ("ILSA") empowers the federal banking agencies to establish minimum capital requirements for banks and bank holding companies. The FRB has authority under ILSA to establish capital adequacy standards for state

405. State Farm, 463 U.S. at 43.
406. As described supra at note 10, an operations subsidiary is a subsidiary of a bank that is engaged in activities authorized for the parent bank at locations permitted to the parent bank.
408. Id.
410. State Farm, 463 U.S. at 42.
411. Id. at 48.
member banks and for bank holding companies and "any nonbank subsidiary thereof," while the FDIC has authority to set capital standards for state nonmember banks.\textsuperscript{414} The failure of a banking institution to meet the required capital standards may be deemed an unsafe or unsound banking practice within the meaning of Section 8 of the FDI Act,\textsuperscript{415} and the capital standards may be enforced under Section 8 by the federal banking agency having jurisdiction over the institution with deficient capital.\textsuperscript{416} 

ILSA expressly provides that the FRB has no authority to establish capital adequacy requirements for state nonmember banks, even if such banks are owned by bank holding companies.\textsuperscript{417} In addition, it appears that the FRB lacks authority to regulate the capital of any operations subsidiary of a state nonmember bank. As already noted, the capital standards adopted in the ILSA are to be enforced under Section 8 of the FDI Act.\textsuperscript{418} Under the BSC Act, a BSC that is principally owned by a state nonmember bank is subject to the enforcement authority of the FDIC under Section 8 as if the BSC were itself a state nonmember bank.\textsuperscript{419} Because an operations subsidiary of a bank is identical to a wholly-owned BSC, such a subsidiary should be treated as a "bank" under Section 8 of the FDI Act and not as a "nonbank subsidiary" of any holding company that controls the parent bank.\textsuperscript{420} Moveover, ILSA provides that a federal banking agency may not apply capital standards to an affiliate of a bank unless the agency has been granted responsibility for regulating that affiliate.\textsuperscript{421} The BSC Act plainly indicates that the FDIC, and not the FRB, is the agency responsible for regulating BSCs (and thus operations subsidiaries) of state nonmember banks.\textsuperscript{422}

In sum, ILSA and related statutes demonstrate a lack of FRB authority to mandate capital standards for state nonmember banks or their op-

\textsuperscript{414} Id. § 1813(q) (emphasis added), as amended by FIRREA, § 204(f)(4), 103 Stat. 192; id. § 3902(1) (1988). The OCC has authority to establish capital adequacy requirements for national banks. See id.

\textsuperscript{415} See 12 U.S.C. § 3907(b)(1) (1988). For discussion of the FDIC's and the FRB's enforcement powers with regard to unsafe and unsound banking practices, see supra Parts IV(B)(3) and (4).

\textsuperscript{416} See 12 U.S.C. §§ 3907(b) & 3908(c) & (d) (1988).

\textsuperscript{417} As described supra at note 414 and accompanying text, the ILSA provides that FRB shall have authority to regulate the capital of state member banks and bank holding companies and their nonbank subsidiaries, while the FDIC is granted such authority over state nonmember banks.

\textsuperscript{418} For a discussion of the enforcement of capital standards under Section 8, see supra notes 415-416 and accompanying text.

\textsuperscript{419} For explanation of the status of a BSC under Section 8 of the FDI Act, see supra notes 342-343 and accompanying text.

\textsuperscript{420} For further discussion of the view that, in light of the BSC Act, operations subsidiaries should be treated in the same manner as their parent banks under Section 8 of the FDI Act, see supra notes 342-344 and accompanying text.


\textsuperscript{422} For a discussion of the supervisory authority of the FDIC and the FRB with respect to BSCs, see supra notes 342-344 and accompanying text.
operations subsidiaries. The FRB's real estate proposals, if adopted, would appear to exceed the FRB's capital-setting authority in two respects. First, the FRB has proposed to exclude part or all of any real estate investments made by holding company-owned banks (including state nonmember banks) from the capital of their parent holding companies. This proposal would effectively impose an indirect penalty on holding company-owned state nonmember banks to the extent of their real estate investments and would thus appear to interfere with the FDIC's exclusive capital-setting authority with regard to such banks.

Second, the FRB has proposed to impose a capital requirement directly on subsidiaries of holding company-owned banks if such subsidiaries engage in real estate investment or development. This proposal, if applied to operations subsidiaries of holding company-owned state nonmember banks, would infringe upon the apparently exclusive authority of the FDIC to establish capital requirements for such subsidiaries.

C. The Absence of Authority Under the BHC Act for FRB Regulation of the Activities of Holding Company-Owned State Banks and Their Operations Subsidiaries

In recent years, considerable controversy has focused on the issue of whether the FRB has authority under the BHC Act to regulate the activities of either holding company-owned state banks or their operations subsidiaries. The FRB has acknowledged that it does not have authority under the BHC Act to regulate the powers of holding company-owned state banks. However, the FRB has claimed authority to regulate the activities of operations subsidiaries of such banks.

An examination of the language and legislative history of the BHC Act

423. See FRB Real Estate Proposal I, supra note 226, 52 Fed. Reg. at 546-47. For further discussion of this proposal, see supra notes 226 & 230-232 and accompanying text.

424. The FRB's current capital standards (12 C.F.R. Part 225, Appendix A (1989)) and its recently-adopted risk-based capital requirements (1 Fed. Res. Regulatory Service 4-797) each evaluate the capital adequacy of bank holding companies on a consolidated basis, i.e., by comparing the total capital and the total assets of all of the holding company's bank and nonbank subsidiaries. See 12 C.F.R. Part 225, Appendix A, at 97 (1989); 1 Fed. Res. Regulatory Service 4-797, at 4-187. To the extent that the FRB proposal would reduce the capital of a bank holding company by the amount of any real estate investments made by a subsidiary state nonmember bank, that proposal would impose a new financial cost on the holding company by requiring it to raise additional capital elsewhere to maintain its consolidated capital position. The proposal would have, at least potentially, an adverse impact on the subsidiary state nonmember bank, since the parent holding company, in view of its additional capital costs, would have relatively fewer financial resources available to assist the bank in expanding or in meeting financial difficulties.

425. See FRB Real Estate Proposal II, supra note 234, 52 Fed. Reg. at 42,302. For further discussion of this proposal, see supra note 237 and accompanying text.

426. For discussion of the FDIC's apparently exclusive authority to regulate the capital of operations subsidiaries of state nonmember banks, see supra notes 417-422 and accompanying text.
establishes that the FRB has no authority thereunder to prohibit or restrict the activities of either holding company-owned state banks or their operations subsidiaries. While Congress has empowered the FRB to regulate the activities of bank holding companies and their nonbank subsidiaries, Congress has not granted to the FRB a general regulatory power over holding company-owned state banks or their operations subsidiaries.

The scope of authority of the FRB over holding company-owned state banks was examined in a recent article by Keith Fisher. Mr. Fisher's article reaches conclusions similar to those stated in this Article, and his analysis of the BHC Act is based in part on an appellate brief prepared in 1987 by the author of this Article. Because a detailed review of the legislative history of the BHC Act appears in Mr. Fisher's article and in a recent article by Professor Aman, only the highlights of that history will be reviewed here.

1. The Statutory Provisions

a. Section 3 of the BHC Act

Section 3(a) of the BHC Act requires prior FRB approval for any acquisition of a bank by an existing bank holding company or by a company that is to become a bank holding company. Section 3(c) requires

---


428. In August 1987, the author of this Article was the principal drafter of a brief filed by the Conference of State Bank Supervisors (hereinafter CSBS Brief) in Independent Ins. Agents of America, Inc. v. Board of Governors, 835 F.2d 1452, 1453 (D.C. Cir. 1987). The analysis set forth in Fisher, supra note 427, of the legislative history of the BHC Act closely parallels the discussion of that history in the CSBS Brief. Compare Fisher, supra note 427, at 353-62 (analyzing legislative history of BHC Act) with CSBS Brief, supra, at 15-31 (same). The editors of the University of San Francisco Law Review have recently acknowledged the CSBS Brief as a source for Mr. Fisher's article. See 24 U.S.F. L. Rev. No. 2 (Winter 1990) (unnumbered page entitled "Correction" appearing before the "Contents" page). A copy of the CSBS Brief is on file with Fordham Law Review.


430. See Aman, supra note 430, at 863-69. In addition, the legislative history relating to Section 3(d) of the BHC Act (the Douglas Amendment) is discussed in Wilmarth, supra note 38, at 1025-34.

431. See 12 U.S.C. § 1842(a) (1988). Section 2(a) of the BHC Act defines "bank holding company" to include, in general, any company that has direct or indirect control over any bank. See 12 U.S.C. § 1841(a) (1988). Section 2(b) defines "company" to include any corporation, partnership, business trust, association, long-term trust or similar organization. See 12 U.S.C. § 1841(b) (1988). Section 2(c) defines "bank" to include, in general, (i) any FDIC-insured bank, or (ii) any uninsured institution that (A) accepts demand deposits or deposits that may be withdrawn by check or similar Negotiable Instrument and (B) engages in the business of making commercial loans. See 12 U.S.C. § 1841(c) (1988).
the FRB, in deciding whether to approve such an acquisition, to consider specified competitive factors and also to evaluate "the financial and managerial resources and future prospects of the company or companies and the banks concerned, and the convenience and needs of the community to be served."\(^{432}\)

In view of the FRB's mandate under Section 3(c) to consider the financial resources and prospects of each acquiring bank holding company and each acquired bank, the FRB has authority to deny any acquisition that it determines to be financially unsound.\(^{433}\) In addition, Section 3(c) could possibly be read to authorize the FRB, in acting on a proposed acquisition of a bank by a holding company, to obtain commitments requiring the maintenance of specified capital or the acceptance of restrictions on particular business practices of the holding company or bank, if the FRB reasonably determined that these commitments were necessary to preserve the financial and managerial soundness of the holding company and the bank.\(^{434}\)

However, Section 3(c) does not grant to the FRB any general authority to regulate or restrict the powers of banks acquired by bank holding companies. Unlike Section 9 of the Federal Reserve Act, which authorizes the FRB to consider the powers of every state bank that applies for membership in the Federal Reserve System,\(^{435}\) Section 3(c) of the BHC


\(^{433}\) In Board of Governors v. First Lincolnwood Corp., 439 U.S. 234 (1978), the FRB relied on Section 3(c) in denying an application to form a bank holding company. The FRB determined that the holding company's initial capital would be inadequate in relation to its debt and would prevent the holding company from acting as "a source of financial . . . strength" for its subsidiary bank. \textit{Id.} at 241 (quoting First Lincolnwood Corp., 62 Fed. Res. Bull. 153, 153 (1976)). The Supreme Court upheld the FRB's action, even though the formation of the holding company would not have caused either anticompetitive effects or a weakening of the bank's financial condition. \textit{See id.} at 242-53.


There is a significant question whether the FRB would be authorized to require a holding company-owned bank (except for a state member bank) to cease and desist from an unsafe or unsound practice as a condition for the FRB's approval of a holding company acquisition under Section 3 of the BHC Act. As discussed supra at notes 342-344 and accompanying text, Section 8(b)(3) of the FDI Act authorizes the FRB to issue cease and desist orders only with respect to bank holding companies and their nonbank subsidiaries. However, certain language in \textit{Lincolnwood}, 439 U.S. at 248-52, could possibly be read to support the view that the FRB has independent authority under Section 3(c) of the BHC Act to require a bank holding company to prevent its subsidiary banks from engaging in specified banking practices, if that requirement is imposed in connection with the FRB's approval of an application under Section 3 and is necessary to preserve the financial and managerial soundness of the holding company and its banks. \textit{See also MCorp}, 900 F.2d at 862 n.5 (stating that "[a]s a condition to approving an application [under Section 3], the [FRB] could possibly require the holding company to agree to maintain the subsidiary banks to some degree of financial soundness") (emphasis added).

\(^{435}\) For discussion of the provision in Section 9 of the Federal Reserve Act empowering the FRB to consider the powers of prospective state member banks, see supra Part IV(B)(1).
Act confers no general power upon the FRB to consider the powers of state banks acquired by holding companies. Moreover, as the Fifth Circuit has held, Section 3(c) "does not grant the [FRB] authority to consider the financial and managerial soundness of the subsidiary banks after it approves the [holding company's] application."437

Even the broadest possible reading of Section 3(c) would only authorize the FRB to consider the safety and soundness of a prospective subsidiary bank as of the time it was the subject of a Section 3 acquisition. Thus, the FRB's arguable power to impose conditions under Section 3(c) in connection with the approval of a holding company's acquisition of a bank does not represent "an all-purpose tool" enabling the FRB to regulate the "day-to-day operations" of holding company-owned banks.439

Nevertheless, the FRB has proposed, in apparent reliance on its authority under Section 3(c), to adopt a general rule requiring all state banks acquired by holding companies to transfer their real estate investment and development activities to a nonbank subsidiary of the holding company and to refrain thereafter from engaging directly in such activities.440 In order to justify this proposed rule under Section 3(c), the FRB

436. In light of the contrast with Section 9 of the Federal Reserve Act, the omission of any reference to FRB consideration of bank powers in Section 3(c) indicates that Congress did not intend to confer upon the FRB any general authority to regulate the powers of holding company-owned banks under the latter section. See INS v. Cardoza-Fonseca, 480 U.S. 421, 432 (1987); Russello v. United States, 464 U.S. 16, 23 (1983).

437. See MCorp, 900 F.2d at 861 (holding that Section 3(c) did not authorize the FRB to require a bank holding company to transfer its own funds to replenish the capital of failing subsidiary banks).

438. As discussed supra at note 435 and accompanying text, the broadest reading of the FRB's authority under Section 3(c), as construed in Lincolnwood, would recognize the FRB's power to require a bank holding company to place restrictions on the activities of a particular bank that was being acquired by the holding company; see also Aman, supra note 115, at 890 (noting that Section 3(c) "seems to mandate an individual determination of the financial and managerial factors of each [holding company] applicant and its proposed subsidiary bank") (emphasis added). Moreover, as stated supra in note 437 and accompanying text, the FRB's power under Section 3(c) would not extend to subsequent bank activities that were not addressed in the FRB's order approving the acquisition.

439. See Lincolnwood, 439 U.S. at 254 (Stevens & Rehnquist, JJ., dissenting) (contending that Section 3(c) is not "an all-purpose tool"); MCorp, 900 F.2d at 861-62 (declaring that Section 3(c) does not authorize the FRB to regulate the "day-to-day operations" of holding company-owned banks). The majority opinion in Lincolnwood, 439 U.S. at 248-52, does not suggest that Section 3(c) would authorize the FRB to impose generalized restrictions on the activities of all banks that are the subject of holding company acquisitions. See MCorp, 900 F.2d at 861 (contending that Lincolnwood "did not read the [BHC Act] to grant the [FRB] authority to regulate the day-to-day financial soundness of the subsidiary banks"); see also Aman, supra note 115, at 890 (questioning the FRB's authority under Section 3 to adopt any "per se rule" banning real estate activities by banks acquired by holding companies).

440. See FRB Real Estate Proposal II, supra note 234, 52 Fed. Reg. at 42,302. In Wake Bancorp, 73 Fed. Res. Bull. 925, 927 (1987), the FRB approved the formation of a holding company to acquire a state savings bank that was authorized under state law to engage through subsidiaries in real estate investment and development. The state savings bank's real estate activities were specially authorized by 12 U.S.C. § 1842(f)(1) (1988). However, as a condition of the FRB's approval, the holding company agreed to alter the
would be required to show that real estate investment and development activities are so inherently risky as to threaten the soundness of virtually every bank holding company that acquired a bank that engages in these activities.\textsuperscript{441} In the absence of such a showing, the FRB does not have authority under Section 3(c) to impose such a generalized condition on banks acquired by holding companies.\textsuperscript{442}

b. \textit{Section 4 of the BHC Act}

Section 4(a) of the BHC Act contains two broad prohibitions on the involvement of bank holding companies in nonbanking activities. Section 4(a)(2) provides, in what has been described as an "ownership clause,"\textsuperscript{443} that no bank holding company may "retain direct or indirect ownership or control of . . . any company which is not a bank."\textsuperscript{444} Section 4(a)(2) further provides, in what has been called an "activities clause,"\textsuperscript{445} that no bank holding company may engage in any activities other than (A) those of banking or of managing or controlling banks and other subsidiaries authorized under [the BHC Act] or of furnishing services to or performing services for its subsidiaries, and (B) those permitted under [Section 4(c)(8) of the BHC Act].\textsuperscript{446}

Thus, Section 4(a) generally prohibits bank holding companies from owning nonbank companies or engaging in activities other than banking. These prohibitions are qualified by several exemptions contained in Section 4(c). The most important of these exemptions is set forth in Section 4(c)(8), which permits a bank holding company to engage in any non-

\textsuperscript{441} As discussed \textit{supra} at notes 67-68 & 226 and accompanying text, the FRB and some analysts have contended that real estate investment and development activities pose significant generalized risks to banks. However, as pointed out \textit{supra} at notes 66, 175 & 242 and accompanying text, and \textit{infra} at note 569 and accompanying text, the FDIC and other analysts and officials have stated that real estate activities do not present any systemic risk to the banking system if prudently managed by individual banks.

\textsuperscript{442} As Professor Aman has pointed out, the FRB has often imposed regulatory conditions on approvals of holding company acquisitions as a means to expand its effective jurisdiction into areas in which it has doubtful authority to act. See Aman, \textit{supra} note 115, at 889-91. The FRB's use of such conditions has been sharply criticized by Professor Aman, \textit{id.} at 889-99, and by Justices Stevens and Rehnquist in their dissenting opinion in \textit{Lincolnwood}, 439 U.S. at 254-58.

\textsuperscript{443} \textit{Merchants National}, 890 F.2d 1275, 1277 (2d Cir. 1989), \textit{petition for cert. filed}, 58 U.S.L.W. 3695 (U.S. April 18, 1990) (No. 89-1620).

\textsuperscript{444} 12 U.S.C. § 1843(a)(2) (1988). Section 4(a)(1) of the BHC Act contains a parallel "ownership clause," which provides that an existing bank holding company may not "acquire direct or indirect ownership or control of any company which is not a bank." 12 U.S.C. § 1842(a)(1) (1988). Thus, Section 4(a)(1) deals with the \textit{acquisition} of direct or indirect control of a nonbanking company by an \textit{existing} bank holding company, while Section 4(a)(2) deals with the \textit{retention} of direct or indirect control of a nonbanking company by a company which \textit{becomes} a bank holding company (e.g., by acquiring a bank).

\textsuperscript{445} \textit{Merchants National}, 890 F.2d at 1278.

banking activity that the FRB 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.”

i. Application of Section 4(a) to Holding Company-Owned Banks

The express terms of Section 4(a) strongly indicate that the prohibitions contained therein do not apply to holding company-owned banks. The prohibitions contained in the “ownership clauses” of Sections 4(a)(1) and (2) and the “activities clause” of Section 4(a)(2) do not apply to a bank holding company to the extent that it owns or controls banks and engages in activities that constitute banking. The term “banking” is not defined by the BHC Act, and it would therefore be appropriate to give the term its “ordinary” and “natural” meaning. An ordinary and natural definition of the term “banking,” as used in Section 4(a)(2), would include each type of business that a subsidiary bank of the particular bank holding company in question is authorized to conduct under the laws governing the bank's operations.

This common-sense approach to the meaning of “banking” in Section 4(a)(2) is consistent with the broad definitions of “bank” contained in Section 2(c) of the BHC Act as originally enacted in 1956 and as most recently amended in 1987. The original definition of “bank” included any national bank or state-chartered bank. The 1987 amendment to the definition of “bank” includes, in general, any FDIC-insured bank. Thus, based on the statutory definition of “bank” in Section 2(c), it appears that the term “banking” in Section 4(a)(2) should reasonably be interpreted to include any activity authorized for an FDIC-insured sub-

447. 12 U.S.C. § 1843(c)(8) (1988). A list of the “closely related” nonbanking activities that the FRB has generally approved for nonbank subsidiaries of bank holding companies is contained in 12 C.F.R. § 225.25 (1989). A bank holding company must obtain FRB approval to engage in these activities, or to conduct other nonbanking activities that the FRB may approve by order, by making application pursuant to id. § 225.23.

448. For the terms of the “ownership clauses” of Sections 4(a)(1) and (2), see supra notes 443-444 and accompanying text. For the terms of the “activities clause” of Section 4(a)(2), see supra notes 445-446 and accompanying text.


450. See, e.g., The Random House Dictionary of the English Language (2d ed. 1987) (defining “banking” as “the business carried on by a bank or banker”).

451. See BHC Act, supra note 118, § 2(c), 70 Stat. 133.

452. See CEBA, supra note 183, § 101(a), 101 Stat. 554 (codified at 12 U.S.C. § 1841(c)(1) (1988)). The 1987 definition also includes uninsured institutions that both accept demand deposits (or deposits that can be withdrawn by check or similar means for payment to third persons) and engage in the business of making commercial loans. This alternative definition of “bank” sets forth the minimum number of functions needed before an uninsured institution will be considered a “bank,” but it does not purport to prescribe the maximum number of functions that would be permissible for a “bank.”
STATE BANK POWERS

A subsidiary bank of the particular bank holding company in question. Such a common-sense definition is further supported by case law construing the general meaning of the "business of banking."

In short, a reasonable construction of the plain language of Section 4(a) leads to the conclusion that the prohibitions contained in Section 4(a) do not apply to the lawful activities of a holding company-owned bank. Moreover, as discussed below, the relevant legislative history confirms that Section 4(a) was not intended to restrict the activities of holding company-owned banks.

ii. Application of Section 4(a) to Operations Subsidiaries of Holding Company-Owned Banks

The FRB agrees that Section 4(a) does not restrict to the activities of holding company-owned banks. However, the FRB contends that the prohibition in Section 4(a) on ownership of nonbank companies does apply.

453. It might be argued that the application of an expansive definition of "banking" to the "activities clause" of Section 4(a)(2) would be overbroad because it would allow the bank holding company to engage, through any of its nonbank subsidiaries, in any nontraditional function authorized for any of the holding company's bank subsidiaries. This argument, however, would overlook the separate impact of the "ownership clauses" of Sections 4(a)(1) and 4(a)(2). Those clauses prohibit a bank holding company from acquiring or retaining control of "any company which is not a bank." 12 U.S.C. §§ 1842(a)(1) & (2) (1988). Thus, the "activities clause" in Section 4(a)(2) would not provide any authority for a bank holding company to acquire a nonbank subsidiary for the purpose of engaging in nontraditional activities, even if such activities were authorized for one of the holding company's subsidiary banks.

454. For example, several courts have held that the term "business of banking," as it appears in the National Bank Act (12 U.S.C. § 24 (Seventh) (1988)), includes all of the activities that (i) are authorized to national banks under an express statutory power, or (ii) are "convenient" or "useful" in carrying out an express power and, therefore, are "incidental" to the "business of banking." Securities Indus. Ass'n v. Clarke, 885 F.2d 1034, 1048-49 (2d Cir. 1989), cert. denied, 110 S. Ct. 1113 (1990); M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377, 1382 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978); Arnold Tours, Inc. v. Camp, 472 F.2d 427 (1st Cir. 1972); AMBAC, 656 F. Supp. at 407-08. These decisions indicate that the "business of banking" with regard to a particular class of banks (such as national or state banks) includes all of the activities which that type of bank is authorized to conduct under the laws applicable to its operation. For a discussion of the historical development of the term "business of banking," see Symons, The "Business of Banking" in Historical Perspective, 51 Geo. Wash. L. Rev. 676 (1983).

455. See infra Part IV(C)(2).

456. See Merchants National, 75 Fed. Res. Bull. at 391-92. The FRB did apply the prohibitions of Section 4 to a holding company-owned bank in Citicorp, 71 Fed. Res. Bull. 789 (1985). In that case Citicorp proposed to acquire a bank in South Dakota for the purpose of engaging in a nationwide insurance business. South Dakota law significantly restricted the ability of the bank to offer banking or insurance services to South Dakota residents. The FRB therefore found that the primary purpose of the bank was to engage in insurance activities that were not permitted under the BHC Act for nonbank subsidiaries of bank holding companies, and that the bank would conduct only insignificant banking operations. The FRB claimed authority to deny Citicorp's application under Section 5(b) of the BHC Act, 12 U.S.C. § 1844(b), in order to prevent an "evasion" of the terms and intent of Section 4. See id. at 790 & n.3, 791. The FRB has subsequently explained that its decision in Citicorp was based upon its finding that the South
ply to operations subsidiaries of holding company-owned banks. In drawing this distinction between holding company-owned banks and their operations subsidiaries, the FRB relies primarily on the “ownership clauses” of Sections 4(a)(1) and (2). As explained above, the “ownership clauses” prohibit a bank holding company from acquiring direct or indi-

Dakota bank was “a bank in name only” and would operate in fact as “a nationwide insurance franchise.” BankAmerica Corp., 76 Fed. Res. Bull. 244, 246 (1990).

As discussed supra at notes 213-215 and accompanying text, insurance industry groups have recently petitioned the FRB to apply its Citicorp decision to prevent Citicorp and other large bank holding companies from engaging in nationwide insurance activities through Delaware banks. The new Delaware statute authorizing such activities bears some resemblance to the South Dakota statute in Citicorp, since the Delaware law appears to prohibit Delaware banks owned by out-of-state bank holding companies from offering insurance products except for credit-related insurance to Delaware residents. However, unlike the South Dakota statute, Delaware law on July 1, 1990 will permit bank holding companies from any state to acquire Delaware banks that can offer a full range of banking services (except insurance services) to Delaware residents. See State of the State Banking System 1989, supra note 38, at 11. Accordingly, there appears to be a strong argument that the reasoning in Citicorp is not applicable to the new Delaware law, because Delaware permits out-of-state bank holding companies to acquire Delaware banks that offer a full range of domestic services as well as interstate insurance services. See, e.g., Insurance Groups Urge Fed, supra note 213, at 946-47; BankAmerica, 76 Fed. Res. Bull. at 246 (approving bank holding company’s acquisition of California state bank that is authorized to provide insurance agency services under California law, and distinguishing Citicorp, because bank “will, in fact, conduct banking activities in California”).

In addition, there is a serious question whether the FRB’s broad assertion in Citicorp, 71 Fed. Res. Bull. at 790 n.3, of authority to “prevent evasion” of the BHC Act is still viable. In Board of Governors v. Dimension Fin. Corp., 474 U.S. 361, 373 n.6 (1986), the Supreme Court held that Section 5(b) of the BHC Act, on which the FRB relied in Citicorp, “only permits the [FRB] to police within the boundaries of the [BHC] Act.” Thus, under Dimension, it appears that the FRB can no longer rely on Section 5(b) to expand its authority over the activities of holding company-owned banks. See MCorp, 900 F.2d at 861; Merchants National, 890 F.2d at 1279 n.2.

[Editors’ Note: On September 5, 1990, the FRB issued its order in Citicorp, 76 Fed. Res. Bull. — (1990), in which it required the life insurance subsidiary of Citibank (Delaware), Citicorp’s subsidiary state bank in Delaware, to cease offering the expanded insurance services authorized by the new Delaware statute. The FRB concluded that these expanded insurance services were not exempt from the general prohibitions in Sections 4(a) and 4(c)(8) of the BHC Act against the offering of insurance services by bank holding companies. Citicorp relied on the FRB’s regulation exempting activities of operations subsidiaries that are authorized under state law for holding company-owned state banks (12 C.F.R. § 225.22(d)(2)(ii) (1989)), discussed supra at note 238-41 and accompanying text, and infra at notes 481-84 and accompanying text. Citicorp pointed out that the Delaware statute permits Delaware state banks to offer expanded insurance services directly through a department or division of the bank. Therefore, Citicorp argued, the life insurance subsidiary of Citibank (Delaware) was an operations subsidiary engaged in activities that its parent state bank could offer directly, as required by Section 225.22(d)(2)(ii) of the FRB’s regulations. The FRB, however, rejected this argument. In the FRB’s opinion, the stringent restrictions imposed by the Delaware statute on an insurance department or division of a Delaware state bank amounted to an effective corporate separation of the bank from its insurance department or division. The FRB concluded, therefore, that a Delaware state bank could not engage directly in the expanded insurance activities, and that the activities of the life insurance subsidiary were not exempted from the prohibitions contained in Sections 4(a) and 4(c)(8).]

rect control of "any company which is not a bank."458 Because operations subsidiaries are "companies" within the meaning of Section 2(b),459 and do not fit within the literal definition of "bank" under Section 2(c),460 the FRB contends that operations subsidiaries are nonbank companies subject to the prohibitions in Section 4(a).461

The FRB finds further support for its position in Section 2(g)(1) of the BHC Act, which provides that any company "owned or controlled by any subsidiary of a bank holding company shall be deemed to be indirectly owned or controlled by such bank holding company."462 Based on Section 2(g)(1), the FRB contends that an operations subsidiary owned directly by a holding company-owned bank would be a nonbank company that is "indirectly" owned by the parent bank holding company. Accordingly, the FRB maintains, the parent holding company's indirect control of the operations subsidiary would subject that subsidiary to the ownership prohibitions in Sections 4(a).463

The FRB's contention that Section 4(a) applies to operations subsidiaries of holding company-owned banks is arguably supported by a mechanical application of the literal terms of Sections 2(g)(1), 4(a)(1) and 4(a)(2).464 Accordingly, it might be argued that Chevron mandates deference to the FRB's interpretation, since the FRB is the agency responsible for administering the BHC Act.465 However, there are three significant factors that militate against such deference. First, other provisions of the BHC Act and related statutes indicate that an operations

463. See id. However, as discussed infra in Part IV(C)(2)(b), the legislative history of the enactment of Section 2(g)(1) in 1966 does not confirm the FRB's interpretation of that provision.
464. The FRB claims that Sections 4(c)(2) and (4) provide further support for its position with respect to the application of Section 4(a) to operations subsidiaries of holding company-owned banks. See FRB Rescission Proposal, supra note 239, 53 Fed. Reg. at 48,921-22. However, these sections have no relevance to operations subsidiaries. Section 4(c)(2) exempts shares of any nonbank company acquired by a bank holding company or any of its subsidiaries in satisfaction of a debt previously contracted in good faith. See 12 U.S.C. § 1843(c)(2) (1988). Section 4(c)(4) exempts shares of any nonbank company held or acquired by a bank in good faith in a fiduciary (i.e., trust) capacity. See id. § 1843(c)(4). Both provisions are designed to deal with ownership interests in companies that are engaged in activities not permissible for banks. See, e.g., S. Rep. No. 1095, 84th Cong. 1st Sess., reprinted in, 1956 U.S. Code Cong. & Admin. News 2482, 2493. Neither provision would be relevant to an operations subsidiary of a holding company-owned bank that is conducting activities that are authorized for its parent bank.
subsidiary of a holding company-owned bank is not intended to be treated as a "company which is not a bank" for purposes of Section 4(a). Second, the legislative history of the BHC Act persuasively demonstrates that Congress intended to exempt both holding company-owned banks and their operations subsidiaries from the prohibitions contained in Section 4(a). Third, the FRB's current position represents a sharp departure from its long-established practice of treating operations subsidiaries as equivalent to incorporated departments of their parent banks.

The overall terms, structure and intent of the BHC Act and related statutes strongly suggest that an operations subsidiary of a holding company-owned bank should be treated as a "bank" for purposes of Section 4(a), because an operations subsidiary engages in banking activities that are authorized for its parent bank. The plain language of the "activities clause" in Section 4(a)(2) of the BHC Act indicates that Congress did not intend to prohibit bank holding companies from engaging, through their subsidiary banks and operations subsidiaries of those banks, in activities that constitute "banking." Section 5(e)(1) of the BHC Act provides further evidence that the FRB's regulatory jurisdiction under the BHC Act is not intended to reach operations subsidiaries of holding company-owned banks.

The FRB claims that the "activities clause" of Section 4(a)(2) does not apply to any subsidiaries of bank holding companies and instead applies only to the direct activities of bank holding companies which are themselves banks. Thus, in the FRB's view, the "activities clause" does not validate the banking activities of an operations subsidiary of a holding company-owned bank. In support of this narrow construction of the "activities clause," the FRB points out that the "ownership clauses" of Sections 4(a)(1) and (2) refer to "direct or indirect" control of nonbank companies, while the "activities clause" does not contain the words "directly or indirectly" before the phrase "engage in any activities other than . . . banking."

The absence of the words "directly or indirectly" in the "activities clause" lends a surface plausibility to the FRB's position that the clause


469. See id. at 391-92 & n.18.
authorizes only the direct activities of bank holding companies which are themselves banks. However, on closer inspection, the FRB's interpretation is clearly contrary to both the language and legislative history of the BHC Act. One significant problem with the FRB's interpretation is that, in practical effect, it requires the term "bank holding company" to be read one way (as including every company that controls a bank) for purposes of the "ownership clauses" of Sections 4(a)(1) and (2), and to be read another way (as including only a bank holding company that is itself a bank) for purposes of the "activities clause" of Section 4(a)(2). Such a double reading runs counter to the general presumption that a term is used with the same intended meaning when it appears in different portions of the same statute. Moreover, the legislative history of Sections

470. In Merchants National, 890 F.2d at 1281, the Second Circuit acknowledged that the absence in the "activities clause" of the words "directly or indirectly" was "supportive of the [FRB's] position." However, the court cautioned that such omission "might also [have] result[ed] from drafting different clauses at different times and assembling them without intending differences in phrasing to have significance." Id.; see also Cass v. United States, 417 U.S. 72, 83 (1974) (quoting Schmid v. United States, 193 Ct. Cl. 780, 789, 436 F.2d 987, 992 (Nichols, J., dissenting), cert. denied, 404 U.S. 951 (1971)) ("In resolving [statutory] ambiguity, we must allow ourselves some recognition of the existence of sheer inadvertence in the legislative process").

471. See Sorenson v. Secretary of the Treasury, 475 U.S. 851, 860 (1986); Patagonia Corp. v. Board of Governors, 517 F.2d 803, 810 (9th Cir. 1975). This presumption carries even greater weight where, as in the case of "bank holding company," the term has been expressly defined in the statute (viz., in Section 2(a)(1) of the BHC Act) and the term is used repeatedly in the same section (viz., in the "ownership clauses" and "activities clause" of Section 4(a)). See Sorenson, 475 U.S. at 860.

The FRB argues that the "activities clause" of Section 4(a)(2) must be read to include only the direct activities of bank holding companies that are themselves banks because otherwise the "ownership clauses" of Section 4(a)(1) and 4(a)(2) would be "superfluous." Merchants National, 75 Fed. Res. Bull. at 392. The FRB reasons that if the "activities clause" is applied to subsidiaries of bank holding companies, it would accomplish the same result (viz., prohibiting the direct or indirect ownership of nonbank companies) as the "ownership clauses." The FRB overlooks, however, another likely purpose for the "activities clause." That clause might well have been intended to prevent holding companies from engaging in unlawful nonbanking activities by causing their bank subsidiaries to conduct operations that were not authorized by their bank charters. The "ownership clauses" would not reach this manipulation of holding company-owned banks, because those clauses only prohibit the direct or indirect ownership of nonbank companies. In fact, when Congress adopted the BHC Act in 1956, there were numerous statements of congressional concern about the ability of bank holding companies to manipulate the operation of their subsidiary banks in ways that violated the letter or spirit of federal and state banking laws. See, e.g., H.R. Rep. No. 609, 84th Cong., 1st Sess. 3-5 (1955); 101 Cong. Rec. 8021 (1955) (remarks of Representative Spence, House floor manager for the original BHC Act); id. at 8032 (remarks of Representative Rains); id. at 8034 (remarks of Representative Marshall).

The FRB has also suggested that the application of the "activities clause" to subsidiaries of bank holding companies would create internal inconsistencies in Section 4, because Section 4(a)(2)(B) exempts from the "activities clause" only such "closely related" nonbanking activities as are authorized by the FRB under Section 4(c)(8). See Merchants National, 890 F.2d at 1281 (discussing FRB's argument). The FRB, however, overlooks Section 4(a)(2)(A), which exempts from the "activities clause" the business of "managing or controlling [nonbank] subsidiaries authorized under [the BHC Act]." 12 U.S.C. § 1843(a)(2)(A) (1988). Thus, in light of Section 4(a)(2)(A), the application of the "activi-
4(a)(1) and (2), as originally enacted in 1956, reflects a clear congressional understanding that both provisions, including the “activities clause,” would apply to all bank holding companies.472

The “most perplexing aspect” of the FRB’s narrow interpretation of the “activities clause” is that it exempts the direct activities of holding company-owned banks from Section 4(a) and yet imposes the restrictions of Section 4(a) on the same activities when conducted indirectly by operations subsidiaries of those banks.473 The Second Circuit has noted the “awkwardness and perhaps illogic of the [FRB’s] generation-skipping approach.”474

The FRB’s attempt to impose the prohibitions of Section 4(a) on operations subsidiaries of holding company-owned banks also runs counter to statutes other than the BHC Act. These statutes confirm that the responsibility for regulating operations subsidiaries is vested in the primary federal regulators of the parent banks, not the FRB under the BHC Act.

For example, the BSC Act provides that a BSC established by a state bank may offer, in the parent bank’s home state, all nondeposit services that the parent bank is authorized to offer at the same locations.475 The BSC Act does not give to the FRB enforcement authority over BSCs established by holding company-owned banks (except for BSCs established by state member banks, as to which the FRB is the primary federal regulator). The BSC Act instead provides that BSCs—which are functionally equivalent to operations subsidiaries—are subject to the supervisory and enforcement authority of the primary federal regulator for the principal bank owner of the BSC.476 Similarly, the FRB has not been given authority under ILSA to establish capital adequacy requirements

472. See, e.g., H.R. Rep. No. 609, supra note 471, at 24 (Section 4(a) “makes it unlawful . . . for a bank holding company to own . . . any company other than a bank or to engage in any business other than . . . banking”); S. Rep. No. 1095, 84th Cong., 1st Sess. (1955), reprinted in 1956 U.S. Code Cong. & Admin. News 2482, 2493, 2502 (Section 4(a) “prohibits a bank holding company from acquiring or retaining voting shares of any nonbank company or engaging in a business other than . . . banking”); 101 Cong. Rec. 8037 (1955) (remarks of Representative Jonas) (Section 4(a) makes it “unlawful for any bank holding company . . . to own . . . any company other than a bank or to engage in any business other than that of banking”).

473. See Merchants National, 890 F.2d at 1282.

474. Id. The Second Circuit explained its “generation-skipping” analogy as follows: “[T]he [FRB] adopts a generation-skipping approach: It may prohibit nonbank activities by bank holding companies and by their ‘grandchildren,’ i.e., the subsidiaries of their bank subsidiaries, but not by their bank ‘children,’ i.e., the holding companies’ immediate bank subsidiaries.” Id.

475. For discussion of the operating powers of BSCs, see supra notes 252-56 and accompanying text.

476. For discussion of the allocation of supervisory and enforcement authority with respect to BSCs, see supra notes 342-344 and accompanying text.
for BSCs.\textsuperscript{477} Moreover, for purposes of Section 23A and 23B of the Federal Reserve Act, an operations subsidiary is generally treated as part of its parent bank.\textsuperscript{478}

Thus, the structure of the BHC Act and related statutes provide evidence of a clear congressional intent to regulate operations subsidiaries of holding company-owned banks as part of their parent banks, not as non-bank companies subject to the prohibitions imposed by Section 4(a) of the BHC Act. Moreover, as discussed below, the legislative history of the BHC Act reveals that Congress has followed a deliberate policy of exempting the activities of holding company-owned banks and their operations subsidiaries from the restrictions contained in Section 4(a).\textsuperscript{479} In these circumstances, the actual intent of Congress should be followed notwithstanding the arguable literal meaning of the "ownership clauses" in Section 4(a).\textsuperscript{480}

Moreover, the FRB's position that Section 4(a) applies to operations subsidiaries of holding company-owned banks is less entitled to deference because it represents a reversal of the FRB's long-established practice regarding such subsidiaries. Since 1971, an FRB regulation has provided that any operations subsidiary that is wholly owned by a national bank or state bank may engage in activities authorized for its parent bank, at locations permitted to its parent bank, without regard to the fact that its parent bank is controlled by a bank holding company.\textsuperscript{481} In exempting operations subsidiaries of holding company-owned banks from the prohibitions contained in Section 4(a) of the BHC Act, this regulation has provided essentially the same authority as that granted by the 1982 amendments to the BSC Act.\textsuperscript{482} The one exception is that the FRB has refused to extend the scope of the regulation's exemption to include operations subsidiaries that are not wholly-owned by a single bank, a position

\textsuperscript{477} For discussion of the allocation of authority with respect to capital requirements for BSCs, see supra notes 418-422 and accompanying text.

\textsuperscript{478} As discussed supra in Part IV(B)(5), Sections 23A and 23B of the Federal Reserve Act do not treat operations subsidiaries as "affiliates" of their parent banks in the absence of a contrary determination by the FRB.

\textsuperscript{479} See infra Part IV(C)(2).

\textsuperscript{480} For discussion of cases holding that the meaning of a statutory provision should be construed in light of the entire statute and related laws, see supra notes 278 and accompanying text. For discussion of additional cases holding that the clear intent of Congress, as revealed in the legislative history of the entire statute, should be followed where that intent conflicts with the apparent literal meaning of an isolated provision, see supra notes 279-280 and accompanying text.


\textsuperscript{482} For discussion of the authority granted to BSCs under the BSC Act as amended in 1982, see supra notes 252-56 and accompanying text.
which appears to be inconsistent with BSC Act. 483

The FRB has recently proposed to rescind its regulation exempting the activities of operations subsidiaries, based on what the FRB sees as potential threats to the safety of bank holding companies resulting from the expansion of state banking powers. 484 The FRB, however, would be obligated to satisfy an enhanced standard of reasoned analysis in order to justify its reversal of position. 485 In view of the reduced degree of deference to which the FRB would be entitled in such circumstances, it would be particularly inappropriate to allow the FRB to extend its jurisdiction


As discussed supra at notes 252-56 and accompanying text, the BSC Act authorizes two or more state or national banks to establish a jointly-owned BSC. Thus, there is no requirement that a BSC be wholly owned by a single bank.

In addition, as explained supra at note 258 and accompanying text, the authorized activities of a BSC are not subject to the restrictions contained in Section 4(a) of the BHC Act, even if the BSC is established by one or more holding company-owned banks. Accordingly, the FRB's refusal to recognize the activities of a holding company-owned bank's operations subsidiary as exempt from Section 4 of the BHC Act, unless the subsidiary is wholly owned by the bank, appears contrary to the BSC Act.

484. In 1971, when the FRB adopted its regulation concerning operations subsidiaries of holding company-owned banks, the FRB stated that the regulation was based in part on an "absence of evidence [indicating] that acquisitions by holding company banks are resulting in evasions of the purposes of the [BHC] Act." 36 Fed. Reg. 9292 (1971). The FRB further stated that "[t]he merits of this decision will be reviewed by the [FRB] from time to time in the light of its experience in administering the [BHC Act]." Id. The FRB now contends that a rescission of its 1971 regulation would be justifiable in light of the recent expansion of state banking powers and the resulting potential for "the conduct of high risk nonbanking activities in subsidiaries of banks outside the framework and safeguards Congress established in the BHC Act." FRB Rescission Proposal, supra note 239, 53 Fed. Reg. at 48916. For additional discussion of the FRB's rescission proposal, see supra notes 238-41 and accompanying text.

485. Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 41-42 (1983). In the past, the courts have imposed a higher burden of persuasion on the FRB when it sought to depart from a long-established position, even in response to changed circumstances. See Dimension Fin. Corp. v. Board of Governors, 744 F.2d 1402, 1405-09 (10th Cir. 1984), aff'd, 474 U.S. 361 (1986); Patagonia Corp. v. Board of Governors, 517 F.2d 803, 810-13 (9th Cir. 1975).

The FRB has contended that, since enactment of the BHC Act in 1956, it has "consistently held that the nonbanking provisions of section 4(a) of the [BHC] Act apply to the acquisition and retention of the voting shares of nonbank companies by holding company banks." FRB Rescission Proposal, supra note 239, 53 Fed. Reg. at 48,917. In support of this contention, the FRB cites two of its rulings codified at 12 C.F.R. §§ 225.101 & 225.102 (1989). However, those rulings dealt with (i) a passive minority investment by a holding company-owned bank in a nonbanking company, and (ii) control by holding company-owned banks over an investment company whose investments consisted exclusively of passive minority investments in other companies. Thus, the rulings cited by the FRB did not deal with the case of an operations subsidiary engaged in activities authorized for its parent holding company-owned bank. In the case of operations subsidiaries, the FRB's consistent practice since 1971 (as discussed supra at notes 481-83 and accompanying text) has been to exempt such subsidiaries from the prohibitions contained in section 4(a).
over operations subsidiaries of holding company-owned banks contrary to the intent of Congress.486

2. The Legislative History of the BHC Act

The legislative history of the BHC Act demonstrates a consistent intent by Congress not to exempt holding company-owned state banks and their operations subsidiaries from the nonbanking prohibitions contained in Section 4(a). In 1956, and again in 1970 and 1982, Congress made clear that it was not seeking to bar holding company-owned state banks from engaging, either directly or through operations subsidiaries, in activities authorized under state law.

a. The Original BHC Act of 1956

One of the major purposes of the original BHC Act of 1956 ("1956 Act"), which applied to all companies owning two or more banks, was to prevent such companies from "engag[ing] in businesses wholly unrelated to banking."487 Section 4 of the 1956 Act was thus designed, in general, to require "the divestment by bank holding companies of investments in businesses extraneous to banking."488 However, Congress expressed no desire to force holding company-owned state banks or their subsidiaries to terminate activities that were authorized for banks under state law.489 For example, Representative Multer, a senior majority member of the House Banking and Currency Committee, stated that Section 4 would not require a bank holding company to divest itself of any subsidiary that "engages only in the business of banking."490

During hearings on proposed bank holding company legislation in 1955, three witnesses advised the House Banking and Currency Committee that state banks and their subsidiaries were engaged in activities that were authorized by state law but not permitted to national banks under federal law. These witnesses further stated that the nonbanking prohibitions contained in Section 4 would not apply to the authorized activities of state banks or their subsidiaries. Governor J. L. Robertson of the FRB explained to the Committee that a commercial or consumer loan

486. See, e.g., Dimension, 744 F.2d at 1405-09; Patagonia, 517 F.2d at 810-13.
488. H.R. Rep. No. 609, supra note 471, at 16; see also 101 Cong. Rec. 8020 (1955) (remarks of Representative Spence, House floor manager for the 1956 Act) (Section 4 "merely attempts to divorce from [bank] holding companies the power . . . to engage in unrelated businesses").
489. See Merchants National, 890 F.2d at 1283 ("The legislative history . . . is remarkably free of clear statements indicating disapproval of nonbanking activities engaged in directly by bank subsidiaries").
company that was owned by a state bank would not be subject to the prohibition on nonbanking activities if the company was "merely an arm of the bank itself." A second witness advised that the nonbanking prohibitions would not apply to the activities of bank holding companies "insofar as [such activities] might be engaged in by bank subsidiaries."

A third witness explained that state-chartered savings banks were permitted by state law in at least three states to engage directly, or indirectly through subsidiaries, in the selling of life insurance, the operation of a registered investment company or the making of equity investments. In response to this testimony, Representative Spence, the committee chairman and later the House floor manager for the 1956 Act, stated that he did not agree with the broad scope of these state powers. Nevertheless, he and Representative Brown made clear in the following colloquy that the 1956 Act would not interfere with the authorized functions of state banks or their subsidiaries:

MR. BROWN: We are not trying to change the State laws, are we?
THE CHAIRMAN (Rep. Spence): We are not changing the State laws at all . . . . This bill doesn't affect State laws. And we don't intend to usurp any of the functions of the States, or change the attitudes of the States in reference to these matters.

These discussions during the House committee hearings, which were noted by the Second Circuit in Merchants National, provide strong evidence that the 1956 Act was not intended to affect the powers of state banks or their operations subsidiaries. Further confirmation of this congressional intent appears in Section 7 of the 1956 Act. Section 7 was enacted to preserve the existing jurisdiction of the states over banks and bank holding companies. It was expressly understood that Section 7 would "reserve[] to the States the full and complete authority over State banks and State banking."

The Senate Banking and Currency Committee drew an important dis-

---

491. Control and Regulation of Bank Holding Companies: Hearings on H.R. 2674 before the House Comm. on Banking and Currency, 84th Cong., 1st Sess. 119 (1955) [hereinafter 1955 House Hearings]. By referring to a subsidiary that was "merely an arm of the bank itself," Governor Robertson was evidently referring to an operations subsidiary. See id.

492. Id. at 231 (testimony of James S. Bush, Vice President of General Contract Corp.).

493. See id. at 552-53, 569 (testimony of Ellery C. Huntington, Jr., President of the Morris Plan Corp. of America).

494. Id. at 553.

495. 890 F.2d at 1283.

496. See BHC Act, supra note 118, § 7, 70 Stat. 138 (codified as amended at 12 U.S.C. § 1846 (1988)). For further discussion of Section 7, see supra note 120 and accompanying text.

497. 1955 House Hearings, supra note 491, at 367 (remarks of Representative Multer); see also 101 Cong. Rec. 8021 (1955) (remarks of Representative Spence, stating that under Section 7 "the States retain every right they have now"); id. at 8182 (remarks of Representative Multer).
tinction between the powers reserved and not reserved to the states under Section 7 of the 1956 Act. The committee explained that the states would have authority under Section 7 "to be more restrictive regarding the formation or operation of bank holding companies within their respective borders than the Federal authorities can be or are under [the 1956 Act]."\footnote{498} The committee cautioned, however, that Section 7 would not authorize states to regulate bank holding companies in a manner so "inconsistent" with the 1956 Act as to "nullify its effect."\footnote{499} Notwithstanding this limitation on state authority over bank holding companies under Section 7, the committee reaffirmed that Section 7 would "preserve to the States those powers which they now have in our dual banking system."\footnote{500}

Thus, the evident purpose of Section 7 was to afford the states an option to be more restrictive but not more liberal than the BHC Act with respect to bank holding companies.\footnote{501} However, with regard to state banks and their subsidiaries, whose powers were not to be affected by the BHC Act, the states were to retain their full regulatory jurisdiction and discretion under the dual banking system.\footnote{502} This distinction accords with the general understanding of Congress in 1956 that the operations of state banks were already subject to adequate supervisory protection under state banking laws, but that a new federal statute was needed to control the previously unregulated activities of bank holding companies.\footnote{503}

\section*{b. The 1966 Amendments}

The 1966 amendments to the BHC retained the basic structure of the 1956 Act but removed certain exemptions granted by the original Act.\footnote{504}
In addition, the 1966 amendments amended the definition of "subsidiary" in Section 2(d) and added a new definition of "indirectly owned or controlled" in Section 2(g)(1) of the BHC Act.\(^5\) Sections 2(d) and 2(g)(1) together provide that any shares or companies owned or controlled by a subsidiary (including a bank subsidiary) of a bank holding company are deemed to be indirectly owned or controlled by the holding company itself.\(^5\)

The FRB has contended that the 1966 amendments were intended to make clear that all investments or subsidiaries of holding company-owned banks, including operations subsidiaries, would be subject to Section 4(a) of the BHC Act.\(^5\) In fact, however, the amendments to Sections 2(d) and 2(g)(1) were primarily designed to prevent holding companies from evading regulation under the BHC Act by establishing a series of intermediate "shell" holding companies that would each own one bank and, thereby, maintain exempt status under the Act.\(^5\) Nothing in the legislative history of these amendments suggests that Congress intended to reverse its original decision in 1956 that Section 4(a) would not apply to activities conducted by subsidiaries of state banks as long as those activities were authorized under state banking laws.\(^5\)

In the absence of a clear expression of congressional intent, a fundamental reversal of the position Congress took in 1956 should not be inferred from the literal terms of the 1966 amendments.\(^5\) Moreover, as


506. See id. For further discussion of Section 2(g)(1), see supra notes 462-64 and accompanying text.


509. For a discussion of the legislative history of the 1956 Act, see supra Part IV(C)(2)(a). The FRB points to comments in the 1966 Senate committee report indicating that Congress passed the 1966 amendments to Sections 2(d) and 2(g)(1) to codify previous FRB interpretations of the 1956 Act. See FRB Rescission Proposal, supra note 239, 53 Fed. Reg. at 48,921 (quoting S. Rep. No. 1179, supra note 504, at 8, reprinted in 1966 U.S. Code Cong. & Admin. News at 2392). However, as discussed supra at note 485, the rulings cited by the FRB do not deal with operations subsidiaries conducting activities authorized by state law for their parent state banks. Instead, those rulings deal with passive minority investments held directly or indirectly by holding company-owned banks.

510. See FDIC v. Philadelphia Gear Corp., 476 U.S. 426, 431-39 (1986) (declining, in the absence of a clear expression of congressional intent, to construe an amendment to the definition of "deposit" in the FDI Act in a manner that would significantly alter the Act's jurisdictional scope); Cass v. United States, 417 U.S. 72 (1974) (declining, without a clear statement of congressional purpose, to interpret an amendment to the definition of...
explained below, Congress reiterated a clear understanding in 1970 that holding company-owned banks and their operations subsidiaries would be exempt from Section 4(a).\textsuperscript{511} In light of this later confirmation of Congress' original position in 1956, the ambiguous history of the 1966 amendments substantially undermines the FRB's attempt to rely on those amendments.\textsuperscript{512}

c. The 1970 Amendments

The 1970 amendments to the BHC Act represented a fundamental reworking of the Act, especially in extending the Act's coverage to holding companies controlling only one bank.\textsuperscript{513} It is therefore particularly significant that Congress in 1970 reaffirmed its original determination in 1956 that Section 4(a) of the BHC Act would not apply to holding company-owned banks or their operations subsidiaries.

Throughout the deliberations on the 1970 amendments, there were repeated expressions of the intent of Congress not to regulate the activities of holding company-owned banks.\textsuperscript{514} For example, although the House adopted a "negative laundry list" prohibiting any bank holding company or its subsidiary banks from engaging in insurance, securities, travel agency, accounting, data processing or leasing activities,\textsuperscript{515} that provision was rejected by the Senate and the conference committee on the 1970 amendments.\textsuperscript{516} The decision of Congress not to adopt restrictions on the activities of holding company-owned banks is particularly striking in

\textsuperscript{511}. See infra Part IV(C)(2)(c).
\textsuperscript{512}. See \textit{Seatrain Shipbuilding Corp. v. Shell Oil Co.}, 444 U.S. 572, 596 (1980) (in construing a statute, "while the views of subsequent Congresses cannot override the unmistakable intent of the enacting one, . . . such views are entitled to significant weight, . . . and particularly so when the precise intent of the enacting Congress is obscure") (citations omitted).
\textsuperscript{515}. For explanation of the intent of the House-adopted "negative laundry list," see 115 Cong. Rec. 33,133-34, 33,138 (1969) (remarks of Representative Blackburn, sponsor of provision); \textit{id.} at 33,134-35 (remarks of Representative Patman, chairman of the House Banking and Currency Comm.); \textit{id.} at 33,136 (remarks of Representative St Germain); \textit{id.} at 33,138 (remarks of Representative Matsunaga).
\textsuperscript{516}. For discussion of the actions of the Senate and the conference committee in rejecting the House "negative laundry list," see 116 Cong. Rec. 42,422-23 (remarks of Senator Sparkman, Senate floor manager for the 1970 amendments); \textit{id.} at 42,427-48 (remarks of Senator Proxmire); \textit{id.} at 42,428-29 (remarks of Senator Goodell); \textit{id.} at 41,953-54.
view of the information given to Congress concerning the involvement of state banks in securities, insurance and other activities.517

During consideration of the 1970 amendments, Chairman Arthur Burns of the FRB specifically advised Congress that the FRB’s jurisdiction under both the existing BHC Act and the 1970 amendments would not extend to the activities of holding company-owned banks or their operations subsidiaries. Chairman Burns advised that the BHC Act authorized the FRB to “regulat[e] the bank holding companies, not the [subsidiary] banks themselves,” and that the subsidiary banks would “continue to function under their present supervisory authorities.”518 This statement was quoted in the Senate committee report on the 1970 amendments.519 Moreover, Chairman Burns stated that a “wholly owned operations subsidiary” of a holding company-owned bank would be exempt from the prohibitions of Section 4(a), because such a subsidiary would “serve in effect, as a separately incorporated department of the bank.”520 Thus, in adopting the 1970 amendments, Congress plainly understood that Section 4(a) would not apply to the activities authorized by state law for holding company-owned state banks and their operations subsidiaries.521

(remarks of Representative Widnall, ranking minority member of House Banking and Currency Comm.); id. at 41,961 (remarks of Representative Reuss).


520. 1970 Senate Hearings, supra note 517, at 141. As Chairman Burns explained in his testimony (id.), the FRB had adopted a ruling in 1968 permitting state member banks to establish wholly-owned operations subsidiaries. The 1968 ruling recognized that a bank’s use of an operations subsidiary to carry on activities authorized for the bank was “simply a convenient alternative organizational arrangement” in place of conducting the same activities directly in a department of the bank. See 33 Fed. Reg. 11,813 (1968) (codified as amended at 12 C.F.R. § 250.141 (1989)).

Notwithstanding this explicit statement by Chairman Burns with respect to operations subsidiaries, the FRB has asserted (without referring to that statement) that Chairman Burns’ testimony at the 1970 Senate hearings “says nothing about nonbank subsidiaries of holding company banks and in no way indicates that section 4(a) does not apply to the acquisition of shares or subsidiaries by holding company banks.” See FRB Rescission Proposal, supra note 239, 53 Fed. Reg. at 48,924. The FRB’s assertion is clearly mistaken.

521. Since the FRB is the agency responsible for administering the BHC Act, see Lincolnwood, 439 U.S. at 248, Chairman Burns’ representations to Congress in 1970 are
In 1982, Congress passed Section 601 of the Garn-St Germain Act to restrict the permissible insurance activities of bank holding companies. Section 601 accomplished this purpose by limiting the FRB's authority to approve insurance activities under Section 4(c)(8). Since Section 4(c)(8) provides an exception from the general prohibitions contained in Section 4(a), Section 4(c)(8), as amended in 1982, has no application to holding company-owned banks or their operations subsidiaries, which are exempt from Section 4(a).

The legislative history of Section 601 confirms that Congress did not intend to restrict the direct or indirect insurance activities of holding company-owned state banks. During the House debates on a predecessor bill to Section 601, Representative Hanley, chief House sponsor of the bill, declared that the bill "covers only the large bank holding companies . . . [and] is not intended to apply directly or indirectly to any type of lending institution other than a bank holding company." Similarly, Governor Partee of the FRB testified during a Senate hearing that the same House bill would not prevent a holding company-owned state bank from engaging in insurance activities to the extent permitted by state law. The Senate committee report on the Garn-St Germain Act stated that Section 601 would apply only to bank holding companies and their nonbank subsidiaries, and would not affect the jurisdiction reserved to

entitled to substantial weight in evaluating the intent of Congress regarding the activities of holding company-owned banks and their operations subsidiaries. See, e.g., Lindahl v. OBM, 470 U.S. 768, 788 (1985). Moreover, Chairman Burns' representations in 1970 were identical in substance to the advice given by Governor Robertson of the FRB to Congress prior to enactment of the original BHC Act of 1956. See supra note 491 and accompanying text. These statements of FRB officials are especially significant because Congress, after hearing them, took no action to apply the nonbanking prohibitions in Section 4(a) to holding company-owned banks or their operation subsidiaries. See Lincolnwood, 439 U.S. at 248, 251-52.


See id. For further discussion of Section 601, see supra note 159-161 and accompanying text. For discussion of the legislative history of the 1982 amendments, see Fisher, supra note 427, at 359-60 (covering much of the same material presented herein); CSBS Brief, supra note 428, at 26-28 (same).

For discussion of the relationship between Sections 4(a) and 4(c)(8), see supra notes 445-47 and accompanying text.

126 Cong. Rec. 14,538-39 (1980) (colloquy between Representatives Hanley and Spellman on H.R. 2255, 96th Cong., 2d Sess. (1980), a predecessor bill of Section 601, confirming that H.R. 2255 would not prevent state savings banks from offering insurance services in accordance with state law); accord id. at 14,536 (remarks of Representative Vento, stating that H.R. 2255 "does not address itself to any other types of financial institutions").


the states under Section 7 of the BHC Act.\footnote{528}{ See id. at 41, reprinted in 1982 U.S. Code Cong. & Admin. News at 3095. For a discussion of the intent of Section 7 of the BHC Act to preserve the regulatory authority of the states over state-chartered banks, see supra notes 496-503 and accompanying text.}

Other provisions of the Garn-St Germain Act, which amended the BHC Act and Section 23A of the Federal Reserve Act, provide further evidence that Congress did not intend to restrict the authorized powers of holding company-owned state banks or their operations subsidiaries. As discussed above, Section 709 of the Garn-St Germain Act amended the BHC Act to authorize one or more state banks to establish a BSC that could provide all of the nondeposit services that its parent bank or banks could provide under state law.\footnote{529}{ See Garn-St Germain Act, supra note 30, § 709, 96 Stat. 1540. For further discussion of the 1982 amendments to the BSC Act, see supra notes 252-61 and accompanying text.} There is no reference in the amended BSC Act to any limitation on insurance activities of BSCs established by holding company-owned state banks. Indeed, the BHC Act provides that the authority of BSCs owned by state banks to engage in banking activities authorized by state law is a power that is independent of the authority of BSCs to offer services permitted under Section 4(c)(8) of the BHC Act.\footnote{530}{ It is noteworthy that the 1982 amendments to the BSC Act were drafted by the leadership of the Senate Committee on Banking, Housing, and Urban Affairs in consultation with the FRB. See 128 Cong. Rec. 25,131 (1982) (remarks of Senator Garn, quoting letter from himself and Senator Riegle to Mr. L. Jenkins, President of the American Bankers Ass'n). Thus, the FRB evidently had no objection to the new powers granted by the 1982 amendments to BSCs owned by state banks.}

Thus, the simultaneous enactment of Sections 601 and 709 of the Garn-St Germain Act indicates that the limitations on insurance activities inserted by Section 601 into Section 4(c)(8) of the BHC Act were not intended to apply to BSCs (i.e., operations subsidiaries) established by holding company-owned banks.\footnote{531}{ Congress is presumed to enact statutes with knowledge of other legislation on the same subject. See Erlenbaugh v. United States, 409 U.S. 239, 244 (1972). Accordingly, the decision of Congress in 1982 to adopt language limiting the insurance activities of bank holding companies under Section 4(c)(8) of the BHC Act, but not to include similar language in the BSC Act, creates a presumption that Congress did not intend to restrict any insurance activities of BSCs that are authorized for their parent banks. See INS v. Cardoza-Fonseca, 480 U.S. 421, 432 (1987).}

Similarly, the amendments made by Section 410 of the Garn-St Germain Act to Section 23A of the Federal Reserve Act show that Congress generally viewed operations subsidiaries as part of their parent banks.\footnote{532}{ See Garn-St Germain Act, supra note 30, § 410, 96 Stat. 1469, 1515 (codified at 12 U.S.C. § 371e (1988)).} As already discussed, one of the modifications made by Section 410 was to provide, in general, that majority-owned subsidiaries of banks would not be treated as "affiliates" of the bank for purposes of Section 601 would apply only to bank holding companies and their "nonbank" subsidiaries).
In adopting this exemption, Congress determined that a majority-owned subsidiary "should be regarded as part of its parent bank." This determination provides further persuasive evidence that Congress did not consider operations subsidiaries of holding company-owned banks to be subject to the restrictions on insurance activities contained in the 1982 amendments to Section 4(c)(8), because those restrictions were applied only to bank holding companies and their nonbank subsidiaries.

e. Unsuccessful Efforts Since 1982 to Restrict the Powers of Holding Company-Owned State Banks and Their Subsidiaries

As described above, Congress has failed since 1982 to take definitive action on proposals to amend federal laws relating to banking powers. During that period, Congress has failed to adopt several proposals that would have imposed permanent restrictions on the powers of holding company-owned state banks and their subsidiaries. Congress was only able to adopt, as part of CEBA, a temporary moratorium on federal agency actions that would expand the securities, insurance or real estate powers of bank holding companies or banks. This moratorium expired on March 1, 1988, and Congress clearly stated that the moratorium would have no effect thereafter on the preexisting powers of banking organizations.

Congress' failure to act on proposals to restrict state bank powers is particularly significant in light of the extensive attention given by Congress to this issue. As discussed supra at notes 407-408 and accompanying text, the FRB ruled in 1970 that wholly-owned operations subsidiaries are not "affiliates" of their parent bank for purposes of Section 23A, because these subsidiaries are equivalent to "separately incorporated departments of the bank." 12 C.F.R. § 250.240 (1989).

In addition, when Congress amended Section 23A in 1982 to provide a general exemption for majority-owned subsidiaries of banks, Congress did so in accordance with recommended legislation submitted by the FRB in October 1981. As part of this proposed legislation, the FRB recommended that Congress generally exempt majority-owned subsidiaries of banks from treatment as "affiliates" under Section 23A. The FRB advised that such subsidiaries "should be considered part of the bank, much like departments within the bank," and that transactions between a bank and its majority-owned subsidiaries "should be viewed as essentially internal bank operations." Letter dated Oct. 2, 1981, from Chairman Paul A. Volcker of the FRB to Senator Garn (on file at Fordham Law Review).

For discussion of the intent of Congress to apply the 1982 amendments to Section 4(c)(8) only to bank holding companies and their nonbank subsidiaries, see supra notes 525-528 and accompanying text.

See supra Parts II(C) & III(B).

For discussion of the temporary moratorium imposed under CEBA and its lack of any long-term effect on the powers of banks and bank holding companies, see supra notes 182-184 and accompanying text.
gress to the activities, especially in the area of insurance, conducted by holding company-owned state banks and their subsidiaries. In 1984 and again in 1988, Congress considered but failed to enact proposals that would have imposed, at least to some degree, the restrictions contained in Section 4(c)(8) of the BHC Act on the insurance activities of holding company-owned banks and their subsidiaries. In each case, Congress was informed of legal rulings by the FRB to the effect that holding company-owned state banks and their operations subsidiaries were not subject to Section 4(c)(8). 538 The repeated failure of Congress to act in the face of these FRB rulings provides compelling evidence that Congress did not wish to subject such banks or subsidiaries to the prohibitions contained in Section 4(a). 539

A question remains whether activities of holding company-owned state banks are exempt from Section 4 to the extent that a state law authorizes a state bank to engage in a designated activity only through a subsidiary and not directly. 540 The FRB's regulation does not exempt a subsidiary of a holding company-owned state bank from Section 4 unless the subsidiary is engaged in activities that the parent bank is authorized to conduct directly and at the same locations. 541

It could be argued that Section 4 was not intended to prohibit holding company-owned state banks or their subsidiaries from engaging in banking activities authorized by state law, and that an activity specifically authorized for a state bank still constitutes "banking" even if it must be conducted through a subsidiary. Certain aspects of the legislative history of the 1956 Act and the 1982 amendments might be read to support this argument, 542 while other aspects of the history of the 1970 and 1982


In addition, Congress was fully informed of the controversy concerning the applicability of Section 4 to holding company-owned banks when it decided in 1987 to impose only a temporary moratorium under CEBA. See, e.g., S. Rep. No. 19, supra note 182, at 16, 44, reprinted in 1987 U.S. Code Cong. & Admin. News at 506, 534.

539. See Bob Jones Univ. v. United States, 461 U.S. 574, 598-602 (1983) (inferring congressional approval of agency ruling from congressional inaction in the face of substantial controversy over the ruling and repeated legislative proposals to reverse the ruling); see also Merchants National, 890 F.2d at 1283-84 (noting the significance of Congress' failure to act with regard to the powers of holding company-owned state banks following expiration of the CEBA moratorium).


542. As discussed supra at notes 491-495 and accompanying text, Congress was aware in 1956 that state banks were engaged in various activities indirectly through subsidiaries, and Congress indicated a general intent not to apply Section 4 to such subsidiaries. Also, as discussed supra at notes 532-535 and accompanying text, Congress indicated in 1982
amendments might be read to support the FRB's current regulation.\textsuperscript{543} It would appear difficult, therefore, to establish that the FRB's current regulation is contrary to clear congressional intent in exempting only those subsidiary activities that can be conducted directly by the parent bank under state law.\textsuperscript{544}

3. Judicial Constructions of Section 4

In three cases, the courts have indicated approval of the FRB's position that Section 4 of the BHC Act does not apply to the activities of holding company-owned banks. The first two of these decisions expressed that approval only in \textit{dicta}.\textsuperscript{545} More recently, however, the Second Circuit in \textit{Merchants National} specifically upheld an FRB order permitting two holding company-owned state banks to engage in state-authorized insurance activities that were not permitted to bank holding companies. While the second Circuit did not find that the language or history of Section 4 expressed a clear congressional intent on the question

that a majority-owned subsidiary should generally be treated as a department of the parent bank under Section 23A of the Federal Reserve Act, and Congress did \textit{not} limit such treatment to only those subsidiaries carrying on activities that could be conducted directly by their parent banks.

\textsuperscript{543} As discussed supra at note 520 and accompanying text, Chairman Arthur Burns of the FRB advised Congress in 1970 that Section 4 of the BHC Act did not apply to a wholly-owned operations subsidiary of a holding company-owned bank. Chairman Burns' statement did not make entirely clear that the FRB's 1968 ruling concerning operations subsidiaries applied \textit{only} to activities that could be conducted directly by the parent banks, although that condition might have been inferred from Chairman Burns' description of an operations subsidiary as a "separately incorporated department of the bank." \textit{1970 Senate Hearings}, supra note 515, at 141. Also, as discussed supra at notes 254-258 and accompanying text, it appears that the 1982 amendments to the BSC Act authorize BSCs owned by state banks to engage only in activities authorized by state law for the parent banks themselves.


\textsuperscript{545} In \textit{Cameron Fin. Corp. v. Board of Governors}, 497 F.2d 841 (4th Cir. 1974), the Fourth Circuit upheld the FRB's determination that a holding company-owned bank was not a "subsidiary" of the parent bank holding company for purposes of the "grandfather proviso" of Section 4(a)(2). In the course of its decision, the court discussed, with evident approval, the FRB's contention that the BHC Act "grant[ed] to the [FRB] authority to regulate \textit{only} the previously unregulated nonbanking subsidiaries" and, therefore, did \textit{not} affect the activities of "banking subsidiaries [that] were already regulated by [federal and state] agencies \textit{other than} the [FRB]." \textit{Id.} at 845 (emphasis added).

Subsequently, in \textit{Board of Governors v. Investment Co. Inst.}, 450 U.S. 46 (1981), the Supreme Court upheld an FRB ruling permitting bank holding companies and their non-bank subsidiaries to act as investment advisers to closed-end investment companies. In rejecting the ICI's argument that the ruling sought to confer unlawful powers upon holding company-owned banks, the Supreme Court declared that "the [FRB] does not have the power to confer such authorization on banks." \textit{Id.} at 59 n.25. The Court then quoted with approval the FRB's statement that the operating authority of a holding company-owned bank "would exist independently of the [FRB's] regulation and its scope is to be determined by a particular bank's primary supervisory agency." \textit{Id.}
of whether Section 4 applies to holding company-owned banks, the court
determined that the FRB

has made a reasonable interpretation of section 4(a)(2), one that con-

fides decisions concerning the scope of insurance and other nonbank

activities of bank subsidiaries to their national and state chartering au-

thorities. If that interpretation is to be altered, Congress will have to

enact suitable legislation.546

Having found that the FRB’s construction of Section 4 was reasonable,
the Second Circuit considered itself obliged under Chevron to uphold the
FRB’s decision.547

While Merchants National affirmed the FRB’s ruling that Section 4
does not apply to holding company-owned banks, there has been no de-

finitive judicial determination concerning the application of Section 4 to
operations subsidiaries of such banks. Two courts of appeal have ad-
dressed this issue, but neither court has resolved the question.

In AMBAC, the District of Columbia Circuit reviewed an OCC ruling
that allowed an operations subsidiary of a holding company-owned na-
tional bank to offer municipal bond insurance. The OCC ruled that mu-
nicipal bond insurance was an activity authorized for national banks and
therefore could be offered by an operations subsidiary without regard to
the insurance prohibitions contained in Section 4(c)(8) of the BHC
Act.548 In its initial decision, the court agreed that municipal bond in-
surance was authorized for national banks.549 However, the court held
that this activity was subject to Section 4(c)(8) when conducted by an
operations subsidiary of a holding company-owned bank. In reaching
this conclusion, the court reasoned that an operations subsidiary of a
holding company-owned bank would be a nonbank subsidiary indirectly
owned by the parent bank holding company within the meaning of Sec-
tion 4(a).550

The initial decision in AMBAC triggered considerable controversy
within the banking industry and led to petitions for rehearing by the
OCC and a coalition of banking industry groups.551 The District of Co-
lumbia Circuit granted rehearing and vacated its initial holding concern-

546. Merchants National, 890 F.2d at 1284.
547. See id. at 1280, 1284.
548. See AMBAC, 865 F.2d at 282-83, 285 (initial decision) (explaining OCC ruling).
549. See id. at 281-84.
550. See id. at 285-87. In concluding that an operations subsidiary of a holding com-
pany-owned national bank would be subject to Sections 4(a) and 4(c)(8) of the BHC Act,
the District of Columbia Circuit rejected the district court’s holding that the operations
subsidiary was exempted under Section 4(c)(5), 12 U.S.C. § 1843(c)(5), and the FRB’s
regulations thereunder. See id. at 286-87.
551. See, e.g., id. at 279, 280 (noting briefs on rehearing filed on behalf of the OCC, the
American Bankers Ass’n, the Conference of State Bank Supervisors and the Independent
Bankers Ass’n of America); Fisher, supra note 427, at 318-22 (describing the controversy
created by the initial decision in AMBAC and noting (id. at 321-22 n.26) that the Ass’n of
Bank Holding Companies and the Consumer Bankers Ass’n joined the brief on rehearing
filed by the American Bankers Ass’n, et al.).
ing the application of Section 4(c)(8) to operations subsidiaries of holding company-owned national banks. The court concluded that it should not have reached this issue in its review of the OCC's ruling, because the OCC had no jurisdiction to determine the scope of the BHC Act and, therefore, the issue should have been presented in the first instance to the FRB.\textsuperscript{552} Thus, \textit{AMBAC} did not resolve the operations subsidiary question.

The Second Circuit considered the operations subsidiary issue in \textit{Merchants National}, with similarly inconclusive results, but with language suggesting that the Second Circuit might not have agreed with the District of Columbia Circuit's initial decision. In \textit{Merchants National} the Second Circuit took note of the FRB's argument that Section 4(a) applies to the activities of operations subsidiaries of holding company-owned state banks even though Section 4(a) does not apply to the same activities when conducted by the banks themselves. As discussed above, the Second Circuit found this "generation-skipping approach" to be "perplexing" and "perhaps illogic[al]."\textsuperscript{553} However, the Second Circuit chose not to resolve the operations subsidiary question because it was not directly presented by the FRB's order under review.\textsuperscript{554} Thus, resolution of the operations subsidiary controversy awaits further action by Congress or the courts.

\textbf{V. CRITIQUES OF STATE AUTHORITY TO DETERMINE THE POWERS OF STATE BANKS UNDER THE DUAL BANKING SYSTEM}

As shown above in Part IV, neither the FDIC nor the FRB has any generalized authority to impose blanket prohibitions with regard to the activities of state banks or their operations subsidiaries. Although Congress could change this situation with preemptive legislation regarding state bank powers, it has not chosen to do so.\textsuperscript{555}

This Article has suggested that the absence of general preemption with respect to the powers of state banks provides significant benefits to our banking system. As shown above, the competition among federal and state regulators within the dual banking system has resulted in a substantial degree of regulatory innovation and responsiveness to the needs of the banking industry and consumers.\textsuperscript{556} In addition, continued regulatory flexibility and experimentation at the state level is needed to provide empirical evidence that could help resolve the current debate over the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{552} \textit{AMBAC}, 865 F.2d at 287-88 (decision on rehearing).
\item \textsuperscript{553} \textit{Merchants National}, 890 F.2d at 1282. For further discussion of the Second Circuit's comments on this issue, see supra notes 473-474 and accompanying text.
\item \textsuperscript{554} See \textit{Merchants National}, 890 F.2d at 1282-83.
\item \textsuperscript{555} For a discussion of the failure of Congress to act on proposals to preempt state law with respect to the securities, insurance, and real estate powers of state banks, see supra Part III(B) and Part IV(C)(2)(e).
\item \textsuperscript{556} For a discussion of the benefits resulting from regulatory competition within the dual banking system, see supra Part II(A)(2).
\end{itemize}
\end{footnotesize}
desirability of expanded bank powers at the federal level.\textsuperscript{557}

The competitive dynamic inherent in the dual banking system would probably be lost if Congress preempted the ability of states to confer powers on state banks that are different from those permitted to national banks under federal law. It is highly doubtful whether an effective dual banking system could survive (at least with respect to large interstate banking organizations) if states could no longer offer a chartering option with favorable powers to offset the advantages of national uniformity in supervision offered by the OCC.\textsuperscript{558} Therefore, this Article opposes any broad-scale federal preemption with respect to state bank powers.

On the other hand, a number of commentators have criticized the current state of the dual banking system, and most of them have called for federal legislation removing the authority of states to grant broader powers to state banks than those available to national banks and bank holding companies. As discussed in Part V(A), the dominant theme of these critics is that the dual banking system creates a dangerous "competition in laxity" between federal and state regulators. In addition, as described in Part V(B), Professors Henry Butler and Jonathan Macey have argued that the current structure of the dual banking system should be discarded because its alleged benefits in creating a competition between federal and state regulators are illusory.\textsuperscript{559}

In response to the first critique, Part V(A) demonstrates that the empirical evidence does not support the existence of a "competition in laxity" between federal and state banking regulators. In recent years, state banks have consistently outperformed national banks in terms of average capital ratios and average returns on assets and equity. In addition, the recent bank failure rate has been lower for state banks than for national banks. There has been no evidence to date of generalized safety and soundness problems resulting from the exercise of expanded securities, insurance or real estate powers by state banks. These facts suggest that the states have not abandoned traditional concerns of safety and soundness in regulating banks. Moreover, because of significant differences in the federal and state regulatory systems for banks and thrifts, the widespread abuses of liberal powers by state-chartered thrifts in certain states, particularly Texas and California, are not comparable to the more controlled exercise of state powers by state banks.

\begin{footnotes}
\item 557. For further discussion of the suggestion that state experimentation with bank powers is likely to provide helpful experimental models for federal reform of bank regulation, see \textit{supra} text accompanying notes 73-78 & 97-104; \textit{State Regulation of Banks, supra} note 90, at 5-6, 26.
\item 558. \textit{See State Regulation of Banks, supra} note 90, at 6, 27; \textit{cf.} Bell & Wilmarth, \textit{supra} note 87, at 732-33 (contending that federal repeal of the McFadden Act and permission of unlimited interstate branching of banks would effectively destroy the dual banking system, because large multistate banks would prefer "unitary supervision under national charter" over "fragmented supervision under state charter," and only "smaller, localized banks" would choose state charters).
\item 559. \textit{See Butler & Macey, supra} note 11, \textit{passim}.
\end{footnotes}
Part V(A) also reviews the literature which has rejected the "competition in laxity" argument as applied to state chartering of corporations. While there are significant differences between the chartering and regulatory systems applicable to corporations and banks, there are also important similarities that have become more prominent in recent years. The analogy to corporate chartering suggests that the ability of states to determine the powers of state banks should not result in a destructive "competition in laxity" so long as state banks are required to maintain substantial levels of capital.

Part V(B) shows that the critique of the dual banking system by Professors Butler and Macey overlooks the significant competition that has occurred between federal and state banking agencies and has resulted in substantial and beneficial innovations in our banking system. Moreover, the most practicable alternative suggested by Butler and Macey is a unitary system of federal regulation, which would remove all supervisory competition from our banking system.

A. The "Competition in Laxity" Critique

Several commentators have asserted that the dual banking system creates a destructive "competition in laxity" between federal and state regulators that encourages regulators to neglect safety and soundness concerns in order to build their regulated constituencies. Recently, three members of the law and economics movement have modified the "competition in laxity" critique by contending that the dual banking system creates "moral hazard" with regard to the states. According to these critics, "moral hazard" in state banking regulation results from the insurance of state bank deposits by the FDIC. These critics point out that losses from state bank failures caused by high-risk activities are borne by the entire nation through the federal deposit insurance system, while any benefits of such activities (such as through the creation of additional jobs and business revenue) generally accrue to the particular states that authorize the activities in order to encourage the chartering or expansion of state banks. Thus, it is contended, the ability of states to impose the cost of bank failures on the federal deposit insurance system creates a perverse incentive for the states to approve unsafe and unsound banking powers.

560. See, e.g., Address of Oct. 21, 1974 by Chairman Arthur Burns of the FRB, quoted in Scott, supra note 8, at 13; see also Fein, The Fragmented Depository Institutions System: A Case for Unification, 29 Am. U.L. Rev. 633, 675-76, 698-700 (1980) (restating competition in laxity argument and calling for an end to the dual banking system); Scott, supra note 8, at 12 (quoting 1963 congressional testimony by Governor J. L. Robertson of the FRB, stating that the dual banking system creates "a dangerous tendency toward a 'race of laxity' in bank supervision").

561. For criticism of the dual banking system based on "moral hazard" concerns, see Butler & Macey, supra note 11, at 680, 696, 712-13; Miller, supra note 19, at 18-19. As explained in Miller, supra note 19, at 18-19, "moral hazard" is a concept used by economists to describe a situation in which a person fails to take adequate precautions against
Other commentators have rejected the contention that the dual banking system results in a competition among regulators to provide lenient and negligent supervision.\textsuperscript{562} Indeed, the "competition in laxity" argument overlooks the strong incentive of both elected public officials and appointed bank regulators to avoid bank failures. Bank failures cause considerable market disruption and public inconvenience in the affected communities, and such failures can injure the entire financial system if they evolve into a generalized run on banks.\textsuperscript{563} Therefore, elected officials and bank regulators understandably have a strong desire to avoid bank failures and to refrain from regulatory measures that would substantially increase the risk of such failures.\textsuperscript{564} Moreover, because elected officials and even appointed bank regulators are subject to political pressures, they have a significant personal stake in avoiding the political consequences that are likely to flow from a public perception that their negligence or poor judgment contributed to a series of bank failures.\textsuperscript{565}

The empirical evidence on state bank performance supports the view that the states have generally maintained good regulatory standards with regard to banks. Over the past six years, the capital ratios, financial results, and failure rates have been significantly more favorable for state banks than for national banks. For example, during the six-year period ended December 31, 1989, the average capital ratio was consistently higher for state banks than for national banks, and the average annual

\textsuperscript{562} For commentaries rejecting the "competition in laxity" argument with respect to the dual banking system, see \textit{Safe Banking Perspectives, supra} note 15, at 276-78; Fischel, Rosenfield & Stillman, \textit{supra} note 16, at 335-36; Frankel, \textit{supra} note 90, at 258-61.

\textsuperscript{563} For discussions of the costs of bank failures and bank runs, see Fischel, Rosenfield & Stillman, \textit{supra} note 15, at 310-12; Garten, \textit{Banking on the Market: Relying on Depositors to Control Bank Risks}, 4 \textit{Yale J. Reg.} 129, 160-63 (1986); Murton, \textit{Bank Intermediation, Bank Runs, and Deposit Insurance}, 2 FDIC Banking Rev. No. 1, Spring/Sumer 1989, at 1, 3-4, 7.

\textsuperscript{564} For discussions of the desire of bank regulators to avoid bank failures, see \textit{1989 House Hearings, supra} note 5, at 213, 214 (testimony on behalf of CSBS by Jill M. Considine, Superintendent of Banks for New York); W. Brown, \textit{supra} note 90, at 38, 40; Garten, \textit{supra} note 5, at 519-21.

\textsuperscript{565} For example, the collapse in 1985 of the private insurance system for state-chartered thrifts in Maryland, and the resulting state-imposed freeze on the deposits of failed institutions for up to four years, effectively destroyed the political career of then-Governor Harry Hughes. \textit{See} Walsh, \textit{Maryland Near End of Chapter in S&L Crisis}, Wash. Post, Wash. Bus. section, June 26, 1989, at 1, 32. Similarly, Richard Doby, the state banking commissioner for Colorado, was pressured into resigning in 1988 following an outside audit of the state banking department. This audit was triggered by the collapse of the private insurance system for state-chartered industrial banks in Colorado. The audit concluded that the failure of Mr. Doby's department "to take timely corrective action" contributed to the failure of several industrial banks and the resulting insolvency of the insurance fund. \textit{See} 50 Banking Rep. (BNA) No. 23, at 950, 950-51 (June 6, 1988).

At the federal level, intense congressional pressure, based on allegations of mismanagement arising out of the FSLIC crisis, led to the resignation of M. Danny Wall as Director of the Office of Thrift Supervision on December 4, 1989. \textit{See} 53 Banking Rep. (BNA) 885 (Dec. 11, 1989).
returns on assets and equity were generally higher for state banks.\(^{566}\)
During the same period, the rate of state bank failures as a percentage of state banks was higher than the comparable rate for national banks in 1984 and 1985, about the same in 1986, slightly less in 1987 and substantially less in 1988 and 1989.\(^{567}\)

Even in Texas, where a majority of the nation’s bank failures occurred in 1988 and 1989, the failure rate for state banks has been lower than that of national banks, the average capital ratio for state banks is higher than that for national banks, and the percentage of nonperforming loans for state banks is lower than that for national banks.\(^{568}\)

The foregoing data would suggest that the state banking system is, if anything, less risky than the national banking system. In addition, the evidence to date has not identified any general threat to bank safety or soundness resulting from the use by state banks of expanded powers under state law.\(^{569}\) It is noteworthy that the high rate of bank failures in Texas has not resulted from the exercise by Texas banks of insurance underwriting or real estate investment or development powers, because

---

\(^{566}\) From 1984 through 1989, the average capital ratio for state banks exceeded that for national banks in every year, the return on assets for state banks exceeded that for national banks in every year except 1988 and 1989. See State of the State Banking System 1989, supra note 39, at 6-7; State of the State Banking System 1988, at 5-6, reprinted in 1989 House Hearings, supra note 5, at 301, 306-07.


\(^{568}\) As of June 30, 1989, there were 656 state banks and 754 national banks in Texas. From January 1, 1988 through August 31, 1989, 82 state banks failed compared to 140 national banks. During the same period, the number of failed banks in Texas (222) represented more than 60 percent of the total number of failed banks in the United States (351). As of June 30, 1989, the average capital ratio (i.e., total equity divided by total assets) was 7.3 percent for Texas state banks compared to 4.2 percent for Texas national banks, and the average ratio of nonperforming loans to total loans was 4.7 percent for Texas state banks compared to 7.4 percent for Texas national banks. See Oversight Hearings on the Condition of the Banking System: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 101st Cong., 1st Sess. (1989) [hereinafter 1989 Senate Hearings] at 261, 262 (Exhibits II and III to testimony of Kenneth W. Littlefield, Texas Banking Commissioner).

\(^{569}\) For discussion of the FDIC’s view that expanded powers of state banks in the securities, insurance and real estate areas have not led to generalized safety and soundness problems, see supra notes 167, 175 & 242 and accompanying text; see also 135 Cong. Rec. S 4120 (daily ed. April 18, 1989) (remarks of Senator Cranston, reporting absence of any problems resulting from use by California state banks of limited real estate investment powers under state law); id. at S 4294 (daily ed. April 19, 1989) (remarks of Senator Robb, reporting profitable and safe exercise of real estate investment powers by state-chartered savings banks in several Northeastern states); 1987 House Hearings, supra note 17, at 64, 552 (testimony of George D. Gould, Under Secretary of the Treasury for Finance, noting absence of any safety and soundness concerns resulting from the exercise of state-authorized securities powers by state nonmember banks); id. at 420 (reprinting article from California Banker newsletter of Oct. 1987, reporting lack of problems resulting from exercise by California state banks of limited real estate investment powers).
Texas does not authorize such powers for banks. Instead, bank failures in Texas have been caused primarily by an excessive concentration of bank assets in commercial loans related to real estate and energy ventures. This lack of diversification in bank assets left Texas banks heavily exposed to losses when the collapse of oil prices in the mid-1980s led to a prolonged slump in the overbuilt residential and commercial real estate markets.

A possible explanation for the absence of serious problems resulting from involvement of state banks in expanded powers is that many states have imposed prudential limits on the exercise of these powers. For example, some states have required such activities to be conducted through a subsidiary of the bank, and many states have limited bank involvement in such activities to a specified percentage of a participating bank's assets, deposits or capital. These prudential restraints on state bank powers stand in sharp contrast to the situation with state-chartered thrifts in California and Texas, where those states failed to impose meaningful restrictions on commercial real estate loans or real estate development activities by thrifts. Texas and California accounted for fifty-four

570. See CSBS Detailed Survey, supra note 203, Appendices 2-4 (indicating that Texas state banks do not have authority to engage in insurance underwriting or real estate investment or development); CSBS Summary Survey, supra note 203 (same); Saulsbury, supra note 204, at 6 (Table 1) (same).

571. Between 1982 and 1987, Texas banks increased the percentage of real estate-related loans in their portfolios from 23 percent to 40 percent. Two-thirds of these real estate-related loans were commercial real estate loans. Nonperforming real estate loans and real estate held under foreclosure accounted for three-fourths of the nonperforming assets of Texas banks in September 1989. Texas banks also held high concentrations of energy-related loans. See 1989 Senate Hearings, supra note 568, at 9-10 (testimony of Texas Banking Commissioner Kenneth W. Littlefield). Other factors contributing to Texas bank failures were (i) the rapid increase in the number of chartered banks in Texas from 1,336 in 1975 to 1,936 in 1985, which resulted in a larger number of banks that had at best only marginal profitability; (ii) excessive borrowing by bank holding companies and individuals in order to purchase bank stock, thereby leaving bank owners unable to infuse additional capital to assist their banks in times of crisis; (iii) fraud and mismanagement by bank insiders; (iv) inadequate discipline of bank management by shareholders and outside auditors; and (v) inadequate supervision by federal and state banking authorities. See id. at 8-14.

572. For discussion of the restraints imposed by a number of states or state bank involvement in securities, insurance and real estate activities, see supra notes 206-08, 211-12 & 218-19 and accompanying text.

573. See, e.g., N. Strunk & F. Case, Where Deregulation Went Wrong: A Look at the Causes Behind Savings and Loan Failures in the 1980s, at 58-64 (1988) (describing liberal state laws in California and Texas which placed no effective limits on the involvement of state-chartered thrifts in commercial real estate lending or real estate development); 135 Cong. Rec. H 2558 (daily ed. June 14, 1989) (remarks of Representative Wolpe, declaring that no effective limitations were placed on the activities of Texas state-chartered thrifts); 1987 House Hearings, supra note 17, at 420 (reprint of article from California Banker newsletter of Oct. 1987, contrasting California state law limiting real estate investments by state banks to 10 percent of assets or 100 percent of equity, with California regulatory practice allowing state-chartered thrifts to invest up to 100 percent of their assets in real estate projects).

For example, during 1988 and 1989, only one small California state bank failed, and
percent of the resolution costs for failed thrifts in 1987 and nearly eighty percent of such costs in 1988, and these states are expected to be responsible for at least a majority of the future thrift resolution costs to be incurred by the RTC.\(^5\)

There are at least three other significant reasons explaining why the massive wave of failures that swept over the thrift industry has not been experienced by state banks engaged in securities, insurance or real estate activities. First, as noted above, state banks have consistently maintained a higher average capital ratio than national banks and a much higher average capital ratio than thrifts.\(^5\) It is generally agreed that bank capital plays a crucial role in providing a "cushion" to absorb operating losses and in disciplining the conduct of bank managers and owners who realize that funds of their own are at risk.\(^5\) In the case of most state banks, there has been a significant amount of capital representing share-

251 out of 267 state banks in California were profitable in 1989. California only permits state banks that are rated in the top two categories of the FDIC's five-tier bank safety rating (CAMEL) system to invest in real estate, and the state banking department closely monitors these investments. See Statement of James E. Gilleran, California Superintendent of Banks, before the House Subcomm. on Financial Institutions Supervision, Regulation and Insurance on April 4, 1990, at 1-2, 6 (on file at *Fordham Law Review*); 1989 Senate Hearings, supra note 568, at 131-33 (testimony of Mr. Gilleran). In contrast, 18 thrift institutions failed in California in 1988 alone, in part because of the state's failure to restrict and prudently supervise thrift real estate investment activities. See 135 Cong. Rec. S 4298, S 4300 (daily ed. April 19, 1989) (remarks of Senator Moynihan); 1989 Senate Hearings, supra note 568, at 133 (colloquy between Senator Riegle and Mr. Gilleran).


575. During the years 1984 to 1989, state banks maintained an average capital ratio ranging between 6.39 percent (in 1984) and 6.99 percent (in 1989). In each year, as indicated *supra* in note 566, the state banks' average ratio was higher than that of national banks. See *State of the State Banking System 1989*, supra note 39, at 9; *State of the State Banking System 1988*, supra note 566, at 5, reprinted in 1989 House Hearings, supra note 5, at 306.


holder investment risk and, therefore, substantial incentive for shareholder discipline of bank managers.

In contrast, the FHLBB and FSLIC permitted hundreds of insolvent or undercapitalized thrifts to remain in operation by adopting lenient capital standards, regulatory accounting principles and capital forbearance programs. In fact, the thrift industry as a whole was already insolvent on a market value basis in 1981, before Congress and the states liberalized thrift powers. This insolvency resulted from the thrift industry's historic concentration of assets in fixed-rate home mortgages and the resulting mismatch between the industry's long-term mortgage assets and short-term deposit liabilities. When inflation and deposit interest rates increased substantially in the late 1970s and early 1980s, the cost of thrift liabilities soared but most thrift institutions were unable to re-deploy their assets in higher-yielding investments. Consequently, the thrift industry's total capital was exhausted by 1981. The banking industry, by comparison, had a shorter-term and more diversified asset portfolio and therefore did not suffer the tremendous losses and capital drain incurred by the thrifts.

Rather than facing the thrift problem squarely, Congress (in response to political pressures from the thrift industry) decided to let the industry try to "grow out of [its] problems" by granting broader (and more risky) powers under the Garn-St. Germain Act. The states soon followed suit with their own expanded powers. The problem was that many of the thrifts exercising these increased powers had little or no capital at risk. These insolvent or undercapitalized thrifts had no incentive to refrain from excessively risky activities because their owners stood to reap all gains and knew that the FSLIC insurance fund would bear any losses.

Second, Congress failed until 1989 to provide funds sufficient to enable the federal regulators to close down more than a small percentage of the insolvent thrifts. A $15 billion recapitalization plan for the FSLIC was


578. See Scott, supra note 577, at 1885-87.


defeated by the House in 1986, and only $10.8 billion was approved under CEBA in 1987, largely because of political pressure brought by members of the thrift industry to forestall receivership and liquidation proceedings by the FSLIC. In contrast, the FDIC's deposit insurance fund for banks, while strained by the large number of recent bank failures, has remained sufficient to allow the FDIC generally to take timely action with respect to failing or failed banks. The ability of the FHLBB and FSLIC to respond to the thrift crisis was further hampered when several members of Congress intervened to stop FHLBB or FSLIC enforcement proceedings against large failing thrifts.

582. For information relating to the failure of Congress to provide adequate funds to the FSLIC in 1986 and 1987, see 47 Wash. Financial Rep. (BNA) 531, 575, 659 (1986) (reporting that 1986 bill to recapitalize FSLIC failed to pass House, and that House action was delayed by House Speaker Jim Wright until FHLBB provided assurances that new funds would not be used by FSLIC to close down Texas thrifts); H.R. Rep. No. 261, supra note 184, at 155, reprinted in 1987 U.S. Code Cong. & Admin. News at 624 (recapitalization of FSLIC under CEBA limited to $10.825 billion, with not more than $3.75 billion to be authorized in any one year); 135 Cong. Rec. S 3998 (daily ed. Apr. 17, 1989) (remarks of Senator Garn); id. at S 4003 (remarks of Senator Wirth); id. at S 4105 (daily ed. Apr. 18, 1989) (remarks of Senator Garn); id. at S 4289 (daily ed. Apr. 19, 1989) (remarks of Senator Dole); id. at H 2588 (daily ed. June 14, 1989) (remarks of Representative Cooper).

583. In 1988 and 1989, the FDIC's insurance fund for bank deposits suffered losses of $4.3 billion and $851 million, respectively. As a result, the size of the fund decreased from $18.4 billion as of the end of 1987 to $13.2 billion as of the end of 1989. The FDIC has indicated that the fund will not experience further losses in 1990 unless there are unexpected failures involving large banks. See BIF's Reserves Drop to $13.2 Billion, Fund Experiences Second Operating Loss, 54 Banking Rep. (BNA) No. 21, at 899 (May 28, 1990).

For recent statements confirming the adequacy of the FDIC's deposit insurance fund to meet the current and anticipated future costs of bank failures, see 1989 House Hearings, supra note 5, at 7, 153 (testimony of Chairman L. William Seidman of the FDIC); id. at 178-79 (testimony of Robert L. Clarke, Comptroller of the Currency); id. at 45-46, 224-30 (testimony of Robert W. Gramling of the General Accounting Office).

Three economists have recently contended that the FDIC's fund is inadequate, and that the FDIC is deliberately permitting insolvent or failing banks to continue in operation. See id. at 236-42 (testimony of R. Dan Brumbaugh and Robert Litan); id. at 315-17 (letter to Representative Annunzio from Messrs. Brumbaugh & Litan); Brumbaugh, Carron & Litan, Cleaning Up the Depository Institutions Mess, reprinted in 1989 House Hearings, supra note 5, at 247, 254-61. For a subsequent critique of the analysis of these economists, arguing that they have overstated the FDIC's current exposure to failing banks and ignored the FDIC's ability to restore its fund based on the increase in bank deposit insurance premiums mandated by FIRREA, see Isaac & Marino, The FDIC's Bank Insurance Fund: Its Future Prospects, 8 Banking Expansion Rep. No. 22 at 1, 8-12 (Nov. 20, 1989).


584. For newspaper articles discussing alleged examples of interference by members of
Third, it was widely perceived that the management authority of the FHLBB over the FSLIC created an inherent conflict of interest between the FHLBB's dual roles as chartering and insuring authority for the thrift industry. As a result, the FHLBB was biased by a desire to promote the thrift industry and, therefore, was reluctant to allow the FSLIC to close down failing thrifts.\(^5\) In contrast, the FDIC has maintained a separate and independent status and has not been subject to undue influence from the federal or state bank chartering agencies.\(^6\)

Thus, there are significant differences between the regulatory systems for thrifts and banks which caution against any automatic assumption that the involvement of state banks in securities, insurance or real estate powers will lead to a repetition of the thrift debacle. In the absence of substantial evidence indicating that the safety or soundness of state banks has actually been threatened by expanded powers or regulatory laxity,\(^7\) it would be unfortunate if Congress reacted to the thrift crisis by forecasting promising innovations by the states with respect to bank powers.

It is also noteworthy that a similar "competition in laxity" argument has been advanced and substantially discredited with regard to state competition in the chartering of corporations.\(^8\) The most persuasive


\(^7\) See, e.g., 135 Cong. Rec. S 4240 (daily ed. Apr. 19, 1989) (remarks of Senator Graham); 1989 House Hearings, supra note 5, at 186-87 (testimony of Robert L. Clarke, Comptroller of the Currency); id. at 215-16 (testimony on behalf of CSBS by Jill M. Considine, New York Superintendent of Banks).

\(^8\) The classic "race for the bottom" argument with respect to state competition in corporate chartering was made in Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 Yale L.J. 663, 705 (1974). For critical responses to Cary's argument, see, e.g., Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J.
response to the argument in the corporate chartering context is that the securities markets discourage states from authorizing excessively risky powers for corporations. If State A permits its corporations to engage in high-risk activities, corporations that do so imprudently are likely to fail. Over time the markets will recognize the higher failure rate of corporations incorporated in State A, and investors will demand higher returns before investing in corporations chartered by State A. This investor response will place corporations chartered in State A at a competitive disadvantage in competing for capital investment with corporations chartered in a state with a lower risk profile in relation to corporate earnings. In an extreme case, corporations chartered in State A will reincorporate to a more favorable state unless State A changes its corporate laws.\footnote{89}

Thus, investor discipline places a significant restraint on the desire of states to compete for corporate charters by granting risky new powers. Of course, the analogy between state chartering of corporations and state chartering of banks is only an approximate one. The granting of bank charters is restricted by several criteria (such as safety and soundness, and the convenience and needs of the community to be served) that do not apply to corporate charters. In addition, a bank can generally carry on a deposit-taking business in only one state because of federal and state prohibitions against interstate branching.\footnote{90}

However, as discussed above, nearly all states allow acquisitions of local banks by out-of-state bank holding companies under certain conditions, and individuals can also own banks in different states.\footnote{91} Accordingly, multistate bank holding companies and individuals do have a wide range of choices in deciding where to acquire a subsidiary bank. Moreover, the states are increasingly competing with one another in attracting entry by out-of-state bank holding companies, and the granting of expanded powers to state banks is an important part of this competi-

Legal Stud. 251 (1977); Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709, 752-53 (1987) (taking a position between Cary and Winter but “closer” to Winter in view of “the important advantages derived from having a federal system”); see also Fischel, Rosenfeld & Stillman, supra note 16, at 335 n.99 (contending that Cary’s argument “has now been discredited both theoretically and empirically”).

589. See, e.g., Amanda Acquisition Corp., v. Universal Foods Corp., 877 F.2d 496, 507-08 (7th Cir.) (Easterbrook, J.), cert. denied, 110 S. Ct. 367 (1989); Fischel, From MITE to CTS: State Anti-Takeover Statutes, The Williams Act, The Commerce Clause, and Insider Trading, 1987 Sup. Ct. Rev. 47, 84-85; Romano, supra note 588, at 711-12, 717-20, 752-53 (acknowledging merit in Winter’s argument, but noting that Winter relies on debatable theory that markets are efficient in pricing shares and understates transaction costs involved in reincorporation); Winter, supra note 588, passim.

590. See Butler & Macey, supra note 11, at 686-88; Miller, supra note 19, at 15.

591. For a discussion of state laws permitting acquisitions of local banks by out-of-state bank holding companies, see supra notes 38-40 and accompanying text. Individuals or groups of individuals may own a “chain” of banks located in more than one state without regard to the BHC Act’s restrictions on interstate ownership of banks by bank holding companies, as long as the individual owners are not deemed to be a “company” as defined in 12 U.S.C. § 1841(b). E. Symons & J. White, supra note 79, at 44.
Thus, it appears that a meaningful competition between states in bank chartering is already occurring.

As in the case of corporate chartering, investor discipline could play a substantial role in restraining state competition in bank chartering, provided that state banks are required to maintain substantial amounts of equity capital. When a bank fails, the FDIC rescues the depositors but generally the shareholders lose most or all of their investment. Therefore, the securities markets should have an incentive to identify those states that create a greater probability of bank failure by granting excessively risky powers to state banks. Shareholders should refrain from investing in banks chartered in those states unless premium returns are offered. And if the risks of failure exceed the likely returns from the expanded activities, banks chartered in a state with high-risk powers should be placed at a competitive disadvantage in competing for capital with banks chartered in lower-risk states.

In sum, over the longer term, investor discipline should help to restrain the states in granting higher-risk powers to state banks. Of course, the presence of federal deposit insurance requires appropriate supervisory vigilance, at both the federal and state levels, to ensure that undercapitalized state banks are not tempted to gamble with risky powers over the short term at the expense of the FDIC's fund. But corporate theory, like the available evidence, suggests that state experimentation with expanded bank powers is not likely to result in a competition in laxity, provided that prudent capital standards and regulatory oversight are maintained.

B. The “Myth of Competition” Critique

Professors Butler and Macey have denied the existence of any meaningful regulatory competition within the dual banking system. They contend that federal preemption and the competitive equality doctrine

592. See, e.g., State Regulation of Banks, supra note 90, at 17-18; Delaware Passes Bill to Let Banks Sell, Underwrite Insurance Nationwide, 54 Banking Rep. (BNA) No. 21, at 905 (May 28, 1990) (new Delaware law allowing banks to engage in nationwide insurance business was promoted as “an economic development measure” that would encourage out-of-state bank holding companies to establish new banks in Delaware, thereby increasing state jobs and tax revenues).


594. As explained supra in note 110, and infra at notes 613-20 and accompanying text, the Supreme Court and other courts have applied the principle of “competitive equality” between national banks and state banks in determining the extent to which national banks may branch under the McFadden Act.
stifle any possibility for regulatory innovation by the states. In addition, they maintain that the federal and state banking regulators have actually cooperated in maintaining anticompetitive barriers to bank entry and geographic expansion. They therefore dismiss, as a "myth," the argument that "effective competition exists in the dual banking system." The "myth of competition" critique is contrary to much of the historical and current evidence discussed above. Butler and Macey consistently understate the amount of regulatory innovation that has occurred in the dual banking system. They acknowledge, for example, that the successful introduction of NOW accounts by several states led to federal authorization of these accounts for all depository institutions, but they overlook many other banking innovations that have been pioneered by the states.

Moreover, Butler and Macey make little or no reference to the fact that the states have taken significant initiatives in permitting interstate acquisitions of banks by bank holding companies and in authorizing new powers for state banks. As described above, these state initiatives have been especially noteworthy in comparison to the relative inaction by Congress. In addition, as shown above, state adoption of laws permitting interstate acquisitions and expanded powers has created a substantial competition among states in granting bank charters to multistate bank holding companies.

Butler and Macey also overstate the degree of federal preemption in banking regulation. To be sure, federal preemption has increased in recent years, most notably in 1980 when Congress extended reserve requirements to all depository institutions. However, Butler and Macey exaggerate the amount of preemption accomplished by other federal stat-
utes. For example, they point out that Section 103 of CEBA for the first time applied Sections 20 and 32 of the Glass-Steagall Act to state non-member banks. They neglect to add, however, that these provisions enacted only a temporary moratorium that expired on March 1, 1988.

Similarly, Butler and Macey claim that the BHC Act "grants the [FRB] complete control over the definition of the activities that a bank holding company's subsidiaries may conduct." They specifically assert that the BHC Act "impos[es] activity restrictions on state banks" that are owned by bank holding companies. As demonstrated above, however, the FRB does not have general authority under the BHC Act to restrict the activities of holding company-owned state banks.

Butler and Macey also point to regulatory controls placed by the FDIC on FDIC-insured state banks. As shown above, however, the FDIC (like the FRB) cannot deny to state banks, as a general matter, powers that have been authorized by state law.

In addition, Butler and Macey exaggerate the impact of the competitive equality doctrine in homogenizing the powers of national and state banks and limiting competition between them. The courts have applied the principle of competitive equality only in cases in which the federal statute governing national banks has expressly incorporated state banking law as the applicable standard. In other situations, where the federal statute does not make state banking law the governing rule, the courts have not protected state banks under the competitive equality doctrine.

Moreover, even in the area of national bank branching under the McFadden Act, where the competitive equality doctrine has received its fullest elaboration, that doctrine has been significantly restricted in two

603. See id. at 697 (citing CEBA, supra note 183, § 103, 101 Stat. 566-67). For discussion of the prohibitions contained in Sections 20 and 32 of the Glass-Steagall Act, see supra notes 127-29 and accompanying text.

604. See CEBA, supra note 183, § 103, 101 Stat. 567. For a discussion of the limited effect of the temporary moratorium enacted by CEBA, see supra notes 182-84 and accompanying text.

605. Butler & Macey, supra note 11, at 698.

606. Id. at 710.

607. See supra Part IV(C).

608. See Butler & Macey, supra note 11, at 699-700.

609. See supra Part IV(B)(2)-(4).

610. See Butler & Macey note 11, at 701-05.


recent decisions. First, the Supreme Court limited the doctrine in \textit{Clarke v. SIA} by holding that the McFadden Act "requir[es] 'competitive equality' only in core banking functions."\(^{614}\) Thus, the Court held, the McFadden Act's branching restrictions do \textit{not} reach "all activities in which national banks are specifically authorized to engage."\(^{615}\)

Second, the Fifth Circuit Court of Appeals held in \textit{Deposit Guaranty} that state-chartered thrifts are "State banks" for purposes of the McFadden Act.\(^{616}\) This decision has enabled national banks to branch to the same extent that state-chartered thrifts may branch under state law, even if state commercial banks are more limited in their branching rights.\(^{617}\) As Professor Butler has pointed out in another article, \textit{Deposit Guaranty} has already pressured several states to grant statewide branching powers to commercial banks and, therefore, may well destroy "the last vestiges of intrastate restrictions . . . on geographic expansion by national banks."\(^{618}\)

Thus, the competitive equality doctrine no longer plays a major role in restraining the intrastate expansion or product development opportunities of national banks. Moreover, the doctrine never eliminated rivalry between the state banking regulators and the OCC. Contrary to the suggestion of Butler and Macey that the federal regulators welcomed the McFadden Act,\(^{619}\) in fact the OCC consistently tried to find loopholes in the McFadden Act that would enable national banks to escape intrastate restrictions on branching. While several of the OCC's earlier attempts were unsuccessful,\(^{620}\) the decisions in \textit{Clarke v. SIA} and \textit{Deposit Guaranty} have largely fulfilled the OCC's strategy.

In sum, Butler and Macey's contention that the dual banking system stifles competition between federal and state bank regulators does not accord with the historical record. Of course, such competition could be ended by the enactment of a federal law preempting the authority of the states to determine the scope of state bank powers. Indeed, that is one of the proposals made by Butler and Macey, based on their fear that the states will authorize excessively risky powers at the expense of the federal deposit insurance fund.\(^{621}\) As explained above, there is no substantial


\(^{615}\) \textit{Clarke}, 479 U.S. at 406. In this regard, the Supreme Court held that national banks could open offices providing discount brokerage services (an authorized banking activity) without reference to the McFadden Act. \textit{See id.} at 408-09.


\(^{617}\) \textit{See id.} at 268 (noting that state-chartered thrifts in Mississippi were given greater branching rights than state commercial banks).


\(^{619}\) \textit{See} Butler & Macey, \textit{supra} note 11, at 702-03, 707-08.

\(^{620}\) For examples of earlier unsuccessful attempts by the OCC to evade state restrictions on branching, \textit{see} \textit{supra} note 110.

\(^{621}\) \textit{See} Butler & Macey, \textit{supra} note 11, at 712-13.
evidence to date indicating that the states have permitted state banks to engage in excessive risk-taking. Moreover, Butler and Macey acknowledge that federal preemption would transform the current dual regulatory system into a centralized federal regulatory "monopoly" that would have "no incentive to liberalize the restrictions on entry into the banking industry, to develop innovative ways to solve contracting problems banks face, or to respond rationally to technological changes."

As an alternative to federal preemption, Butler and Macey suggest that the current system of federal deposit insurance and federal regulation of banks could be replaced by a free bank chartering system under which banks could obtain charters in any state and would operate without any substantial regulation except for that imposed by the banks' contracts with private deposit insurers. This proposal seems unworkable given the collapse of private deposit insurance plans in recent years and the unlikelihood (especially in view of the FSLIC crisis) that the public would have confidence in any deposit insurance system not backed by the federal government.

As an intermediate proposal, Butler and Macey suggest that a free bank chartering system under state law could operate under federal deposit insurance if appropriate risk-based deposit insurance premiums were introduced. However, they do not explain how the degree of federal regulation required to protect the federal deposit insurance fund could coexist in harmony with a free (and thus largely unregulated) bank chartering system at the state level. In addition, Butler and Macey admit that federal risk-based deposit insurance would involve problems of pricing by the federal government as the monopoly provider of such insurance.

622. See supra Part V(A).
623. Butler & Macey, supra note 11, at 713. For commentaries opposing centralized federal control over bank regulation, see Frankel, supra note 90, at 58, 61; Scott, supra note 8, at 34-35.
624. See Butler & Macey, supra note 11, at 714-17.
625. For authorities discussing the collapse in 1985 of private insurance systems for state-chartered thrifts in Ohio and Maryland, and concluding that a federal guarantee of deposit insurance is required to provide sufficient public credibility, see Scott, Deposit Insurance—The Appropriate Roles for State and Federal Governments, 53 Brooklyn L. Rev. 27, 28, 42-43 (1987); Lapidus, State and Federal Deposit Insurance Schemes, 53 Brooklyn L. Rev. 45, 48-52 (1987) (agreeing that only a federal deposit insurance system would be credible as a sole or primary insurer of bank deposits, but suggesting that a state insurance fund could play a useful role in providing excess coverage for large deposits that are not federally insured); Safe Banking Perspectives, supra note 15, at 191.

[Editor's Note: A recent survey indicates that nine out of the 12 members of the European Community ("EC") have adopted government-sponsored deposit insurance programs, and the remaining three countries will soon do so under pressure from the European Commission. The general adoption of government deposit insurance in the EC is a significant departure from past banking practices in most EC countries and appears to be a response to international competitive pressures and consumer concerns about bank safety. Sibley, How The Europeans Do It, Wall St. J., Aug. 29, 1990, at A10, col. 4.]
626. Other commentators have pointed out that federal risk-based deposit insurance would give the FDIC great power to influence the composition of bank assets and would
In sum, it appears that federal deposit insurance and federal regulation of banks are likely to remain features of our banking system for the indefinite future. As long as this is the case, the existence of a state chartering and regulatory option for banks will provide important benefits in bringing a significant degree of competition and innovation into a highly regulated industry.

**Conclusion**

The dual banking system has fostered a significant degree of competition between the federal and state banking regulators in providing responsive and innovative supervision. Although this regulatory competition is restrained by considerations of bank safety and soundness, the dual regulatory system for banks stands in marked contrast to other regulated industries where the federal government has exercised a monopoly of supervision. The recent state initiatives in expanding state bank powers are promising developments, especially when viewed in comparison with the inability of Congress to act on the question of banking powers. Accordingly, these state experiments should not be preempted by federal legislation in the absence of substantial evidence indicating that expanded state powers involve excessive risks of bank failure.

There is a further reason for allowing state experimentation with bank powers to continue. At present, there is substantial debate over the question of whether expanded securities, insurance or real estate activities present unreasonable risks for banks. In addition, there are arguments about the degree to which banks can be insulated from the risks inherent in bank loans before repayment problems are experienced. See, e.g., *1989 House Hearings*, supra note 5, at 25 (testimony of Chairman L. William Seidman of the FDIC, indicating the considerable power that risk-based deposit insurance would confer upon the FDIC, and noting the difficulty in predicting bank risks, since the large Texas banks that failed in the late 1980s because of loan problems had been highly profitable only a few years before); R. Litan, *supra* note 15, at 153-56 (explaining the difficulty of assessing the risks inherent in a bank's loan portfolio, before loan problems occur, in order to establish risk-based deposit insurance premiums); *Safe Banking Perspectives*, *supra* note 15, at 235-38 (recognizing same difficulty but suggesting that risk-related premiums might be workable).

There is a general consensus that the existence of federal deposit insurance requires a system of federal regulation designed to protect the insurance fund against the costs of bank failures. See, e.g., Garten, *supra* note 5, at 504 & n.11; *Safe Banking Perspectives*, *supra* note 15, at 246.

For a discussion of the benefits provided by the dual banking system, see *supra* Part II(A)(2). Professor Scott has pointed out that, while federal and state banking regulators have not allowed free entry into the banking industry, their record is far different from that of the former Civil Aeronautics Board, which enjoyed a regulatory monopoly over air passenger carriers, and did not authorize a single new trunkline air carrier during the four decades that followed the agency's creation. See Scott, *supra* note 8, at 34-35.

For authorities expressing differing views on the desirability and safety of bank involvement in expanded securities, insurance or real estate activities, see *supra* notes 63-77 and accompanying text.
in nontraditional activities if the activities are conducted through separate subsidiaries or affiliates.\textsuperscript{630} State experiments with new bank powers should provide helpful evidence in addressing these issues, because, as described above, the states have taken differing approaches in authorizing new activities, in placing limitations on the amount of bank resources that can be devoted to them, and, in some cases, by requiring such activities to be conducted through subsidiaries or affiliates.\textsuperscript{631} Thus, as has often been true during the history of our dual banking system, state innovation may provide the basis for a new federal approach to bank regulation and the appropriate scope of bank powers.

\textsuperscript{630} For differing views on the extent to which banks can be protected from the risks of activities conducted through separate subsidiaries or affiliates, see Mandate for Change, supra note 17, at 65-75, 86-96, reprinted in 1987 House Hearings, supra note 17, at 206-16, 227-37 (expressing the FDIC's view that banks can be adequately insulated from risk if nontraditional activities are placed in a subsidiary of the bank); S. Rep. No. 305, supra note 23, at 130 (additional views of Senators Garn and Bond, taking same position); id. at 16-17 (majority views, maintaining that the placing of securities activities in a separate nonbank subsidiary of the parent bank holding company would be "a much sounder alternative" (id. at 16) than allowing direct subsidiaries of banks to conduct securities activities); 1987 Senate Hearings, supra note 63, at 93-95 (testimony of Chairman Alan Greenspan of the FRB, taking same position); Safe Banking Perspectives, supra note 15, at 146-58, 305-06 (contending that banks cannot be adequately insulated from the risks of nontraditional activities conducted by nonbank subsidiaries or affiliates; regulation therefore must address the consolidated risk of the entire banking organization); Garten, supra note 5, at 553-58, 568-69 (taking similar position).

\textsuperscript{631} See supra Part II(D).