SAFETY AND SOUNDNESS IN BANKING REFORM: IMPLICATIONS FOR THE FEDERAL DEPOSIT INSURER

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I. INTRODUCTION

The federal deposit insurance fund, administered by the Federal Deposit Insurance Corporation (FDIC), insures bank deposits against the risk of bank insolvency.[1] The primary purpose of federal deposit insurance is to promote public confidence in the banking system. Banks play a vital role in the nation's economy, providing credit, a safe place to store and invest funds, and essential components of the payments system. Interruption of these functions through destabilization of the banking system could cripple daily commercial activities.

The primary responsibility of the federal deposit insurer is to protect the deposit insurance fund against undue risk. Although the insurer must be concerned with the financial well-being of individual banks, it also must identify and address threats to the stability and vitality of the banking system as a whole.

There is a general consensus that the banking system is in need of reform. In recent years, due to rapid and extensive changes in the financial services marketplace,[2] commercial banks in the United States have faced increasing competition from non-bank financial firms. Fettered by

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The views represented herein are those of the authors and do not necessarily reflect the views of the FDIC.

1. The FDIC administers both the Bank Insurance Fund, which insures deposits in commercial banks and savings banks, and the Savings Association Insurance Fund, which insures deposits in savings and loan associations and other thrift institutions. This Article addresses the Bank Insurance Fund.

2. These changes, which began to emerge or accelerate principally in the mid-1970s, are largely attributable to high rates of inflation, interest rate volatility, and advances in technology, such as developments in information processing and transmission. For a brief overview of the changes, *see* U.S. DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS XVIII 9-12 (1991) [hereinafter TREASURY REPORT].

statutory restrictions on both product and geographic expansion, banking organizations, unlike their non-bank competitors, have not had the flexibility to respond fully to these changes. As a result, banks have experienced substantial losses of business to non-bank competitors, reduced profitability, and a corresponding decrease in their ability to attract new capital.

The question facing policy makers and the banking industry is what, rather than whether, corrective action is warranted. The need for broad reform to protect the deposit insurance fund is clear. Although a number of issues associated with reform merit debate and thoughtful consideration, the most important for the deposit insurer is financial safety and soundness. In addition to identifying and evaluating the potential safety-and-soundness benefits associated with relaxing or eliminating existing product and geographic restrictions, the deposit insurer must be concerned with whether such reform, on balance, would enhance the stability of the banking system or expose the system and the insurance fund to excessive risk.

The safety-and-soundness benefits associated with reform are substantial, as are the safety-and-soundness risks. It is believed, however, that the risks can be addressed adequately by appropriate safeguards carefully tailored to specific concerns.

In light of the risks and the importance of the banking system in the nation's economy, great care should be taken to ensure that entry by banking organizations into new product and geographic areas is not permitted until sufficient safeguards are in place. Moreover, because it is impossible to anticipate fully all of the ramifications of extensive reform of the system, relaxation of existing restraints should be phased in on an orderly, progressive basis.

Past experience has taught that broadening the powers available to insured depository institutions cannot be accomplished safely absent increased supervisory oversight.[3] Federal bank regulatory agencies, including the FDIC, will need additional supervisory authority and re-

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3. During the early 1980s, federal legislation granted broad new powers to savings and loan associations and to other thrift institutions. *See* Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980); Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469. However, this legislation did not provide adequate safeguards, such as increased supervisory powers, to protect against excessive safety-and-soundness risk. On balance, the new powers adversely affected the financial health of the savings and loan industry, as well as the federal deposit insurance fund that covered savings and loans at the time.

sources to monitor individual banks in connection with their involvement with new activities.

Despite existing restrictions, banking organizations have been able to expand to a limited extent into new product and geographic areas. Even absent statutory reform, such expansion can be expected to continue. In their effort to compete more effectively, banks will attempt to keep pace with developments in the marketplace. A carefully considered, cohesive reform policy is needed to provide a rational framework within which banks can expand more freely, subject to the safeguards necessary to ensure the continued stability of the banking system and to avoid unnecessary losses to the deposit insurance fund.

II. SAFETY-AND-SOUNDNESS BENEFITS OF REFORM

The primary goal for any statutory scheme governing the nation's banking system should be a safe, workable system, free of unnecessary governmental restraints. Unnecessary regulation adds to the cost of doing business, impedes competition and economic efficiency, and ultimately can affect the health and vitality of the system. Clearly, some restrictions are needed. The difficult task is identifying those restrictions.

Existing limitations on geographic and product expansion by banking firms have had substantial adverse effects. Geographic restrictions have seriously impeded the ability of banking organizations to enhance their financial stability through geographic diversity and to provide greater customer convenience. Although these restrictions have been loosened substantially in recent years, the available means of geographic expansion are often the most costly or are limited to the same region in which the banking organization already operates, thereby reducing the benefits to be achieved by such expansion.

Existing restrictions on expansion into new product areas similarly have impeded banking organizations' efforts to compete with other financial services firms in a rapidly changing economic environment. Nonbank financial services firms, free of such constraints, have been better able to meet customer needs by creating new products and product packages.[4] Today, non-banking firms offer alternatives for most banking products or services, often at lower cost.

4. For example, securities firms offer asset management accounts that combine such components as money market mutual funds, "checking" (funds withdrawal and deposit) features, credit cards, personal loans, and securities brokerage. Such accounts are available through the local offices of regional and national firms.

Relaxation of these restrictions would allow banking organizations to achieve greater product and geographic diversity, spreading the risk of financial loss over broader areas and reducing the possibility that problems in one area could cause bank insolvency. It also would permit greater flexibility to meet competition from other financial services providers, or to initiate competition, by adapting existing offerings or introducing new products or product packages that are more responsive to customers' changing needs. Providing banking organizations the opportunity to offer non-banking products that have synergies with banking products would better enable them to take advantage of applicable economies of scale or scope, improve their economic efficiency, and allow them to offer the products at a lower cost.

By providing banking organizations with the flexibility to operate more efficiently and to compete more effectively, geographic and product reform should enhance profitability and promote the attractiveness of the industry for new capital. The increased availability of additional capital would contribute further to the safety and soundness of the banking system.[5] Improved stability and vitality of the system would, in turn, reduce the risk of loss to the federal deposit insurance fund.[6]

III. SAFETY-AND-SOUNDNESS ASPECTS OF GEOGRAPHIC REFORM

Federal statutory restrictions on geographic expansion by banking organizations take two basic forms: limitations on branching by national banks, and limitations on interstate acquisitions of banks by bank holding companies. As to both, Congress effectively has left to the states the decision of how much expansion to permit.

Under section 7 of the McFadden Act,[7] national banks are permitted to branch only to the extent that state banks are permitted to branch

5. The importance of banking reform is summarized in the following statement by L. William Seidman, Chairman of the FDIC: "the banking system must prosper in order to be safe and sound, and prosperity can be achieved only if banks are free to attract capital and compete effectively at home and abroad." *GAO Report: Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies: Hearings Before the Subcomm. on General Oversight and Investigations of the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 23-24 (1990). Broad reform is needed, Mr. Seidman stated, for banks to be able to compete effectively and to prosper. *Id.*

6. Other potential benefits of reform, beyond the safety-and-soundness benefits identified above, include greater customer convenience, product innovation, and increased competition in markets into which banking organizations are permitted to expand.

7. Ch. 191, 44 Stat. 1224, 1228 (codified at 12 U.S.C. § 36 (1988)).

under state law.[8] Similarly, section 3(d) of the Bank Holding Company Act of 1956 ("BHC Act")[9] permits bank holding companies to acquire out-of-state banks only if the target bank's state law expressly authorizes such acquisitions.[10] One obvious way to relax federal restrictions would be to permit national bank branching or holding company bank acquisitions independently of, or with less reliance on, state law. For example, national banks could be permitted to branch statewide, or even nationwide.[11] Bank holding companies could be permitted to acquire banks anywhere in the country.[12]

Meanwhile, state law restrictions on bank expansion have been greatly liberalized over the past decade. In 1939, eighteen states permitted statewide branching, while nine others limited their banks to a single office (known as "unit banking").[13] These numbers changed very little until the 1980s.[14] By 1990, however, thirty-six states allowed statewide branching to some extent, and the number of unit banking states had declined to two.[15] The 1980s also saw a dramatic increase in the number of states permitting bank acquisitions by out-of-state holding companies.[16] As of August 1990, all but three states had authorized entry by

8. Prior to enactment of the McFadden Act, national banks were not authorized to branch. First Nat'l Bank v. Missouri *ex rel.* Barrett, 263 U.S. 640 (1924) (national banks limited to one office, with no implied power to branch). The McFadden Act, as enacted in 1927, permitted national banks to branch within their home city, town, or village, provided that state banks could do so. This authority was expanded in 1933 to permit branching "at any point in the State," consistent with state law governing state banks. Banking Act of 1933, ch. 89, § 23, 48 Stat. 162, 189-90.

9. Ch. 240, 70 Stat. 133, 134-35 (1956) (codified at 12 U.S.C. § 1842(d) (1988)). Section 3(d) is commonly referred to as the "Douglas Amendment."

10. The Douglas Amendment was itself amended in 1982 to exempt from its restrictions certain emergency acquisitions involving failed or failing banks. *See* § 118(c) of the Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469, 1479. The emergency acquisition procedure addressed by the amendment was added to the Federal Deposit Insurance Act as new § 13(f) (codified at 12 U.S.C. § 1823(f) (1988)), by § 116 of the Garn-St. Germain Act.

11. In its recent report recommending reform of the banking system, the Treasury Department calls for new authority for national banks to branch into any state in which their holding companies could acquire a bank. In addition, the report recommends that the Douglas Amendment be repealed, with a three-year delayed effective date. TREASURY REPORT, *supra* note 2, at 51-52.

12. The BHC Act does not impose geographic restrictions on bank holding company ownership of non-bank subsidiaries.

13. Mengle, *The Case for Interstate Branch Banking*, ECONOMIC REVIEW, Nov.-Dec. 1990, at 3, 7 (Federal Reserve Bank of Richmond).

14. *Id.*

15. *Id.*

16. Maine, in 1975, was the first state after enactment of the Douglas Amendment to adopt a statute authorizing bank acquisitions by out-of-state holding companies. P. ROSE, THE INTERSTATE BANKING REVOLUTION 55-56 (1989). In 1982, Massachusetts and New York enacted their own

out-of-state holding companies.[17] Of the forty-eight states (including the District of Columbia) permitting entry, thirty-four do so on a nationwide basis, while entry into the remaining fourteen states is limited to holding companies owning banks within the same region.[18]

Notwithstanding these important state initiatives, major barriers to geographic expansion still remain. For example, many states still impose substantial intrastate branching limitations,[19] which apply to national banks under the McFadden Act, and national banks are generally believed to lack authority to branch across state lines.[20] Also, the differing approaches adopted by states that permit interstate expansion by bank holding companies have resulted in a patchwork of disparate rules. In addition to the confusion created by this disparity, such rules often preclude entry. For example, due to regional limitations imposed by a number of states, a New England bank holding company seeking to expand into another part of the country with a different type of economy would not be permitted to acquire a bank in the Sunbelt (Florida, Georgia, Alabama, Mississippi, South Carolina, North Carolina, or Arkansas) or in some Western or Midwestern states.[21] Moreover, many states prohibit de novo entry (through formation of a new bank) or entry through

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interstate statutes. The New York statute permitted entry by banking organizations nationwide, but the Massachusetts law limited entry to banking organizations from a six-state northeastern region (which did not include New York). Connecticut and Rhode Island adopted regional statutes in 1983. State authority geographically to limit entry in this manner was upheld by the Supreme Court, in a challenge to the Federal Reserve Board's approval of interstate acquisitions under the Massachusetts and Connecticut statutes, in Northeast Bancorp v. Board of Governors, 472 U.S. 159 (1985). Following this decision, formation of regional compacts moved forward.

17. *See Interstate Banking Laws: State by State*, BANK EXPANSION REP., Aug. 20, 1990, at 7-10. These actions by state legislatures to approve interstate entry have been attributed both to lobbying at the state level by bankers unsuccessful with Congress and to the perception that such action would aid economic development in the state. See ROSE, *supra* note 16, at 14, 56.

18. *See* BANK EXPANSION REP., *supra* note 17.

19. While Congress presumably could grant broader branching authority to state banks, it is far more likely to leave such policy making to the states. The dual banking system, under which state-chartered banks are regulated primarily by state law and national banks are regulated by federal law—an arrangement that has existed successfully for well over a century—would be seriously undermined by broad federal control of state bank branching.

20. The prevailing view is that the McFadden Act does not authorize interstate branching by national banks (the express authority is for branching "at any point *in the state*" (emphasis added)). *See, e.g.*, Northeast Bancorp v. Board of Governors, 472 U.S. 159, 169 (1985) (when the BHC Act was enacted in 1956, "interstate branch banking was already prohibited by the McFadden Act") (dictum). In any event, interstate branching generally is not authorized by state law. *See* UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS, INTERSTATE BANKING 1990: A GUIDE TO STATE LAWS (1990).

21. *See* BANK EXPANSION REP., SUPRA note 17.

acquisition of a bank in existence for less than a minimum period of time (most commonly, five years).[22] Some states permit nationwide entry only where certain special conditions, such as job creation and community reinvestment requirements, are met.[23]

Thus, banking organizations still face significant geographic impediments to diversification and effective competition with other financial services firms. There is good reason to expect that, absent federal legislation relaxing these restrictions in a cohesive and systematic manner, persistent piecemeal efforts to chip away at the existing law through regulatory approvals and litigation will continue.[24] Adoption of legislation reflecting a considered, unified approach to geographic reform is by far the preferable alternative.

Opposition to the relaxation of geographic restrictions appears to be founded more on socio-political concerns, such as the possibility of increased nationwide concentration of banking resources,[25] than on safety-and-soundness considerations. The perceived concern that seems most

22. *Id.*

23. *Id.*

24. For example, the Office of the Comptroller of the Currency (OCC) has permitted national banks in several states to establish branches at locations where state banks would not be permitted to branch, based on a rationale involving the definition of "State bank" in the McFadden Act, 12 U.S.C. § 36(h) (1989), the "banking" activities of state savings associations under state law, and state branching authority that is broader for savings associations than for banks. This rationale has been upheld by several federal courts. *See, e.g.*, Department of Banking & Consumer Fin. v. Clarke, 809 F.2d 266 (5th Cir.), *cert. denied*, 483 U.S. 1010 (1987). Another initiative to increase geographic flexibility involved the so-called "non-bank bank." This phenomenon was based on the pre-1987 definition of "bank" in the BHC Act as an institution that both accepts demand deposits and engages in the business of making commercial loans. An institution that met only one of these criteria was not a bank for BHC Act purposes, even though it might be the functional equivalent of a bank. *See* Board of Governors v. Dimension Fin. Corp., 474 U.S. 361 (1986). Such institutions therefore could be acquired by an out-of-state bank holding company without regard to the Douglas Amendment. This two-pronged definition was amended by the Competitive Equality in Banking Act of 1987 (CEBA), Pub. L. No. 100-86, § 101(a)(1), 101 Stat. 554 (codified at 12 U.S.C. § 1841(c) (1988)), in order to close what was commonly referred to as the "non-bank bank loophole."

25. This seems to be more of a socio-political concern than an economic one since few banking products are likely to involve a truly "national," rather than a smaller or larger, market. There is, however, a safety-and-soundness aspect to this concern. If increased consolidation results in a few dominant banking organizations, failure of any one could pose a significant threat to the stability of the banking system. At present, the level of concentration of banking assets in the United States is low: the four largest U.S. bank holding companies control less than 15% of the nation's total commercial banking assets. Some increase in concentration should not cause significant concern. However, if a meaningful likelihood that geographic reform would result in harmful levels of concentration develops, the better approach is not to reject reform but rather to adopt specific safeguards to address that concern. For example, one approach proposed in the past, and noted here solely for the purpose of illustration, would impose size limitations on acquisitions involving banks.

directly related to safety and soundness is the possibility of bank failures due to an inability to survive in a more competitive environment. To the extent this concern is warranted, it must be weighed against the substantial safety-and-soundness benefits of geographic reform. Efforts to enhance the financial health and viability of the banking system and the deposit insurance fund should not be rejected because of a possible adverse impact on a limited number of banks.[26]

IV. SAFETY-AND-SOUNDNESS ASPECTS OF PRODUCT REFORM

Proposals for product reform have focused primarily on the restrictions imposed under the Glass-Steagall Act[27] and the Bank Holding Company Act.[28] Stated broadly, the Glass-Steagall Act prohibits banks from engaging in, or becoming affiliated with entities engaged in, securities activities.[29] The BHC Act, by limiting the non-banking activities of bank holding companies to those that are "closely related to banking,"

Another possible approach, applicable to the extent concerns over increased concentration actually do involve market power, would be to implement safeguards through antitrust enforcement policy.

26. As discussed above, one of the primary benefits of geographic reform is the opportunity for banking organizations to achieve geographic diversity and spread their risk of financial loss among areas with varying types of local economies, customers, and financial services needs. The value of this benefit to the banking system as a whole is likely to exceed the potential harm of failures among banks unable to survive increased competition. A bank should not lack the ability to compete just because of its size. There is substantial evidence that larger banks do not have significant efficiency advantages over smaller banks, and that the latter can compete very well with the former. *See, e.g.*, Benston, *What Does Experience Tell Us About Competition*, in INTERSTATE BANKING: STRATEGIES FOR A NEW ERA, 137, 143 (1985). Indeed, larger banks have been found to be less efficient than smaller banks. *Id.* Thus, it is probable that the banks most at risk from increased competition would be those already experiencing difficulty. Since such banks might fail even in the absence of additional geographic reform, it is difficult to assess the magnitude of this perceived problem. Deposit insurance exists because of the expectation that some banks will fail. The more important concern is the financial health of the banking system as a whole.

27. This is the popular name of four sections of the Banking Act of 1933: §§ 16, 20, 21, and 32, ch. 89, 48 Stat. 162, 184, 188, 189, and 194 (codified at 12 U.S.C. §§ 24 (Seventh), as amended, Pub. L. No. 101-513, 104 Stat. 2036, 2037 (1990), 377, 378, and 78) (1988).

28. Section 4 of the BHC Act (codified at 12 U.S.C. § 1843 (1988)), addresses bank holding company ownership or control of non-banking entities.

29. Section 16 provides that, except with respect to certain government-related securities, national banks are prohibited from underwriting securities, and are permitted to purchase and sell securities only "without recourse, solely upon the order of, and for the account of, customers." (Section 16 is made applicable to state banks that are members of the Federal Reserve System by § 5(c), 12 U.S.C. § 335 (1988)). Section 20 generally prohibits affiliation between banks that are members of the Federal Reserve System ("member" banks) and entities "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities. Section 21 bars any firm engaged in "the business of issuing, underwriting, selling or distributing . . . securities" from also engaging in the business of accepting deposits; and section 32 prohibits director, management, or

forces separation of banking and nonfinancial commercial activities.[30]

Banking organizations have sought a wide range of securities powers, including authority to engage in full-service brokerage, and to underwrite and deal in municipal revenue bonds, mortgage-backed securities, commercial paper, and instruments backed by consumer receivables. Other proposed powers have included insurance brokerage and underwriting and real estate brokerage, investment, and development. Despite existing restrictions,[31] banking firms are permitted to engage in such activities to a limited extent. This authority comes from narrow grants of power in federal statutes[32] and from initiatives at the state level.[33] In addition,

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employee overlap between member banks and entities "primarily engaged in the issue, flotation, underwriting, public sale, or distribution" of securities.

30. Section 4(c)(8) of the BHC Act, 12 U.S.C. § 1843(c)(8) (1988), permits a bank holding company to own or control companies engaged in activities determined by the Federal Reserve Board, by order or regulation, "to be so closely related to banking or managing or controlling banks as to be a proper incident thereto . . ." In making such a determination, the Board is required to consider the potential public benefits and the possible adverse effects of participation in the activity by an affiliate of a bank holding company. Specific factors listed for Board consideration include competitive effects, efficiency, conflicts of interest, and unsound banking practices. Activities that have been approved by the Board by regulation are enumerated at 12 C.F.R. § 225.25 (1990).

31. For a historical perspective on the restrictions imposed under the Glass-Steagall Act and the BHC Act, *see* FDIC, MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INDUSTRY, 17-45 (1987) [hereinafter MANDATE FOR CHANGE].

32. For example, although § 4(c)(8) of the BHC Act, as amended by § 601 of the Garn-St. Germain Depository Institutions Act of 1982, 12 U.S.C. § 1843(c)(8) (1988), generally deems the provision of "insurance as a principal, agent, or broker" to be "not closely related to banking" (and therefore not a permissible activity for non-bank subsidiaries of bank holding companies), it does set out some limited exceptions that permit, *inter alia*, insurance agency activity in communities with populations not exceeding 5,000. National banks similarly have express power to act as insurance agents in small towns. *See* 12 U.S.C. § 92 (1988). (For a discussion regarding the proper citation for § 92, which has been omitted from the U.S. Code since 1952, *see* Abbott, Scott & Barrett, *Banks and Insurance: An Update*, 43 BUS. LAW. 1005, 1015 n.32 (1988)).

33. Banks chartered under state law are sometimes granted powers not available to national banks. For example, according to FDIC data, approximately 26 states permit their banks to engage in full-service securities brokerage, approximately 23 permit equity participation in real estate, and approximately 6 permit insurance underwriting and brokerage beyond credit life coverage. The extent to which state banks may exercise such powers, however, can be affected by federal law. For example, §§ 16, 20, and 32 of the Glass-Steagall Act are applicable to state member banks, and § 21 is applicable to all banks. (Section 21 does not, however, bar non-bank securities activities by affiliates or subsidiaries of state non-member banks. Investment Co. Inst. v. Federal Deposit Ins. Corp., 606 F. Supp. 683 (D.D.C. 1985), *aff'd.*, 815 F.2d 810 (D.C. Cir.) (per curiam), *cert. denied*, 484 U.S. 847 (1987)). In addition, the FDIC in 1984 adopted regulations requiring that securities powers granted to insured state non-member banks under state law be exercised only indirectly, through a "bona fide subsidiary," rather than by the bank directly. *See* 12 C.F.R § 337.4 (1990). The FDIC is currently considering whether similar restrictions would be appropriate for other expanded powers permitted under state law.

some increased product flexibility has been achieved through successful efforts to test the limits of existing federal restrictions.[34] As with geographic restrictions, such efforts surely will continue in the absence of a systematic approach to product reform.

Safety-and-soundness concerns associated with expanded powers focus on the possibility that participation in expanded activities would expose banks to increased risk of financial loss.[35] There are three principal areas of concern: the possibility that the bank would be legally liable for losses resulting from the expanded activities; the increased potential for conflicts of interest adversely affecting the bank's financial condition; and a loss in public confidence in the bank due to the financial difficulties of a

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34. For example, the OCC has permitted national banks to engage in discount brokerage activities. *See, e.g.*, Securities Indus. Ass'n v. Comptroller of the Currency, 577 F. Supp. 252 (D.D.C. 1983) (upholding OCC's approval of such activities), *aff'd*, 758 F.2d 739 (D.C. Cir. 1985) (per curiam), *cert. denied*, 474 U.S. 1054 (1986) (on the activities issue). The OCC also has allowed national banks to combine such services to some extent with investment advisory services. *See, e.g.*, OCC Interpretive Letter No. 386 (June 10, 1987), *OCC Quarterly Journal*, December 1987, at 36, *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,610. The OCC also has permitted national banks to issue and sell interests in pools of bank assets, such as mortgages originated by the bank. *See, e.g.*, Securities Indus. Ass'n v. Clarke, 885 F.2d 1034 (2d. Cir. 1989) (upholding OCC's decision to permit issuance and sale of securities backed by national bank's mortgage loans), *cert. denied*, 110 S. Ct. 1113 (1990).

Securities activities approved by the Federal Reserve Board on a case-by-case basis under the BHC Act have included a limited volume of underwriting and dealing in municipal revenue bonds, mortgage-backed securities, commercial paper, and securities backed by consumer receivables. *See* Securities Indus. Ass'n v. Board of Governors, 839 F.2d 47 (2d Cir. 1987) (generally upholding Board's order approving several applications for such activities), *cert. denied*, 486 U.S. 1059 (1988). Other activities approved by the Board have included underwriting and dealing in corporate debt and equity securities on a limited basis. *See* Securities Indus. Ass'n v. Board of Governors, 900 F.2d 360 (D.C. Cir. 1990) (denying petition for review of Board's approvals to underwrite and deal in corporate debt and equity securities). The Board's approvals of these applications, in which the Board originally limited the activities to five percent of the subsidiary's gross revenues, were based in part on its interpretation of the term "engaged principally" in § 20 of the Glass-Steagall Act. *See, e.g.*, Citicorp, et al., 73 FED. RES. BULL. 473 (1987) (Board's order of April 30, 1987, approving several applications to underwrite and deal in municipal revenue bonds, mortgage-backed securities, and commercial paper). The five percent revenue limit subsequently was increased by the Board to ten percent. *See Fed Raises Section 20 Order Limit to 10 Percent, Allows Affiliate Deals*, 53 BANKING REP. (BNA) 372 (Sept. 18, 1989).

For a discussion of such developments, *see* Kurucza, Ballen & McTaggart, *Securities and Investment Activities of Banks*, 43 BUS. LAW 1107 (1988).

35. In addition to safety-and-soundness concerns, other concerns associated with expanded powers include consumer protection, competitive parity, and resource concentration issues. Although this Article is not intended to address such issues, it is believed that, as with safety-and-soundness concerns, the better approach is to identify and adopt safeguards tailored to specific problems rather than to retain the existing broad prohibitions. The safeguards discussed *infra* with regard to safety-and-soundness issues can provide protections in these other areas as well.

related entity involved in expanded activities.[36]

These are legitimate concerns. Absent protective measures, a broad grant of new powers could expose the banking system to undue risk and the deposit insurance fund to excessive losses. The important question, however, is whether there are feasible safeguards that can limit the risks to an acceptable level. This standard does not require banks to be totally immune from all risks associated with expanded powers. The activities in which banks have engaged traditionally are not risk-free, and continued confinement to those activities despite the changing market environment can increase banks' overall risk.[37] The primary purpose of authorizing expanded powers is to reduce overall risk through such means as diversification and improved efficiency. The more the bank is insulated from the risks of expanded activities, the more it is also insulated from the benefits. A framework is needed that will provide a workable balance between maximizing the benefits to the bank from expanded activities and minimizing the risks to the banking system and the deposit insurance fund.

Two basic measures to provide protection from excessive safety-and-soundness risk have been proposed: legally separating the banking operation from the expanded activities and imposing restrictions on dealings between the bank and its affiliates or subsidiaries that engage in expanded activities. When combined with other protective measures, such as increased supervisory powers, these insulating mechanisms can limit risk exposure to an acceptable level.

As a general rule, investors in a corporation are liable for the obligations of the corporation only to the extent of their investment. Limited liability is based on the theory that the corporation is a separate entity that exists apart from its shareholders.[38] In general, the corporate entity, and limited liability, will be recognized unless to do so would produce unjust results or undesirable consequences inconsistent with the "sepa-

36. For discussions of these three types of risk, *see, e.g.*, MANDATE FOR CHANGE, *supra* note 31, at 65-74; UNITED STATES GENERAL ACCOUNTING OFFICE, BANK POWERS: INSULATING BANKS FROM THE POTENTIAL RISKS OF EXPANDED ACTIVITIES (1987).

37. One way in which risk could increase is if a bank loses business to non-bank competitors and moves into higher-risk substitutes for that business. For example, as prime corporate borrowers have turned to commercial paper as a lower-cost alternative to commercial loans obtained from their banks, the banks have turned to somewhat less creditworthy borrowers as loan customers. MANDATE FOR CHANGE, *supra* note 31, at 6-7.

38. H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 146 (3d ed. 1983).

rate entity" theory.[39] "The prevailing rule is that where corporate formalities are substantially observed, initial financing reasonably adequate, and the corporation not formed to evade an existing obligation or a statute or to cheat or to defraud, even a controlling shareholder enjoys limited liability."[40]

In determining whether to recognize or disregard the separateness of subsidiaries or other affiliated corporations, relevant criteria include the extent to which there are common directors, officers, and employees; the extent to which separate stockholders' and directors' meetings are held; the adequacy of the corporation's financing for operation as a separate unit; the extent to which the corporation is operated as a separate entity; the extent to which separate books and accounts are kept; and the extent to which the affiliated corporations are presented to, and perceived by, the public as separate business entities.[41] Where such criteria support the corporate separateness of a bank and its affiliates or subsidiaries, the risk that the bank would be deemed liable for the obligations of the affiliates or subsidiaries is minimized.[42]

Legal separation does not eliminate the incentives that the banking organization might have to use bank resources to benefit a non-bank affiliate. Even if the bank were not legally liable for the obligations of a related entity, it might choose to assist the entity voluntarily. Intercompany interaction that is financially detrimental to the bank can increase its risk of failure. Examples of interaction raising such conflict-of-inter-

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39. *Id.* Where the corporation is merely the "alter ego" of a person, it may be disregarded. 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.10 (C. Keating & G. O'Gradney rev. perm. ed. 1990). The rationale for this "alter ego" doctrine is that the law will not recognize the corporation as a separate entity if the actions of the shareholders or the corporations themselves belie separateness. *Id.*

40. *Id.*

41. *See, e.g.*, HENN & ALEXANDER, *supra* note 38, § 148; PRACTISING LAW INSTITUTE, RESPONSIBILITY OF THE CORPORATE PARENT FOR ACTIVITIES OF A SUBSIDIARY 18-22 (1987).

42. The FDIC has applied the concept of legal separation in its rule requiring that certain securities activities permitted to insured state non-member banks under state law be performed only through a "bona fide subsidiary" of the bank and not by the bank directly. *See* 12 C.F.R. § 337.4 (1990). A "bona fide subsidiary" must be adequately capitalized, be physically separate and distinct in its operations from the operation of the bank, maintain separate accounting and other corporate records, observe separate formalities such as separate directors' meetings and not share common officers with the bank, conduct its business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary of certain "separateness" circumstances (including the information that the subsidiary is a separate organization from the bank), and maintain separate employees who are compensated by the subsidiary. *Id.* In addition, a majority of the board of directors of the subsidiary must consist of persons who are neither directors nor officers of the bank. *Id.*

est concerns are bank loans to financially troubled non-bank affiliates, purchase by the bank of low-quality assets from an affiliate, and bank purchase of securities being underwritten by an affiliate.

Safeguards against this kind of risk already exist. Sections 23A and 23B of the Federal Reserve Act[43] impose strict limitations on transactions between a member bank and its affiliates. Section 23A covers, among other transactions, loans to affiliates, purchases of assets from an affiliate, investment in affiliate-issued securities, and acceptance of securities issued by an affiliate as collateral on loans to third parties. Furthermore, the total amount of such transactions with any affiliate is limited to ten percent of the bank's capital stock and surplus, and to twenty percent for transactions with all affiliates in the aggregate. Section 23A also requires that extensions of credit by a bank to an affiliate be collateralized fully, and that all covered transactions be consistent with safe and sound banking practices. Section 23B supplements these limitations, further requiring that all covered transactions, as well as certain additional transactions, be at arm's length. The additional transactions include sales of securities and other assets to an affiliate, the payment of money or the provision of services to an affiliate, or transactions with third parties that involve an affiliate.

Additional measures might be needed in connection with product reform to supplement these existing safeguards. For example, operating subsidiaries of a bank, not included in the definition of "affiliate" for purposes of sections 23A and 23B, are not covered by those provisions.[44] Applying similar restrictions to transactions involving the bank and its non-bank subsidiaries might be advisable, particularly regarding subsidiaries engaging in expanded activities.

The third main concern about exposing the bank to increased risk involves a possible public perception that the financial difficulties of a non-bank affiliate or subsidiary of the bank would have an adverse financial effect on the bank. Such a perception could result in a run on the bank, or the bank might, to its financial detriment, come to the aid of the trou-

43. Section 23A was added to the Federal Reserve Act by § 13 of the Banking Act of 1933, 48 Stat. 162, 183 (codified at 12 U.S.C. § 371c (1988)). Section 23B was added by CEBA § 102(a), 101 Stat. 554, 564 (codified at 12 U.S.C. § 371c-1 (1988)). Both sections are made applicable to state non-member banks by 12 U.S.C. § 1828(j) (1988).

44. The FDIC has, by regulation, imposed such restrictions with respect to certain securities subsidiaries of insured state non-member banks. *See* 12 CFR § 337.4 (1990).

bled entity in an effort to protect the interests of the bank or those of a common parent company.

Legal separation of the bank and non-bank activities and restrictions on intercompany transactions guard against this "market perception" risk. Elements of legal separation—such as separate offices and employees, and procedures designed to alert the public to the firms' separate corporate existences—are particularly helpful in this regard. Another measure that merits consideration is requiring written disclosure by the bank to customers purchasing products or services of a non-bank affiliate. The disclosure could inform customers that the bank is merely acting as an agent in making the product or service available, that the firm actually providing the product or service is a separate entity from the bank, and that the product or service is not covered by federal deposit insurance.

In developing a framework that balances the safety-and-soundness risks and benefits of expanded powers, it is not clear that it is necessary or desirable to require that all expanded activities be separated from the bank through non-bank subsidiaries of a parent holding company. As suggested above, permitting expanded activities to be conducted in an operating non-bank subsidiary of the bank, or even in a separate department within the bank, has advantages. Profits earned by the non-bank subsidiary or the department would benefit the bank directly, and the subsidiary or department could be sold in order to aid a financially troubled bank or to satisfy claims against an insolvent bank. Although these benefits might be available indirectly to the bank if the non-banking activities were conducted through a separate subsidiary of the same parent holding company, they would not be of the same value to the bank. Moreover, expanded activities would not be available to independent banks not part of a holding company structure, and forming such a structure would involve significant costs. There are also disadvantages to the direct bank subsidiary and department arrangements, including a lesser degree of risk insulation for the banking operation. Considerations relevant in determining what expanded activities could be permitted to the bank directly or through a non-bank subsidiary include the degree of risk associated with the activity and how closely related the activity is to traditional banking activities.[45]

45. Another consideration, which is not wholly a safety-and-soundness issue, is whether the activity is consistent with the purposes of federal deposit insurance and thus one appropriately covered by the deposit insurance "safety net." If not, it should not be permitted within the bank.

In addition to the basic safeguards discussed above, other measures can be adopted to protect against excessive safety-and-soundness risk. These measures include requirements concerning capital investments in entities engaging in expanded activities, and grants of additional supervisory authority to bank regulators.

Adequate capitalization is an important element in achieving legal separation of the banking and non-banking operations. Adequate capitalization of the non-banking operation is also important in minimizing the possibility that the bank would need to provide financial assistance to a troubled non-bank affiliate or subsidiary. Non-banking entities engaged in a regulated industry, such as securities or insurance, should be obligated to meet minimum capitalization requirements for that industry. Absent such an industry requirement, the entity should be required to maintain a level of capitalization adequate to the business it conducts.

A related issue is whether, when determining if a bank satisfies established capital requirements, calculation of the bank's assets should include its equity investment in a direct subsidiary engaged in expanded activities. The more prudent approach would exclude the equity investment, thus promoting the bank's capital adequacy and enhancing corporate separateness. An even stricter approach would take the additional precaution of increasing the capital required of the bank in an amount equivalent to any loans made by the bank to the subsidiary. This latter approach effectively would force the subsidiary to go to the market for funding and, accordingly, would provide an additional incentive for the subsidiary to remain creditworthy.

Another issue involving capital is whether there should be restrictions on the portion of a bank's total capital that could be invested in expanded activities. The greater the portion permitted, the less of its total capital the bank would have available to invest in the basic banking business.

Finally, a matter that must be resolved before expanding banking firms' powers in regulated industries is the identity of the primary regulator of a non-bank affiliate. Under the "functional regulation" approach, bank regulatory agencies would supervise only the bank itself, and probably the bank holding company. Non-bank affiliates would be supervised by the appropriate non-bank regulator, such as the Securities and Exchange Commission or the state insurance commissioner. Under this approach, which is likely the most efficient from a regulatory perspective, banking regulators would need the authority, for such purposes as en-

forcing the restrictions on intercompany transactions, to monitor both sides of such transactions.

These are just a few of the tough issues facing policy makers in connection with banking reform. Resolution of the issues will not be easy, but it is necessary if meaningful long-term improvements are to be made.

V. Conclusion

Extensive reform of the banking system is necessary in order to preserve the stability and viability of the system and to protect the deposit insurance fund. Such reform can be accomplished without excessive safety-and-soundness risk, provided adequate safeguards are applied. Developing a new regulatory framework for the banking system that achieves an acceptable balance between the benefits and risks will require careful consideration of many issues and resolution of many difficult policy questions.

It is time to give serious attention to banking reform. Steps must be taken soon to begin the process, before the situation reaches a more critical stage.