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Report to the Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate and the Chairman, Committee on Banking, Finance and Urban Affairs, House of Representatives

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BANK POWERS

Insulating Banks From the Potential Risks of Expanded Activities

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The Honorable William Proxmire
Chairman, Committee on Banking, Housing and Urban Affairs
United States Senate

The Honorable Fernand J. St Germain
Chairman, Committee on Banking, Finance and Urban Affairs
House of Representatives

This report presents our observations on one way being proposed to allow banks to participate in expanded activities while insulating insured bank deposits from the potential risks by organizationally separating the new activities. We conducted this review because of the high level of interest in these matters and our expectation that they will be addressed in this Congress.

Copies of this report are being sent to the Chairman, Board of Governors of the Federal Reserve System, Comptroller of the Currency, Chairman of the Federal Deposit Insurance Corporation, and other interested parties. Craig A. Simmons may be contacted on 275-8678 if you have any questions about the report.

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Executive Summary

Purpose

In today's rapidly changing financial markets, the traditional barriers between banking and other financial service providers are breaking down. As more and more securities firms, retailers, and other nonbank institutions offer bank-like services, banks are seeking new powers to help them meet this competition.

The new powers banks seek, however, may pose new financial risks to the banks' deposits and, as a result, to the Federal Deposit Insurance Corporation (FDIC) fund. As Congress considers granting banks power to engage in such activities as real estate brokerage, insurance underwriting, and underwriting of municipal bonds, opponents to bank expansion argue that the new activities threaten bank safety and soundness, could lead to significant losses to FDIC, and create conflicts of interest.

In this report, GAO presents its observations on one way being proposed in which banks might be able to participate in new activities without endangering their insured deposits: by organizationally separating new activities from bank operations in order to insulate bank deposits from the activities' risks.

Background

Banks are currently allowed to perform several nontraditional activities that are similar to the new, or expanded, powers they seek. These activities include discount securities and financial futures brokerage, insurance sales, and investment advising.

Banks generally operate these nontraditional activities under one of four organizational structures: (1) the bank department—an operating unit of the bank itself; (2) the bank subsidiary—a separate corporation directly owned or controlled by the bank; (3) the bank holding company subsidiary—a separate corporation owned or controlled by the company that owns the bank; and (4) less frequently used, the bank service corporation—a separate company owned by two or more banks or bank holding companies. (See pp. 26 to 35.)

Nontraditional activities not expressly provided for by law or a bank's charter require approval from the bank regulators Banks are regulated by the Office of the Comptroller of the Currency, the Federal Reserve, or the FDIC, depending on whether they are (1) national banks, (2) state-chartered banks that are members of the Federal Reserve System, or (3) state-chartered banks that are not members of the Federal Reserve System. State authorities also regulate state banks, and the Federal Reserve regulates bank holding companies.

GAO studied 19 banks conducting nontraditional activities to determine whether the organizational structures they used insulated their deposits from nontraditional activities.

Results in Brief

A bank unit or affiliate conducting a nontraditional activity may be able to minimize the risk to the bank's insured deposits by separating the activities legally, economically, and in the perception of the market. Certain organizational and management factors can help such separation. (See pp. 18 to 25.)

Exposure to risk does not necessarily lead to losses; in fact, profits may be realized. It is the potential for losses and the implications for the FDIC insurance fund that are of concern in this discussion. (See p. 12.)

GAO's observations of banks using the three primary organizational structures—the department, bank subsidiary, and bank holding company subsidiary—to conduct nontraditional activities showed that none of these structures could by itself completely insulate a bank's deposits. This is particularly true regarding market perception risks. Generally, insulation varied with the structure used and with each institution's individual characteristics, management, and methods of operation. Also, there appeared to be a positive correlation between the degree of insulation afforded the bank and the resulting cost to the bank. (See p. 36.)

GAO's Analysis

Legal Separation

If a bank and its unit or affiliate are legally separate, then the bank's deposits are insulated from legal risks because the bank generally is not legally liable for the debts of its affiliate. Factors important to such separation include separation of the organizations' day-to-day business and of the formal management structures of each organization, including boards of directors and board meetings. (See pp. 19 and 20.)

Economic Separation

Economic separation involves protecting the bank's deposits from the risk that the bank might choose to come to its affiliate's aid even when it is not required to do so. Important insulating factors include restricting the flow of funds, such as bank loans and dividend payments, from the bank to the affiliate. (See pp. 20 to 22.)

Market Perception Separation

Banks conducting expanded activities run the risk that the market will perceive the bank and the affiliate or unit as one. Even if the bank and the affiliate are legally and economically separate, this perception could lead to a run on the bank if the affiliate has trouble. Banks increase market perception separation by using a separate name and logo for the bank and the affiliate, locating the bank and the affiliate in separate locations, conducting marketing activities separately, refraining from selling each other's products, and developing separate customer bases. (See pp. 22 to 24.)

Strengths and Weaknesses of Three Structures and Summary Observations

Of the three structures GAO examined, the bank department provided the least amount of structural insulation. Banks are legally liable for their departments, which are not separate from the bank. Banks using departments told GAO that insured deposits were not at risk because the bank conducted only low-risk activities or other activities on a small financial scale. (See pp. 26 and 27.)

Subsidiaries of bank holding companies and banks generally provided legal and economic protection to bank deposits. However, neither fully protected the bank from market perception risks. The subsidiaries GAO visited sometimes used names, entrances, customers, and marketing services similar to the banks'. (See pp. 27 to 35.)

It is important to emphasize that the same type of structure could operate differently depending on the activity and the way it is managed.

Furthermore, depending on its scale and potential profitability, banks might choose not to conduct a new activity if an imposed insulation structure were too expensive or inconvenient. In addition, if they could not use their established names and reputations, they might not see much value in conducting new activities. (See pp. 34 to 36.)

Recommendations

GAO is making no recommendations.

Agency Comments and Our Evaluation

GAO requested official comments on a draft of this report from FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System. The first two provided comments (see apps. II and III); Federal Reserve officials told GAO the Board would not have comments.

FDIC commented that the report provides a useful discussion of the issue and said it agreed with the basic thrust of the report, that no one structure can be said to completely insulate a bank from risks of expanded activities. The Office of the Comptroller of the Currency interpreted the report as concluding that the holding company was the best insulation structure because it uniquely provided certain protections. GAO did not reach such an unqualified conclusion and in fact stresses that each of the insulation structures have both strengths and weaknesses. In practice, even the same types of structure could operate very differently depending on management. These and other FDIC and Office of the Comptroller of the Currency comments are discussed on pages 37 to 39

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Abbreviations

FDIC	Federal Deposit Insurance Corporation
FHLBB	Federal Home Loan Bank Board
GAO	General Accounting Office
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission

Introduction

As Congress considers allowing banks to engage in expanded activities, such as insurance and securities underwriting, real estate development, and brokerage services, concerns have been raised that such powers could lead to bank failures and resulting losses to the Federal Deposit Insurance Corporation (FDIC). (FDIC protects accounts up to $100,000 at insured institutions, funded by fees levied on banks.)[1] Some of these concerns recall the situation just over 50 years ago when the Nation's banking network failed, public confidence was severely shaken, and revisions to the Nation's banking laws (including separating investment and commercial banking and establishing federal deposit insurance) were made to repair the damage and restore public confidence. Some concerns have also been raised by insurance, securit es, and real estate industries that feel threatened by possible increased competition.

Regardless of these concerns, the traditional barriers among the banking, insurance, securities, and thrift industries are breaking down. The ability of other financial service providers, such as securities firms, insurance companies, and retailers, to respond innovatively and rapidly to market changes has blurred the distinction between traditional banking and nonbanking services. In response to this increased competition, banks are attempting to broaden their product lines—by expanding into securities and insurance areas, for example. However, according to bankers, their efforts to diversify into new areas are hampered by the existing legal and regulatory framework and by arguments that such an expansion of powers could threaten bank safety and soundness. This report provides observations on one way that has been cited and proposed in legislation that banks might be able to expand into new areas without imposing additional risks on the federal deposit insurance fund: by insulating the bank from the risks of expanded activities.

Regulation of Expanded Bank Activities

Currently, federally insured national and state banks in the United States are regulated by one of three federal bank regulators: the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and FDIC. State banks are also regulated by the state in which they are located. Regulatory jurisdiction is determined by the bank's charter (national or state) and by a state bank's decision on whether or not to become a member of the Federal Reserve System.

[1] For more information on FDIC deposit insurance, see the GAO Staff Study Deposit Insurance Analysis of Reform Proposals (GAO/GGD-86-32, Sept 30, 1986)

Table 1.1: Regulatory Jurisdiction

Type of institution	Primary federal regulator
National bank	OCC
State banks	
Member of Federal Reserve System	Federal Reserve
Nonmember	FDIC

The regulation of expanded powers of a bank are no different from the regulation of any other bank powers. Banks may perform activities provided they are allowable by their charter and their primary federal bank regulator (OCC, Federal Reserve, or FDIC) does not find that the activity is a threat to bank safety. If the powers are not specifically listed in the law, the bank may need to obtain a specific determination of its allowability. Bank regulators may prevent the bank from continuing an activity if it threatens the bank's safety.

The Federal Reserve also regulates the expanded activities of all bank holding companies (a company that owns or controls one or more banks). The bank holding company must apply for Federal Reserve approval, and the Federal Reserve can order the termination of any activity if it threatens the bank's safety.

Banks Are Becoming Involved in Expanded Activities

The competitive pressures of today's financial services marketplace are contributing to a breakdown in the traditional boundaries separating banks, thrifts, investment banks, insurance companies, and securities firms. Virtually every major bank-like or thrift-like product is available from a diversified financial services firm, yet no bank or bank holding company can offer the range of services that nonbanks can provide increasingly sophisticated consumers. Sears, Prudential-Bache, Merrill Lynch, American Express, and others offer a diverse range of bank-like products. In response, banks are finding ways to become more involved in expanded activities. For example:

- In January 1983 the Federal Reserve approved Bank America Corporation's application to acquire Charles Schwab Corporation, a nationwide discount securities brokerage firm. (As of February 1987 Charles Schwab was in the process of being sold.)
- In September 1984 American Banker identified 15 banks owning financial futures brokerage operations.
- A November 1984 MidContinent Banker article stated that between 150 and 250 banking organizations owned credit life re-insurance companies.

A 1985 Federal Reserve report prepared at our request lists about 1,000 bank holding companies engaging in insurance activities.

- In 1984, according to the Investment Company Institute, a trade association representing mutual funds, 17 banks were providing investment advice to mutual funds.
- A May 1985 American Banker survey reported that 97 of the nation's 250 largest bank holding companies offered discount brokerage services.

Although banks or their affiliates have had the authority to conduct some of these activities for over 50 years, participation was not very great until a few years ago. In 1984, during congressional hearings on expansion of bank powers, six national banking industry trade associations[2] united in their support for additional securities, insurance, and real estate powers. The associations echoed the theme that the definition of allowable activities for bank holding companies needed to be expanded. The six associations also sought the following specific powers: municipal revenue bond underwriting; mutual fund sponsorship; mortgage-backed securities underwriting and trading; real estate investment, development and brokerage; and insurance brokerage and underwriting.

Proposed legislation in 1984 (the Financial Services Competitive Equity Act), which passed the Senate but not the House of Representatives, would have expanded bank powers to allow bank holding companies to underwrite municipal bonds, render investment advice to an investment company, deal in and underwrite real estate mortgage-backed securities, and underwrite and deal in commercial paper. Legislation introduced in June 1986 would have also expanded bank securities activities to allow banks to underwrite revenue bonds, mortgage-backed securities, commercial paper, and mutual funds but this legislation did not pass. A key feature of both bills was the requirement that all bank securities activities be conducted in a "depository institution's securities affiliate" of the holding company.

[2]During the February 1984 Senate Banking Committee hearings, the six national banking industry trade associations represented were the Association of Bank Holding Companies, the American Bankers Association, the Independent Bankers Association of America, the Consumer Bankers Association, the Dealer Bank Association, and the Association of Reserve City Bankers

Benefits of Expansion Into New Product Areas

Officials representing industry trade associations claim expanding the products and services they are allowed to offer would produce many potential benefits. They explain that an expansion of powers would benefit consumers, enhance the competitive environment, and stimulate the development of new products. Some of them also contend that the expansion could be accomplished without risk to bank safety and soundness.

More specifically, bankers insist that consumers would benefit from expansion because a wider range of borrowing and investment products and information would be available. Such a range of alternatives, they believe, would enable consumers to make better, more informed financial decisions. They explain that expansion would also elevate competition, allow providers to realize economies of scale and scope, and enable them to offer many services more cheaply. Competition would drive providers to offer new and more innovative products that would be more responsive to consumer needs.

Bankers say that the problems experienced in the 1930s were resolved through subsequent legislation, that risks to public confidence are reduced by federal deposit insurance, and that no empirical evidence shows that the powers banks seek are any riskier than traditional banking activities. In fact, bankers also contend that the new powers they seek are in many respects less risky than traditional banking activities.

Furthermore, some researchers contend that allowing banks to expand their activities would allow them to diversify, which might actually make banks safer. Diversification, they explain, reduces overall risks by spreading them across a number of investments, thereby reducing the chance that problems in any one line of business could lead to a bank's failure. They believe that such diversification would therefore enhance the bank's overall strength.

Disadvantages of Expansion Into New Product Areas

During 1984 congressional hearings on expanding bank powers, representatives from the insurance, securities, and real estate industries countered with arguments that expanded activities could cause an undue concentration of power, decrease competition, create conflicts of interest, and create unfair competitive advantages. More specifically, opponents expressed concerns that expanded bank powers would result in the following:

- The Nation's becoming overly dependent on a few large financial institutions. If such institutions were to get into trouble, the entire monetary system could be destabilized. Also, the consumer could suffer if a few large institutions controlled the country's financial resources.
- A lessening of competition as banks perform only those services that produce the maximum return to the bank. Concentrating on the more lucrative products, banks would leave the other industries with less profitable products. Also, the larger institutions would force the smaller ones into excessive competition, resulting in the demise of many small firms that are unable to attain the economies possib e through large-scale operations.
- Increased potential for conflicts of interest. Offering many related products could result in the possibility of questionable tie-in sales. For example, the consumer could be coerced into purchasing credit life insurance to secure a loan or a mortgage, or into purchasing a securities product where insurance might be better.
- An unfair competitive advantage to banks because they can obtain funds by offering accounts covered by FDIC insurance at a lower cost. Besides enjoying the advantages of having federally insured deposits, banks have access to the Federal Reserve discount window and federal funds market. Banks have also received preferential tax treatment, including special bad debt reserves, deductions for interest on obligations incurred to purchase tax-exempt securities, and special rules for loss carryovers and carrybacks. These combined benefits put banks in a special class and provide them with special competitive advantages.
- Concern that the current regulatory system is not designed to cope with expanded activities and that banking regulation would no longer be capable of protecting depositors or preserving public confidence.

The Risk to the Deposit Insurance Fund

Although there are many potential risks associated with expanding bank activities, the purpose of this study is to focus on the potential impact on the FDIC insurance fund. Exposure to risk does not necessarily lead to losses; in fact profits may be realized. However, the potential for losses and the implications for the FDIC insurance fund should a bank fail are of concern when analyzing insulation issues.

According to a 1983 FDIC study, deposit insurance should perform two basic objectives. First, it should protect depositors of modest means from the consequences of a bank failure. Second, it should protect communities, states, and the Nation against the economic consequences of bank failures. The study noted that by fulfilling these objectives, deposit insurance maintains public confidence.

There are major risks to banks, and therefore the deposit insurance fund, of engaging in new activities. The three major risks are:

- The bank might be held legally responsible for the liabilities of the new activity.
- The bank might endanger its own financial health and safety by directly or indirectly assisting a failing activity.
- Public confidence in the bank might be shaken if problems develop in the activity despite the bank's lack of legal liability or voluntary financial assistance, causing a run on the bank and perhaps its ultimate failure.

We focused on three factors that might minimize or eliminate the above risks by providing for

- legal separation (consisting of factors necessary to help ensure a separate corporate entity),
- economic separation (consisting of factors needed to help prevent bank funds from flowing unrestricted to the nonbank activity), and
- market perception separation (consisting of factors that would help prevent the public from perceiving that the bank and nonbank activity were one).

Possible Methods for Expanding Bank Powers While Protecting the Deposit Insurance Fund

Industry officials and bank regulators have proposed several ideas which they believe could allow the expansion of bank powers and further bank deregulation while still protecting the FDIC fund. For example, FDIC has long proposed that deposit insurance premiums paid by all banks covered by insurance be based on risk. The present system of flat rates based on a percentage of domestic deposits imposes no penalty on banks that engage in riskier activities or operate less prudently than others. However, FDIC has concluded that an ideal risk-related premium is probably not feasible, since it would involve unrealistic data requirements and greater oversight. FDIC envisions, at best, a limited risk-based program in the future and is reviewing other, perhaps more promising, ideas from the private sector. More recently, the three bank regulators have proposed capital requirements based on the degree of risk as a means of deterring excessive risk-taking.

Other ideas revolve around the concept of increasing market discipline over risky banks. One of these methods would be to improve the information banks disclose to the public. Publicly available sections of bank call reports, through which banks regularly report on their operations, could be expanded to enable depositors and investors to better determine a bank's level of risk exposure.

Another idea designed to subject insured depository institutions to closer market scrutiny is to reduce the effective insurance coverage of accounts above the current $100,000 level that results from arranging purchase and assumption transactions and direct assistance packages for failing banks. According to a 1983 FDIC study, to the extent the existence of deposit insurance provides insured depository institutions an incentive to take more risks than the market would permit in the absence of insurance, reducing the effective insurance would restrict the extent to which investors would place uninsured deposits in a bank that is poorly managed or taking excessive risks. This would force investors to better assess the risks a bank is taking and would result in better overall private sector policing of the industry. However, FDIC adds, such an approach would defeat its goal of protection against the destabilizing effects of bank failures.

Another idea designed to subject insured depository institutions to closer market accountability would be to let the private insurance industry supplement FDIC coverage. FDIC believes that if the private sector could offer a form of deposit insurance and base its premiums on an assessment of the bank's overall risks, market forces policing banking would be stronger.

In lieu of such techniques to increase regulatory effectiveness, bank regulators told us that the only other options for change would be to increase the degree of regulation or try to restrict the expansion of activities to only low-risk activities. Expanded powers and new products will require some adjustments, new procedures, or additional training, but, they said, do not pose a major crisis to the concept of supervision and regulation. However, bank regulators told us that their work is expanding and, without new ways to increase regulatory effectiveness, they may need to increase their staffs.

An alternative advocated in a 1982 Treasury Department proposal to the Congress and contained in a bill introduced in June 1986 by Senator Garn, would have allowed expansion to occur without altering the insurance system or increasing market discipline. The proposed legislation, which did not pass, would have required that activities be separated from the bank in affiliated institutions. Under the proposal, dealings between the bank and its affiliates would be prohibited or strictly regulated and deposit insurance would apply only to the bank.

The merits of insulating banks from new activities in this way continue to be discussed. Opponents contend that it is impractical to separate the operations of the bank from those of an affiliate. In a June 1986 statement before the House Subcommittee on Commerce, Consumer, and Monetary Affairs, Committee on Government Operations, Federal Reserve Chairman Paul Volcker highlighted concerns over insulating banks from expanded activities. He noted that the practical realities of the marketplace and the internal dynamics of a business organization under central direction drive bank holding companies to act as one business with the component parts drawing on each other for marketing and financial strength. He said that because the market tends to consider the bank holding company as an integrated entity, problems in one part of the system will inevitably be transmitted to other parts. Furthermore, he noted that experience indicates that when a subsidiary or a related business enterprise of a bank holding company experiences financial problems, strength will be drawn from other parts of the organization—including banking subsidiaries—to protect the reputation of the entire organization.

However, proponents counter that real separation has never been actively attempted or pursued by regulatory agencies and that both legal precedent and bank practices support the proposal's validity. The possibility of effectively insulating the bank from the risks of new activities is the subject of this report.

Objectives, Scope, and Methodology

Since the Treasury Department developed a legislative proposal in early 1982, there have been several attempts to pass legislation which would allow expanded bank powers. We undertook this work to assist Congress as it reviews the proposals.

This report provides observations on one way that has been cited and proposed in legislation that banks and bank holding companies might be able to expand into new areas without unduly endangering FDIC's insurance fund—that is, by organizationally insulating the bank from the risks of the expanded activities. We attempted to determine how alternative organizational structures used to conduct expanded activities work and identified some of their advantages and disadvantages in insulating the bank, and therefore the deposit insurance fund, from the risks of the new activities.

To meet our objectives, we first identified the kinds of risks the expanded powers might present to the bank. We did this by examining relevant federal bank legislation and regulations, reviewing legal, financial, and economic journal articles, and holding discussions with industry experts, staff of the Federal Reserve System, the OCC, the FDIC, the Federal Home Loan Bank Board (FHLBB), and the Securities and Exchange Commission (SEC), and with representatives from the American Bankers Association, Association of Bank Holding Companies, the Bank Administration Institute, the Securities Industry Association, and the Investment Company Institute.

To determine how banks are currently organizing nontraditional activities, we reviewed relevant federal legislation and regulations and judgmentally selected a sample of banks and bank holding companies to identify some of their operating experiences and practices. We judgmentally selected the 23 organizational entities that were conducting various nontraditional activities on the basis of our discussions with several bank regulators and trade association representatives and a review of available documents. These entities were located in 19 banks or bank holding companies in New York, Chicago, San Francisco, and Minneapolis Federal Reserve districts. The organizations we selected included some of the country's largest bank holding companies as well as both large and small national and state banks. Each of the expanded activities of these organizations was being carried out using at least one of the three organizational structures regulators had identified as commonly used. To review their operating experiences, we spoke with officials at these entities and reviewed results of the most recent federal supervisory examination. While our review results are not projectable to all of the Nation's banks, they do provide some insights into the operations of some major participants in nontraditional activities.

Federal bank regulators also pointed to the bank service corporation as another viable organizational structure. Although it is infrequently used, for both traditional activities and expanded activities its structure offers several benefits, particularly for small banks. While we did not review any service corporations, we did obtain general information on this organizational structure from the Federal Reserve and the OCC.

We then compared the operating experiences and practices we observed at the 23 entities with legal, economic, and market perception separation factors (see ch. 2) important to insulation. Using a series of structured questions, we obtained insights from their officials into the strengths and vulnerabilities to risk of the various structures.

We focused our review specifically on the concern that expanded bank powers might adversely affect FDIC's deposit insurance fund. Other concerns, such as potential conflicts of interest or concentration of power, were beyond the scope of this review. Also, while we reviewed the general kinds of risks to the insurance fund, we did not review the riskiness of individual activities.

Our work was performed in accordance with generally accepted government auditing standards and was conducted during the period May 1985 to June 1986.

Factors Important in Insulating Banks From Risks of Expanded Activities

When banking organizations expand into new areas, they may encounter new risks which have the potential for negatively affecting the bank. First, creditors of or investors in a failing or failed activity may seek to attach the bank's assets to recoup their losses or investment. Second, the bank may willingly transfer good assets to or purchase bad assets from a failing activity and thereby undermine its own financial strength. Third, the public perception of problems in the nonbank activity may result in a lack of confidence in the bank itself and possibly cause a run on the bank's deposits, however unjustified. This chapter discusses the factors important in insulating banks from these risks of expanded activities and discusses advantages and disadvantages of requiring separation of such activities from bank operations.

Requiring Separation as an Insulation Strategy

In practice, federal regulators have required some financial institutions to separately incorporate their nonbank activities. For example, the FHLBB requires thrifts to operate separate savings and loan association service companies when offering securities brokerage and investment advisory services. Likewise, the FDIC requires insured state nonmember banks to form a "bona fide subsidiary" to engage in certain securities activities.

In addition, recently proposed legislation in this area would employ separateness as a protective mechanism. In early 1982, the Treasury Department developed a proposal which was introduced into the Senate that would have authorized banks to engage in certain securities activities but only through a separate subsidiary of a bank holding company. During 1983 several bills were introduced in the Senate to expand bank powers. These bills included the separate subsidiary approach for new bank holding company activities. In September 1984 the Senate overwhelmingly passed the Financial Services Competitive Equity Act. However, the bill did not pass the House. This bill would have expanded bank securities activities provided they were conducted in a separate subsidiary of the holding company. Finally, the Deposit Insurance Reform and Competitive Enhancement Act introduced in June 1986 would have also allowed bank securities activities to be placed in a separate subsidiary of the holding company. If this bill had passed, it would have enabled the SEC to regulate bank securities activities conducted in a depository institution's securities affiliate.

Factors Important in Insulating a Bank From Risk

Some regulations and recently proposed legislation subscribe to the belief that a bank may be insulated from the problems that a nonbank line of business could incur by separating the two operations. This theory is described in the work of some economists, most notably Samuel Chase. In both a 1972 study written when he was Associate Director for the Federal Reserve Board's Research and Statistics Division[3] and in a 1983 study commissioned by the American Bankers Association,[4] he concludes that banks can use the mechanism of corporate separateness to protect themselves from the risks of expanded activities if they are legally distinct and operate separately. In a parent-subsidiary relationship, the parent has no legal obligation to come to the rescue of the subsidiary, and the parent's risk is normally limited to the amount it invested in the subsidiary.

However, if a bank and its affiliate are separate, the bank's deposits may not be fully insulated from the affiliate's activities even if the affiliate is a separate corporation. From the studies we reviewed, we extracted certain general factors which should strengthen insulation. These legal, economic, and market perception factors are classified and explained below. (Also see app. I.)

Legal Separation

If a bank and its affiliate are legally separate, the affiliate's creditors will not be able to reach the bank's assets to settle claims against the affiliate, and the bank's losses would be limited to the amount invested in the affiliate. To be legally separate, therefore, the bank and its affiliate must conduct business in such a manner that the courts will recognize their independence. Although we did not identify specific criteria that would fully guarantee the courts would keep the so-called "corporate veil" from being pierced, four general "standards" were presented in a 1929 Yale Law Journal article written by William O. Douglas and Carrol Shanks. This article, based on a review of court cases in which the corporate veil was pierced, claims that adherence to these four standards assures that two separately incorporated business units will be recognized as separate entities.

[3]Samuel B. Chase, Jr., "The Bank Holding Company - A Superior Device for Expanding Activities?," Policies For A More Competitive Financial System (Federal Reserve Bank of Boston, June 1972)

[4]Samuel Chase and Donn L Waage, Corporate Separateness As A Tool of Bank Regulation (an independent study prepared for the Economic Advisory Committee of The American Bankers Association, 1983)

Under the first standard, each corporate unit must be separately financed in a manner sufficient to withstand the normal strains upon it. Under the second, the day-to-day business of each unit must be kept separate, including books and records. The third requires that formal barriers between the two management structures, such as a prohibition against joint operations, be maintained. Finally, the fourth standard requires that the two units not be publicly represented or advertised as being one unit.

These considerations remain relevant today, although since 1929 they have been modified by researchers. For example, some modifications suggested include the following. Separation of a unit's day-to-day business should include separate accounting personnel, policies and procedures, and physical assets, and also operation as a separate profit center with separate budgetary discretion. If the affiliate uses any bank facilities or services, such as legal, computer, or marketing services, the unit should be charged a market price for them. Finally, in order to avoid representing the two units as one, the autonomous status of a business unit should be indicated by a separate name and logo, a separate name for the unit's products and services, and the physical separation of the entities.

In commenting on our report, OCC noted that Phillip Blumberg in The Law of Corporate Groups[5] concludes that the "piercing" doctrine is based on relatively meaningless formalisms such as the existence of separate management (see p. 52) and suggests that the "entity" theory (that separately incorporated business units will be recognized as separate entities) is gradually being replaced by an "enterprise" approach. In the latter, the underlying economic realities of the relationships between units are examined to determine whether a common enterprise exits. We note that in his book Professor Blumberg further states that, with some recent exceptions, the courts have usually relied on entity law.

Economic Separation

Economic separation provides that a bank and its affiliate be adequately and separately funded with no commingling of assets and that any services or loans obtained from the bank be at rates comparable to those

[5]Philip I. Blumberg, The Law of Corporate Groups - Problem in the Bankruptcy or Reorganization of Parent and Subsidiary Corporations, Including the Law of Corporate Guarantees (Boston Little Brown and Company, 1985)

charged non-affiliated parties. A bank and an affiliate must also separate themselves financially to prevent the bank from unduly transferring assets to or purchasing bad assets from an ailing affiliate. Economic separation restrictions are generally addressed through funds flow restrictions and restrictions on the payment of dividends.

The law governing funds flow is Section 23A of the Federal Reserve Act. Section 23A limits the extent to which all FDIC insured banks may grant loans or extend credit to their affiliates. Under Section 23A, loans or extensions of credit to the affiliate, purchases of investment securities of the affiliate, or the transfer of assets between the bank and the affiliate are limited for transactions involving any one affiliate to 10 percent of the bank's capital stock and surplus and for all affiliates to 20 percent of the bank's capital stock and surplus. Also, a bank and its subsidiaries may not purchase low-quality assets from an affiliate, and any covered transactions between a bank and an affiliate shall be on terms and conditions that are consistent with safe and sound banking practices. Furthermore, any loan or extension of credit to, or guarantee on behalf of, an affiliate granted by a bank or its subsidiary must be secured by collateral having a market value of 100 percent or greater than the loan, extension of credit, or guarantee. Other banking law provisions also contain dividend payment restrictions generally consisting of notifying and receiving approval from State and federal regulators. For example, a national bank must obtain approval from the Comptroller of the Currency, and a state member bank must receive approval from the Federal Reserve before paying in any calendar year dividends exceeding the total of that year's net profits combined with retained net profits of the preceding 2 years. States frequently have similar requirements.

The importance of funds flow controls is illustrated by the failure of Hamilton National Bank. In the mid 1970's, severe problems developed in the holding company's mortgage banking affiliate which specialized in real estate development loans with its operations funded through bank lines of credit and the sale of holding company commercial paper. When the parent holding company was unable to roll over its commercial paper, it forced Hamilton National Bank to buy a large amount of low quality mortgages from the severely distressed mortgage banking affiliate of the holding company. These purchases far exceeded the amount permitted by law (Section 23A of The Federal Reserve Act) and resulted in the subsequent failure of the bank.

In recently proposed legislation, an attempt has been made to place additional restrictions on transactions with affiliates. Through a proposed Section 23B of the Federal Reserve Act, transactions covered under Section 23A and other transactions involving the sale of securities or assets, the payment of money, affiliate brokerage, or transactions involving a third party would be subject to additional restrictions. A bank and its subsidiaries would be able to engage in such transactions only on terms that are substantially the same as, or no more favorable than, comparable transactions involving nonaffiliated companies.

Market Perception

Even if legal and economic separation are attained, full insulation requires that the public recognize the separate nature of the bank and the affiliate performing the nontraditional activity. If the organizations represent their relationship unclearly or ambiguously, the public may improperly perceive that problems in the activity are necessarily shared by the bank. Therefore, banks must make sure their relationship is clearly separate from the nontraditional activity to ensure correct market perception. FDIC's regulations governing the bona fide subsidiary structure require that the affiliate conduct business with independent policies and procedures designed to inform customers and prospective customers that the affiliate is separate organization from the bank. The regulations further state that the subsidiary should be adequately capitalized, be physically separate and distinct in its operations, should not share a common name or logo with the bank, should maintain separate accounting and other corporate records, observe separate formalities such as separate board of directors meetings, maintain separate employees (compensated by the subsidiary), and otherwise operate and hold itself out to the public as a separate entity.

Although this rule was adopted in November 1984 and took effect the following month, the state nonmember banks were given until December 28, 1985, to comply with the requirements for separate names and entrances. That month FDIC postponed the effective date of the two provisions until June 30, 1986. In late June FDIC voted to reconsider its ban on the use of common facilities and names in response to petitions from two banking subsidiaries of securities firms and a bank with a securities subsidiary that operated out of the same facility as the bank. The effective date for the two provisions was extended until January 1, 1987. The date was again extended until June 30, 1987. According to FDIC officials, the requirement of a name distinction and separate offices currently applies to firms that are new entrants. The effective date of the requirement was postponed only for those institutions which had an affiliation with a securities company or had a subsidiary prior to the effective date of the regulation.

Additionally, according to Samuel Chase's work, the subsidiary or affiliate will more readily be perceived as separate if it has a name that is not easily confused with the name of the bank, uses its own letterhead, and conducts its own advertising. He further states that other ways to clarify public perception would be to use separate marketing strategies, refrain from cross-selling the unit's and bank's products and develop a separate customer base. Lastly, he states that the bank and the unit performing the expanded activity must be careful not to publish advertisements or enter into agreements stating or suggesting that the bank would be responsible for the obligation of the unit performing the expanded activity or implying that the operations of the unit are insured by the FDIC.

The importance of market perception is illustrated by the impact adverse publicity has had on bank safety and soundness. For example, in 1973 adverse publicity associated with a holding company's bad loans to a real estate developer caused a large-scale bank run and the eventual merger of a national West Coast bank. Furthermore, the following cases which are discussed in an appendix to the June 1986 statement by the Federal Reserve Chairman (see p. 15) illustrate how banks have gone to great lengths to preserve their reputation in the marketplace:

- In 1970 a California bank voluntarily assumed responsibility for the debts of its Swiss subsidiary which failed after incurring losses of nearly $40 million from unauthorized speculation in cocoa futures. They sustained the losses, even though the bank had no legal obligation to do so, to preserve the bank's reputation.
- In 1974 in order to preserve its reputation, a large midwestern bank holding company purchased certain loans that it would not otherwise have bought, if not for its role as an advisor, and provided $5.5 million in financial support to assure that a real estate investment trust under its advisement would not go bankrupt.
- In 1976 a large New York bank similarly purchased $160.6 million of a real estate investment trust under its advisement to save the trust from bankruptcy and maintain the bank's reputation.
- In 1980 a large midwestern bank participated with a securities brokerage firm in the $230 million rescue of a money-market fund under its advisement when it suffered liquidity problems. The bank refunded $1 million of previously paid advisory fees and waived additional fees to help resolve problems and protect its reputation.

- In 1982 two large New York banks paid a combined $190 million in interest owed by a major government securities dealer, even though the two were only financial intermediaries. They made these payments for a variety of reasons including considerations of legal liabilities and market pressures.
- In 1985 a large Chicago bank incurred losses of $131 million on its $15 million investment in a Brazilian bank. The Chicago bank sustained the losses to preserve its reputation and stature as a major international bank.

As shown, market perception is a powerful factor in influencing a bank's course of action when it feels its own good name is threatened or in influencing consumers when they feel their funds are at risk.

Implications of Requiring Separation

Although it might be hard to mandate that banks separate their traditional and expanded activities and meet all the insulation factors discussed in this chapter, such an insulation strategy might provide a framework within which banks could more safely expand their business with less risk to the federal deposit insurance fund. However, absolute insulation might also create disadvantages that would diminish the advantages of conducting expanded activities.

The major advantage of imposing an insulation strategy would be its potential for minimizing risk to the federal deposit insurance fund. Through appropriate legal protections, theoretically, a bank's potential loss from involvement in a nonbanking area could be limited to the amount it invested. Economic protections could preserve the bank's liquidity and solvency by restricting a bank's ability to financially assist a unit performing an expanded activity. Market perception protections could minimize the risk that the public would perceive the actions or problems of the unit as those of the bank.

An imposed insulation strategy could also have several disadvantages. For example, organizing an expanded activity in accordance with a particular organizational structure and in compliance with various insulation requirements could be costly; for smaller banks these costs, such as legal, administrative, and personnel, could be prohibitive. Such costs could deter banks from diversifying into new areas. Likewise, banks may be inhibited from piloting new ideas on a small scale before launching full-scale operations.

Restrictions on the flow of funds could keep banks from taking reasonable actions to help temporarily weakened units, actions that might be necessary to preserve the bank's goodwill and maintain its customers. According to one Federal Reserve bank official we interviewed, when an extensive market segment is at risk, actions by the bank to save a failing affiliate might even be prudent because corporate goodwill is extremely valuable.

Another disadvantage, according to OCC, is that the bank could lose an improved ability to raise both debt and equity and lower its cost of funds in those cases where the market perceived an integrated expanded activity to be profitable.

Finally, an imposed insulation strategy could impede other desirable effects that are the very reasons banks move into new business areas. For example, banks could develop skills in bond underwriting or investment advising but then be prevented from taking advantage of these skills to sell mutual funds or related securities products. Therefore, a mandated insulation strategy could be so stringent as to defeat its own purpose: if the strategy is as costly as the benefit of the expanded activity, the bank will have little if any incentive to undertake the activity.

How Some Banks Organize and Operate Expanded Activities

Each of the organizational structures banks generally used to perform expanded activities—departments, bank subsidiaries, bank service corporations, and bank holding company subsidiaries—has inherent strengths and weaknesses in protecting a bank from the risks of these activities. We found that each structure could be viewed as falling on a continuum with increasing degrees of insulation. Furthermore, the strengths and weaknesses of these structures were influenced by the activity the organization operated and the strategy the bank or holding company used to implement the activity and market the services of the unit. We found that the bankers we interviewed had differing reasons for organizing their activities under the structures they chose, reasons often not directly related to protecting the bank's deposits.

Bank Departments

A bank department is an operating unit within the bank. Departments are funded through the bank's operating budget, use bank employees and bank resources, and sell their products in conjunction with the bank's other products. Banks we visited used departments to perform such expanded activities as municipal bond underwriting and discount securities brokerage.

Bankers we contacted who used departments to perform expanded activities told us they selected the department structure because it was a simple, low-cost, easy-to-establish, and easy-to-manage structure. One banker explained that departments have the full use of the bank's strengths and facilities and avoid time-consuming meetings. Others said departments are not only inexpensive to set up but involve less reporting than separate subsidiaries do. Another banker said the department structure was useful for starting up a pilot operation which could be changed as the scale of the operation increased.

Although the department may be relatively easy and inexpensive to organize, banks using the department subject themselves to legal, economic, and market perception risks. Because the department is not a legally separate entity, any of its liabilities are the bank's liabilities. The bank's deposits are vulnerable to economic risks because no regulations govern the movement of funds between the bank and the department (except for trust departments, which are specifically regulated); in fact, departments are funded directly out of the bank's budget. Moreover, the department does not insulate against market perception risks because the public will naturally and correctly perceive the actions of the bank and the department as one. Therefore, departments afford no insulation.

However, the bankers we talked to who are using departments told us they are aware of the risks in using them to perform expanded activities. In defense of using departments, they explained that the activities carried out by their departments are not very risky. One banker said that for some activities, banks can reduce risks by establishing contractual agreements with customers that spell-out relationships and risks. In addition, we found that most of the departments we reviewed did not involve a large investment in the expanded activity.

Bank Subsidiaries

Bank subsidiaries are corporations owned and controlled by the bank but incorporated separately to perform a specialized operation. As a separate corporation, the subsidiary should have its own budget, board of directors, staff, books and records, and policies and procedures. Bank subsidiaries are currently already organized to perform a wide variety of expanded activities.

According to federal bank regulators, there are three kinds of bank subsidiaries: the operating subsidiary of a national bank, the state bank subsidiary, and the bona fide subsidiary through which state nonmember banks may conduct certain securities activities. Requirements for establishing subsidiaries depend on (1) what state the bank is chartered in, (2) whether the bank is chartered as a state or national bank, (3) whether the bank is a Federal Reserve member, and (4) what expanded activity the bank wishes to perform. Establishing a bank subsidiary can thus be as simple as separately incorporating the organization and starting up the activity, or as complex as separately incorporating, obtaining prior approval from the primary bank regulator, and strictly conforming to numerous restrictions.

Three of the banks we visited that used the subsidiary structure were national banks. They had the option of conducting an expanded activity either through a bank subsidiary (requiring approval from OCC) or through a subsidiary of the holding company (requiring approval from the Federal Reserve). Bankers from each of these institutions said they elected to organize as a bank subsidiary primarily because they thought waiting for approval from the Federal Reserve would take too long.[6] Bankers we interviewed said they felt that choosing the bank subsidiary over the bank holding company subsidiary provided adequate insulation

[6]One banker explained that his institution was convinced to go through OCC to organize the activity in a bank subsidiary because of the delays another bank experienced in getting Federal Reserve permission to acquire a discount brokerage unit as a holding company subsidiary

because the activities they conducted presented little risk to the bank deposits. One told us that if the bank had thought the expanded activity presented a greater risk it might have used another structure, even if that meant a delay in receiving approval.

Although the different types of bank subsidiaries, the varying regulations, and the management of each individual corporation make the degree of insulation of the bank subsidiary structure special to each case, the subsidiaries we visited encompass many of the insulation factors we described in chapter 2. Two examples follow.

- A large multinational bank holding company organized a discount brokerage operation as a subsidiary of the bank. The operation was a legally separate corporation, with a separate board of directors that held separate meetings, and it had separate books, records, and staff. Economically separate, the subsidiary segregated its assets from the bank's, paid the bank for use of its facilities, adhered to Federal Reserve funds flow restrictions, and established a policy of borrowing from the bank at market rates.

  The bank was protected against some but not all market perception risks. The subsidiary disclosed to its customers that it was a fully-owned subsidiary of the bank; it identified itself as a separate corporation and used a detailed account application that described its separate relationship with the customer. It did not publish advertisements or agreements stating or suggesting that the bank was responsible for the subsidiary's obligations. However, the subsidiary had a name simi ar to the bank's, engaged in cross-selling of products with the bank, shared common entrances with the bank, and used the bank's marketing services.
- Another large multinational bank holding company organized a futures commission merchant operation as a subsidiary of its lead bank. The bank and the futures subsidiary adhered to corporate separateness principles in the same ways the organization in our first example did. Economic funds flows were also separated in ways similar to those in our first example, and bank officials told us that the only risk to the bank was the capital investment it made to set up the subsidiary. Market perception risks consisted principally of closely using the bank's name for the subsidiary and using a common entrance for the subsidiary and the bank. However, the futures subsidiary offset some of these weaknesses by selling its services through its own employees, disclosing to customers their rights in the event of failure in the futures subsidiary, and

using a detailed customer agreement that defined the terms and conditions of the financial relationship. The subsidiary also avoided misleading advertisements and agreements, as did the subsidiary in our first example.

While these two cases show how the bank subsidiary can help protect a bank from risk, in the following sample case a bank subsidiary's operations were very closely integrated with the bank's operations, and the unit left the bank subject to various potential risks.

- A moderate sized bank with about $450 million in assets organized a small operation with four staff members. This operation was housed in the corner of the bank as a separate investment advisory subsidiary. Although the subsidiary was separately incorporated, it relied heavily on the bank for supervisors and used bank staff and office space, such that it appeared to resemble a bank department.

Moreover, the subsidiary used the bank's initials in its name and in its advertising brochure, which described the subsidiary services and was distributed along with other bank brochures. Funded for a nominal amount to cover only salary and expenses, the operation also presented the economic risk that the bank might feel compelled to continually support any financial problems the subsidiary encountered. The weaknesses in this case, however, must be balanced by the small scale of the subsidiary's operations.

Bank Service Corporations

The bank service corporation is a special corporation established by one or more banks in accordance with the Bank Service Corporation Act (P.L. 87-856, as amended) to perform a particular activity. As a separate corporation, the risk of the investing banks is limited to their initial investment. The bank service corporation may perform any activity that the Federal Reserve has found permissible by regulation for a bank holding company. The bank service corporation is infrequently used by banks for engaging in expanded activities.

To invest in a bank service corporation, banks must obtain the prior approval of the appropriate federal banking regulatory agency and any appropriate state regulators. In determining whether to approve or deny the application, the federal banking agency considers the financial and managerial resources and future prospects of the banks and the bank service corporation involved. This review evaluates each bank's financial ability to make a proposed investment and considers possible adverse effects such as undue concentration of resources, unfair or decreased competition, conflicts of interest, and unsafe or unsound banking practices.

The principal advantage of the bank service corporation is that it allows the smaller banks to engage in the full range of allowable nonbank activities without the need to establish a holding company. Other advantages include enabling two or more small banks to pool resources and thereby recognize economies of scale in performing a service or expanded activity, allowing for interstate expansion, and providing another option for banks to perform a wider range of activities than would otherwise be allowable through the bank or a bank subsidiary. Banks using the service corporation obtain the protection of corporate limited liability, are restricted in the amount they can invest, and if other banks are involved will likely structure a service corporation with its own public identity.

Possible disadvantages in using the bank service corporation would include administrative costs, problems obtaining timely approval, and coordinating operations with other banks.

Bank Holding Company Subsidiaries

The bank holding company subsidiary structure is frequently used for conducting expanded activities. Holding company subsidiaries, established by the holding company instead of the bank, are used to conduct various types of expanded activities.

Nonbank activities conducted in the bank holding company subsidiary are subject to the Federal Reserve's prior approval under section 4(c)(8) of the Bank Holding Company Act. This approval process requires that the holding company notify the Federal Reserve of the proposed activity and publish a newspaper notice of the application. Notice of the application is also published in the Federal Register and a hearing may be required if a protest is received. Each application must be approved by the Board or a Reserve Bank, acting for the Board under delegated authority. If the activity is on a pre-approved list of activities that the Board by regulation has determined is "so closely related to banking or managing or controlling banks as to be a proper incident thereto" the Reserve Bank may approve the application. Applications to engage in other activities must be decided by the Board in light of the statutory criteria specified in the Bank Holding Company Act. In addition to the closely related test previously mentioned, the activity must also be reasonably expected to produce public benefits that outweigh possible adverse effects. Benefits to the public can include such things as greater convenience, increased competition, and gains in efficiency; adverse effects can include undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices. To determine whether a holding company may conduct such an activity, the Federal Reserve evaluates the financial and managerial resources of the applicant, its subsidiaries, and any company to be acquired.

Bankers we contacted gave several reasons for selecting the holding company structure:

- Since prior Federal Reserve approval is required, there is less risk that the legitimacy of the expanded activity or the structure used to conduct the activity would be challenged in the courts.
- Using this structure allows bank holding companies to determine in which state it may be most advantageous to establish the expanded activity.
- It may allow for improved management of the expanded activity.
- It affords the opportunity to better compensate and thereby hire and keep specialized personnel by administratively separating them from the bank.
- It allows banks to take advantage of various interstate opportunities, marketing services nationwide, or favorable regulations in another state.
- It clarifies the applicability of particular regulations. For example, there is no question that the securities laws apply to bank securities operations conducted in the holding company.

In our discussions with Federal Reserve officials, they identified certain benefits and protections afforded by the holding company and its subsidiaries. According to Federal Reserve officials, the bank holding company subsidiary structure provides banks with

- distinct tax advantages,
- an avenue for conducting nonbank activities on an interstate basis,
- greater funding flexibility through the use of commercial paper,
- a separate corporate operation with a separate corporate structure and separate banks and records, and
- a separate corporate structure to minimize corporate separateness and market insulation concerns.

There is also the belief that the holding company subsidiary structure provides greater protection. Samuel Chase believes that the bank holding company subsidiary would provide greater protection than the other structures. With regard to piercing the corporate veil he contends that:

"....piercing crosswise [through the holding company] would be less likely than piercing upward [through the bank]. That is, if a nonbank subsidiary failed, the likelihood that a banking subsidiary would be held liable for its debts is considerably smaller than the (already small) likelihood that the parent holding company would be held liable.

It therefore seems reasonably safe to say that, for banking organizations as well as for other corporations, piercing would be the exception, not the rule, as long as steps were taken to make nonbank subsidiaries separate in substance as well as in form "[7]

Whereas OCC, FDIC, and the Federal Reserve supervise and examine the banks under their regulation, all bank holding company non-bank subsidiaries are regulated by the Federal Reserve. The following requirements under the Federal Reserve Act and the Bank Holding Company Act are related to the supervision and examination of bank holding company subsidiaries.

- The Federal Reserve must review and approve each application to perform a nonbank activity.
- The Federal Reserve may examine the bank holding company and the subsidiary performing the expanded activity.
- The Federal Reserve may terminate the bank holding company's performance of any activity it has reasonable cause to believe constitutes a serious risk to the safety, soundness, or stability of the bank holding company subsidiary bank.
- Transactions between the bank and the holding company subsidiary performing the nonbank activity will be subject to restrictions under Section 23A of the Federal Reserve Act.

OCC, in its comments on a draft of this report, noted that with respect to national banks, their departments and operating subsidiaries, it may examine the entity performing the expanded activity and terminate an activity it believes constitutes a serious risk to the safety and soundness of the bank. OCC also said that prior approval by any regulator has proven useful in the event of litigation.

The following two examples of companies we visited illustrate strengths that the bank holding company subsidiary structure can provide:

[7]Chase, "The Bank Holding Company," p. 82

- A large multinational bank holding company acquired a discount brokerage subsidiary. Organized as a separate corporation before the acquisition, the subsidiary continued to function as a separate corporation and maintained legal protections through separate books and records, personnel, policies and procedures, budget, board of directors, board meetings, and a distinct name. The holding company also displayed economic separation strengths: it segregated bank and subsidiary assets, granting loans to the subsidiary at market rates, required that bank assets not be used to support subsidiary borrowings, and charged fees for the use of bank services. Federal Reserve holding company examiners found no major problems with the bank's compliance with requirements on dividend restrictions or financial transactions with the bank. Moreover, this holding company also exhibited several market perception strengths. The subsidiary had a separate and distinct name, conducted operations in a building separate from the bank and in separate offices throughout the country, used a separate and distinct logo and letterhead, and subsidiary officials told us that they adhered to a policy of not publishing advertisements or entering into any agreements that stated or suggested the bank would be responsible for the discount brokerage operation's obligations.

  Several of these protections may be traced to the discount brokerage operation's separate corporate existence prior to its acquisition by the bank holding company. However, its reliance on the bank for various services may have weakened this market perception separation. According to a subsidiary official, it now participates in cross-selling products with the bank, uses the bank's marketing services, and relies on the bank's customer base.

- A moderate-sized holding company combined various investment advisory functions into a separate holding company subsidiary for marketing purposes. Although the marketing advantages failed to accrue, the resulting structure encompassed many of the factors important to insulating the bank. Legal separation factors consisted of the subsidiary's separate incorporation along with separate books and records, staff and procedures; the absence of any commingling of assets with the bank; the use of a separate budget; and the use of a separate board of directors with separate board meetings. The bank also displayed several economic separation strengths through the separation of bank and subsidiary financial operations, a policy that any loans from the bank be at market rates, the prohibition against using bank assets to support subsidiary borrowings, and a fee charged for the use of the bank's facilities and services. Moreover, the Federal Reserve holding company examination (the most recent one completed prior to our visit) revealed no violations involving financial transactions between the bank and the investment advisory subsidiary. With regard to market perception, the subsidiary used its own personnel to market its products, thereby developing its own customer base, did not cross-sell products with the bank, did not use bank marketing services, and did not publish advertisements or enter into any agreements stating or suggesting the bank was responsible for the subsidiary's obligations. However, there are also a few market perception risks because the subsidiary and the bank use the same logo to begin their name, subsidiary operations are located in the main bank building, and customers must use a common entrance.

According to bankers we contacted, there are several disadvantages associated with using the bank holding company structure. They identified the most common disadvantage as its administrative cost and delays in obtaining regulatory approval. One banker told us that the holding company subsidiary approval process takes a very long time (one recent case requiring almost a year for Federal Reserve approval) and causes much uncertainty. Because activities cannot be started until approval is obtained, delays can be very expensive; the bank risks losing its market while publicly disclosing what it plans to do. The banker emphasized that there are distinct market "windows of opportunity"—and waiting 6 months for approval could cause the bank to lose a market opportunity. Two bankers managing small holding companies found the holding company approval process particularly onerous and expensive to administer. One of the two further explained that he wished the bank had organized the unit as a department because he would then have been able to exercise greater control over the activity and it would have been less costly to operate.

Another disadvantage in using the holding company subsidiary structure is that it, like other subsidiaries, does not fully protect against market perception risks. All of the bank holding companies in our sample displayed several market perception weaknesses. Of our 12 sample holding company subsidiaries, all but 1 told us that they were coordinating sales or marketing activities with the bank. In addition, 10 subsidiaries incorporated the bank's name, initials, or part of the bank's name in the name for the expanded activity, and only 1 had a separate and distinct name for the holding company subsidiary performing the expanded activity. Several of the bankers managing these subsidiaries told us that they purposely trade on the bank's name, customer base, or organizational strengths. In fact, one banker stated that if he could not trade on the bank's name and goodwill, there wouldn't be much sense in conducting the new activity, and another stated that they want to be able to trade on the corporate name for any unit.

Two organizations in our sample, both subsidiaries of small bank holding companies, did not provide a high degree of separation. Both were small credit life insurance companies of the holding companies. Both operations resembled bank departments—the insurance policies were typically sold in the bank, by bank employees, to bank customers. Therefore, both organizations were subject to potential market perception risks.

- In the first case, although the subsidiary was separately incorporated and as such had separate books and records and did not commingle assets with the bank, the lack of separate management including the lack of a separate board of directors and separate board meetings and the heavy reliance on the bank for services made legal separation somewhat weak. The subsidiary's heavy use of bank facilities and services without charge made it questionable whether economic separation was attained. With regard to market perception, the bank and the subsidiary did not publish any advertisements or enter into any agreements stating or suggesting that the bank would be responsible for the subsidiary's obligations. However, the cross-selling of the subsidiary's insurance policies with bank products, in the bank, to bank customers, by bank employees with the bank planning the overall market strategy weakens the market perception of the bank and the subsidiary as separate entities.
- In the second case, the subsidiary was also separately incorporated, with separate books and records and a separate board of directors but the lack of separate employees and the reliance on the bank for services creates weaknesses in legal separation. Economic separation strengths include loans to the subsidiary at market rates and a fee charged for the use of bank facilities and services. Similar to the first case, this company also cross-sold subsidiary and bank products, used the bank's marketing services, and sold insurance products in the bank, by bank employees, to bank customers.

Therefore, although the holding company subsidiary structure may be established in such a way as to provide a high degree of protection, it can also be used in a manner that reduces the benefits of legal, economic, and market separation.

Summary Observations

Some bankers explained that their decisions on what activities to perform and how to organize them involve an overall determination of what works best for the bank and the overall organization. If they don't see a way to conduct the activity in a cost-effective or safe manner, they won't do it. If the activity is relatively risky, they explained, they may elect to do it only under the holding company subsidiary structure and might even try to gain greater separation by not conducting the activity under the bank or holding company name. They explained that if the activity is relatively risk free, they may elect to do it as a department, just so they can start operations as soon as possible. Bankers also told us that they would use different structures for different expanded activities in order to meet specific needs or improve the overall safety of their operations.

Therefore, the present set of structures for establishing expanded activities provides bankers some freedom to meet their needs. However, none of these structures guarantees complete protection to insulate the bank from risk. Moreover, decisions on what structure to use are sometimes driven by the desire to get operations started. In making these decisions bankers might consider risks to the bank, but other factors—such as the chance to utilize bank strengths, expand operations or take advantage of market opportunities to thereby gain additional revenue—are also important.

Insulating the bank, and therefore federal deposit insurance funds, is not a clear-cut issue. One cannot say that one structure insulates the bank while another does not. Rather, we found that the structure under which nontraditional activities are conducted falls along a continuum with increasing degrees of insulation provided the bank. Some organizational structures provide for greater insulation than others. However, we found in practice that even the same type of structure could operate very differently and provide varying degrees of insulation, depending on the expanded activity conducted and the way it was implemented by management. Furthermore, there is a trade-off between the costs (legal, administrative, personnel, etc.) to the bank, and the level of insulation and protection to the insurance fund. When Congress is considering giving banks expanded powers, it should recognize these differences and also that no one structure can provide a guarantee that an organizational structure will automatically protect the bank from the risks of the expanded powers.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from FDIC, OCC, and the Board of Governors of the Federal Reserve System. The first two provided comments (see apps. II and III); Federal Reserve officials told us they were not commenting officially because the draft report did not contain recommendations.

FDIC said that the report provided a useful discussion of the organizational structures typically used to separate banks from risks associated with nontraditional banking activities. FDIC noted that it agreed with the basic thrust of the draft report and could find no objective inaccuracies in the substantive conclusions. FDIC said that based on the evidence in the report, it cannot be said that one structure insulates a bank while another does not. FDIC provided a number of suggestions, which are discussed below or at the close of its letter in appendix II.

FDIC's primary concern was that the report's executive summary and summary observations in chapter 3 understate the important role that management plays in detaching a bank from the risks accompanying new activities, adding that managerial decisions can sometimes supersede the influence of structure. The importance that management plays is mentioned in the executive summary and summary observations, but to prevent any misunderstanding we have strengthened our discussion of this matter in the executive summary. (See pp. 3 and 4.)

FDIC noted that the draft report did not make a distinction between the short and long-run insulation effects which may follow the imposition of given structural requirements on banking firms. A comparative analysis of short and long-run insulation efforts was not part of this report's scope. FDIC also commented that the draft report did not evaluate atypical bank departments, in which savings banks presently conduct life insurance activities. We agree that our report focuses on primary organizational structures, not various atypical or hybrid arrangements.

OCC, on the other hand, thought that the draft report presented a conclusion that was unsupported and biased, and suggested corrective changes. OCC believed we concluded that the holding company approach affords the best insulation strategy for banks and that the draft implied that certain protections cited would exist only if the expanded powers were used through a holding company subsidiary.

We do not reach such a conclusion. Rather, we concluded that insulating the bank, and therefore federal deposit insurance funds, is not a clear-cut issue. We note that some organizational structures by their very nature, along with legal and/or regulatory requirements, provide for greater insulation than others. We continue to say that, in practice even the same type of structure could operate very differently and provide varying degrees of insulation, depending on the expanded activity conducted and the way it was implemented by management. While regulators and bankers described many positive benefits of the holding company structure, we emphasize that each structure had both strengths and weaknesses. (See p. 36.) Given OCC's interpretation of the draft, however, we clarified the discussion relating to the Bank Holding Company Act and added OCC's statement concerning its supervisory powers over national bank departments and subsidiaries (see pp. 31 and 32).

OCC provided a number of more specific comments. Stating that the draft report categorized as new or nontraditional such activities as discount securities and financial futures brokerage, insurance sales, and investment advising, etc., it pointed out that not all of these activities are new. We note on page 10 that banks or their affiliates have had the authority to conduct some of these activities for over 50 years, but participation was not great until a few years ago.

OCC also observed that the draft seemed to assume that risk from expanded activities invariably resulted in the realization of losses whereas it may result in profits. The draft did not address the positive side of risky activities, and we added material to recognize explicitly the potential for gains as well as losses from expanded activities (see pp. 3 and 12) and revised language accordingly. We believe, however, that the potential for losses and the implications for the FDIC insurance fund should the bank fail are of direct concern to the discussion of expanded activities.

OCC felt that our discussion of the disadvantages of imposed insulation should include market perception of a nonbanking act vity as "separate" from the bank, noting that if the market perceived an activity as a profitable one that is integrated within the bank, the bank could improve its ability to raise both debt and equity as well as lower its cost of funds. Such benefits could be lost if the bank were forced to make the market believe the activity were separate. This may be true, but the report's focus was on the difficulty of completely insulating bank operations from the expanded activities, especially regarding market perceptions. Nevertheless, we have recognized this possibility in the report (see p. 25). The disadvantage of a lack of market perception of separation occurs when the market does not perceive the activity as profitable and believes the bank itself threatened.

OCC further noted that the draft report did not recognize the undesirable business, marketing, managerial, and regulatory consequences of excessive separation and certain virtues inherent in a less segregated structure. We recognize on pages 24 and 25 that required separation can have negative implications. We note there that imposed insulation may result in costly administrative, legal and personnel actions; restrict banks from using funds to aid a temporarily weakened unit; and, impede other desirable effects of expanding into nontraditional activities. OCC also provided information from a book that suggests that the entity theory of legal separation is gradually being replaced by an enterprise theory. We added a discussion of this on page 20.

OCC next said that there was a significant sampling bias in the case studies of organizational units conducting activities because most of the bank subsidiaries discussed did not appear to be true subsidiaries. As we say on page 16, we judgmentally selected the 23 organizational entities conducting various nontraditional activities. Although the entities, located at 19 banks or bank holding companies, were not intended to represent the Nation's banks, we selected some of the country's largest bank holding companies as well as large and small national and state banks. We did not know the level of insulation an entity had from the bank before we selected them. We believe that our observations provide insights into the operations of some major participants in nontraditional activities.

Finally, OCC said that the definition and discussion of economic separation in appendix I varied from the explanations in the body of the report. We have expanded the report to avoid such a misinterpretation by including the summary comments on page 40 in the detailed discussion on pages 20 and 21. OCC said that some parameters for separation that we cited on page 40, for example that a bank obtain services from an affiliate at market prices, seem irrelevant to the goal cited on page 3 of preventing a bank from aiding an affiliate. We disagree and believe transactions at market price are relevant to insulation, because this would prevent a bank from aiding an affiliate by paying above market price for services provided by an affiliate, or charging below market price for services provided to it. OCC also provided separately some updated references and other technical changes which have generally been made.

List of Factors Important to Insulating Banks From Risks of Expanded Activities

Our review of banking law, regulations, and insulation research and discussions with industry experts identified various factors which were considered important in protecting a bank from the risks of expanded activities. According to this research, a fully insulated bank should be separate from its affiliate legally, economically, and in the perception of the market.

Legal Separation

The unit performing the expanded activity is generally considered as legally separate from the bank if it meets the following:

- incorporated as a separate company;
- established with adequate financing so as not to be dependent on the bank;
- operated on a day-to-day basis as a separate business unit (as evidenced by separate banks and records, separate staff, separate policies and procedures, arms length transactions, etc.);
- organized with its own separate board of directors and own separate board meetings; and
- is held out to the public as a separately incorporated business apart from the bank.

Economic Separation

Factors important to assuring that the unit performing the expanded activity is funded in a manner that is economically separate from the bank include:

- The unit is adequately and separately funded with no commingling of assets with the bank, and any services or loans obtained from the bank are at rates comparable to those charged non-affiliated parties.
- All transactions between the bank and the unit conform to banking regulations governing the extent of investment, prior notification of the federal bank regulator, and the terms of repayment or remuneration for services.

Market Perception Separation

Factors important to helping the market perceive the bank and its associated unit performing the nontraditional activity as separate include:

- The bank and the unit performing the expanded activity are held out to the public as separate, and customers are sufficiently informed of the separate identities through such items as separate names, separate business locations and separate logos and letterheads.

- The bank and the unit performing the expanded activity demonstrate a separate existence to the public through separate marketing, the absence of cross-selling, and the development of a separate and distinct customer base.
- The bank and the unit performing the expanded activity do not publish advertisements or enter into any agreements stating or suggesting that the bank shall be responsible for the unit's obligations.

Comments From the Federal Deposit Insurance Corporation

Note GAO comments supplementing those in the report text appear at the end of this appendix

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D C 20429

OFFICE OF THE CHAIRMAN

October 21, 1986

Dear Chuck:

The FDIC has reviewed the GAO report entitled Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities. It is a useful discussion of the organizational structures typically used to separate banks from risks associated with nontraditional banking activities. We agree with the basic thrust of the report and can find no objective inaccuracies in the substantive conclusions drawn by the GAO.

The report suggests that locating nontraditional activities in a department of a bank offers less protection from risk than placing these activities in bank subsidiaries or bank holding company subsidiaries (other things equal). The report notes, however, that the latter two structures do not provide complete risk protection. Any given organizational structure offers varying degrees of insulation depending on the nature of the activity being conducted and specific management practices. Based on the evidence in the report, it cannot be said that one structure insulates a bank while another does not.

The FDIC's comments are primarily suggestions for further analysis or elaboration of specific points raised in the report. We also note some language in the report that may mislead readers. A detailed set of staff comments follows.

Sincerely,

Bill

L. William Seidman
Chairman

The Honorable Charles A. Bowsher
Comptroller General
of the United States
U.S. General Accounting Office
441 G Street, N.W.
Room 7071
Washington, D.C. 20548

Enclosure

cc: Mr. William J. Anderson
Assistant Comptroller General

Comments on GAO Report #233119

GAO has undertaken a difficult task in its attempt to assess the relative degrees of insulation afforded by different organizational structures. Despite the intricacies of the analysis, the observations in the report are generally accurate and the thrust of the report is unobjectionable. However, there are some omissions and ambiguities which could lead to misunderstanding, and the following comments pertain to these areas of the report

See p 37

Perhaps the major obstacle to accuracy in this effort is the difficulty of disentangling the unique contribution of structure from that of management's internal policies. A large body of examination experience and statistical evidence indicates that internal policies and procedures adopted by bank (and holding-company) management play a critical role in determining the extent to which a bank is at risk in the pursuit of nontraditional activities

For example, while the holding-company and bank-subsidiary forms of organization may provide the greatest degree of insulation as judged by structural merits alone, the holding-company arrangement failed to prevent a run on the liabilities of Beverly Hills Bancorp from being transferred to its banking subsidiary (although the bank was sold and did not fail). Similarly, as noted in the GAO report, the insulation provided by a holding company also proved insufficient (partly as a result of illegal transactions) in the failure of Hamilton National Bank. On the other hand, some state banks in California have used bank departments (or their equivalents) to engage in small-scale

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real-estate development and securities underwriting (limited to the issues of qualified investment firms) with no evidence of perilous exposure to the risks that attend these activities Managerial skill may thus result in some bank departments offering greater insulation than that provided by bank holding-company subsidiaries in other organizations.

The GAO report acknowledges a role for management in detaching a bank from the risks accompanying new activities, but the importance of this role appears to be understated in the Executive Summary and the Summary Observations. For example, GAO qualifies its structural rankings by saying in the Summary Observations (p. 47) that, based on the observation of several banking firms,

Now on p 36

> ... the same type of structure could operate very differently and provide varying degrees of insulation, depending on the expanded activity conducted and the way it was implemented by management.

While accurate, this qualification fails to indicate that managerial decisions can sometimes supersede the influence of structure. Hence, the reader may be left with the incorrect impression that a well-managed bank department is incapable of providing better economic insulation than a poorly managed bank-subsidiary or bank holding-company structure. (Legal insulation is discussed below) GAO stresses the instructive point that, other things equal, the holding-company and bank subsidiary structures will provide the strongest insulation. But it is also important to emphasize that GAO's structural rankings cannot properly be used alone to make judgments about the relative insulation of any real-world banking firms. Such an emphasis is lacking in both the Executive Summary and Summary Observations, and a reader of only these two sections may be unintentionally misled.

See p 37

In a similar vein, GAO does not make a distinction between the short- and long-run insulative effects which may follow the imposition of given structural requirements on banking firms. In the case of bank holding-company structures, for example, there is an apparent tendency for activities to be shifted out of heavily regulated subsidiaries such as banks and into less-regulated units. This tendency is the likely result of management's attempts to free itself from constraints which (potentially) reduce profits to holding-company shareholders. In the short run, the banking subsidiary may appear to be well insulated as risks are transferred to other areas of the organization. In the long run, however, the bank subsidiary may shrink relative to the rest of the holding company as new activities are located elsewhere and, as a result, the risks facing nonbank subsidiaries may become more intertwined than previously. (As financial services are shifted to various nonbank subsidiaries, the maintenance of customer relationships might require considerable coordination) Given these developments, it may become increasingly unlikely that management would choose not to use the bank's assets in defense of a struggling nonbank subsidiary.

Thus, consideration of long-run effects could suggest additional qualifications to GAO's results. Although the characteristics of holding-company structures appear to offer relatively strong insulation and may do so in the short run, imposing such structures may create incentives that weaken insulation

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(or lead to greater comingling of risks at the holding-company level) in the long run. This possibility has been stressed by many banking analysts, and it might usefully be explored in the GAO report. Any resulting qualifications to GAO's rankings would be more serious the more difficult it is for bank examiners to monitor nontraditional risks when activities are isolated in nonbank subsidiaries as opposed to bank departments.

See p 37

A more objective comment pertains to GAO's evaluation of the bank department as an insulating device. While GAO properly contends that typical bank departments are not legally separate from the bank, the report fails to note the existence of atypical bank departments in which savings banks presently conduct their life insurance activities. In New England states, for example, the life-insurance operations of mutual savings banks are organized into bank "departments" which are statutorily separated from the savings bank. Comingling of assets is prohibited, different accounting standards and regulations apply, and insurance operations are otherwise legally detached from banking operations. Since GAO's report is motivated partly by the desire to inform lawmakers of structural options as they deliberate the expansion of bank powers, consideration of this hybrid departmental organization would seem appropriate.

Apart from these concerns, GAO's observations on the strengths and weaknesses of the various structures are noncontroversial. However, some of the background information offered in Chapters 1 and 2 contains ambiguities which may impede understanding. Specifically,

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Now on pp 9 and 10

See comment 1

- Page 12: The third item in the list of expanded activities refers to credit life insurance. This is not commonly regarded as an expanded power, and it would be useful to know if it was regarded as such for the purposes of the cited Federal Reserve report. More generally, it would be useful to know what types of insurance activities were identified in the 1,000 bank holding companies.

Now on p 13

See comment 2

Now on pp 14, 16, and 31

- Page 17: The last paragraph refers to "regulators" proposing ideas which they believe would allow "for further bank deregulation to occur while still protecting the FDIC fund." Generalizations of this type are often misleading. In this case, for example, the FDIC's view is that many proposed types of deregulation would not be likely to preserve the safety of the fund in the absence of closer supervision by bank regulators. At several places in the GAO report (pages 19, 22, and 40 are examples), accuracy would be improved if the references to "regulators" were more specific.

Now on p 14

- Page 18: The final paragraph appears to oversimplify some of the views expressed in a 1983 FDIC study A proposed substitute paragraph drafted by the FDIC's Legal Division provides a more accurate summary of the findings:

See comment 3

Another idea designed to subject insured depository institutions to closer market scrutiny is to reduce the effective insurance coverage of accounts in excess of $100,000 that results from arranging purchase and assumption transactions and direct assistance packages. (In such situations all depositors, including otherwise uninsured depositors, receive effective total insurance coverage.) According to the FDIC's 1983 study, if the existence of deposit insurance provides insured depository institutions

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an incentive to take more risks than the market would permit in the absence of insurance (i.e., the bank can attract deposits regardless of the quality of its management or the types of activities in which the bank engages) reducing effective insurance by paying out on insured deposits when a bank fails rather than arranging P&A transactions or granting direct assistance would restrict the extent to which investors would place uninsured deposits in a bank that is poorly managed or which engages in excessive risk taking. Thus it would force investors to better assess the risks a bank is taking and would result in better overall private sector policing of the industry. However, the study concludes by saying that while such a plan may provide disincentives to a bank engaging in excessive risk taking, adopting a payout policy would defeat the FDIC's goal of protecting against the destabilizing effects of bank failures. (Such an approach may increase the likelihood of bank runs in the wake of a drop in a bank's earnings or rumors that a bank is facing difficulties.)

See comment 4

Now on pp 22 and 23

-- Page 29: The FDIC's Legal Division further advises that the first paragraph contains an inaccuracy which could be remedied by replacing its final three sentences with the following two:

> In late June the FDIC voted to reconsider its ban on the use of common facilities and names in response to petitions from two banking subsidiaries of securities firms and a bank with a securities subsidiary that operated out of the same facility as the bank. The effective date for the two provisions is now extended until January 1, 1987.

See comment 5

Also, it should be noted on page 29 that the requirement of a name distinction and separate offices currently applies to firms that are new entrants. The effective date of the requirement has been postponed only for those institutions which had an affiliation with a securities company or had a securities subsidiary prior to the effective date of the regulation.

GAO Comments

The following are GAO's comments on matters in the FDIC letter not addressed in the report itself.

1. FDIC noted that credit life insurance is not commonly regarded as an expanded power and thought it would be useful to know if the Federal Reserve report we cited specifies what types of insurance activities bank holding companies were involved in. The Federal Reserve report cited did not include information on the types of insurance activities the 1,000 bank holding companies conducted.

2. FDIC noted that in some places we refer to regulators without being more specific. In general we were talking about the three federal bank regulators (FDIC, OCC, and the Federal Reserve). Accordingly, we changed general references to "regulators" to "bank regulators" or named the specific agency involved where appropriate (see pp. 13, 14, 16, and 31).

3. FDIC commented that we appeared to oversimplify some of the views expressed in a 1983 FDIC study regarding possible changes to the insurance fund. We have expanded the discussion based on language provided by FDIC. (See p. 14.)

4. A "P&A transaction" refers to the purchase and assumption method by which FDIC can liquidate a failed institution by transferring some or all of its assets to another institution, which then assumes some or all of the deposits and other liabilities. Direct assistance may be provided by FDIC to an open bank to keep it from failing. GAO staff study Deposit Insurance: Analysis of Reform Proposals (GAO/GGD-86-32, Sept. 30, 1986) discusses these issues in depth.

5. FDIC advised us that the requirements of FDIC for a name distinction and separate offices currently apply to firms that are new entrants. The postponement only applies in certain situations cited in their comments. We revised the discussion as suggested and also updated it to reflect an additional extension. (See p. 22)

Comments From the Office of the Comptroller of the Currency

Note GAO comments supplementing those in the report text appear at the end of this appendix

Comptroller of the Currency
Administrator of National Banks

Washington, D C 20219

November 13, 1986

Mr. William J. Anderson
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

We have completed our review of your draft report titled "Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities." We appreciate the extension of the time period for our review and comment. We believe that your proposed report addresses one of the most important issues of the day. Accordingly, our attorneys, economists, other specialists and senior management spent a great deal of time considering and discussing the contents of your draft and the issues it raises. This letter contains our substantive comments; we understand that they will be incorporated into the final report. A list of technical suggestions, edits and/or corrections is separately provided as an attachment for your consideration and appropriate use.

See comment

The stated purpose of the report is to present observations on one way being proposed in which banks might be able to participate in new activities without endangering their insured deposits: by organizationally separating new activities from bank operations in order to insulate bank deposits from the activities' risks. To accomplish the stated purpose, the report presents four strategies for insulating banks from risks associated with entrance into new activities.

The structures are the bank department, the bank subsidiary, the bank holding company subsidiary and the bank service corporation. The draft report makes no recommendations; however, it presents a conclusion which we believe is unsupported and biased. The following comments indicate specific ways in which, in our view, the bias might be substantially corrected.

See p 37

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The draft describes "new activities" as new or nontraditional activities such as discount securities and financial futures brokerage, insurance sales, and investment advising, etc. It should be pointed out that not all of these activities are new. For example, banks long have provided brokerage services to their customers. In our view, Congress endorsed this as a traditional banking service in section 16 of the Glass-Steagall Act.

See p 38

The stated purpose of the draft seems to assume that new activities endanger insured deposits. Page 2 states, "The new powers banks seek, however, may pose new financial risks to the bank's deposits and, as a result, to the Federal Deposit Insurance Corporation (FDIC) fund." The apparent assumption underlying the report is that risk is bad, that is, it results in a realization of losses. The draft does not recognize that the risk of realizing a profit from new activities can be just as great or greater than realizing a loss. For example, page 17 lists three major risks together with factors that would "minimize or eliminate" the risks. Another example appears on pages 31 and 32 in discussing imposed insulation. Imposed insulation could minimize risk to the federal deposit insurance fund, if the strategy limits potential losses more than it limits potential gains. The disadvantages to banks from imposed insulation are very well-stated. The disadvantages to banks are real and it should be recognized that they also represent disadvantages to the insurance fund. It could be less confusing and more accurate to speak of the "realization of losses," rather than "risk to the bank," when referring to the potential negative consequences of banks' undertaking new risks. Then, when appropriate, the realization of gains could also be discussed.

See p 38

Now on p 13

Now on pp 24 and 25

The discussion on page 32 could be strengthened by adding a fourth disadvantage of imposed insulation, market perception risk. The fact that the market may perceive a nonbanking activity to be integrated with a bank, that is, not separate, could have beneficial effects on the bank. If the activity is perceived as a profitable one that meshes well with the bank's operations, it could improve the bank's ability to raise both debt and equity, as well as lower its cost of funds. These benefits would be denied if the bank were forced to make the market believe the activity were "separate." Throughout the report, the lack of market perception separation is referred to as a "vulnerability" (pages 36, 43, and 45) or a "weakness" (page 44).

Now on p. 25

See pp 38 and 39

Now on pp 28, 34, and 35

Now on p 34

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See p 39

The draft presents an argument for corporate separateness on the assumption that it is necessary to provide some measure of protection against losses. The presentation does not recognize the undesirable business, marketing, managerial, and regulatory consequences of excessive separation, and certain virtues inherent in a less segregated structure. In addition, Phillip Blumberg (The Law of Corporate Groups) addresses the present status of the "entity" theory and suggests that the theory is gradually being replaced by an "enterprise" approach. He concludes that the "piercing" doctrine is based on relatively meaningless formalisms, e.g., the existence of separate management, separate banks, and separate meetings, and that the courts are examining more broadly the underlying economic realities of the relationships between affiliates to determine whether an ongoing common enterprise might exist. It is unclear whether corporate separateness can ever be achieved or under what criteria it is certain.

Now on p 32

See pp 37 to 39

Nevertheless, the draft report concludes that the holding company approach affords the best insulation strategy for banks to use in entering expanded, non-traditional activities. In discussing the holding company model on page 42, for example, four factors are listed that enhance the protection of the bank under this model. It could be recognized that some of the four factors also apply in the case of the bank operating subsidiary and in the case of a bank department. This is not mentioned; nor are these factors mentioned in the sections that discuss these other separation models. The implication, therefore, is that these protections would only exist if the expanded powers were used through a holding company subsidiary. It should be pointed out that, with respect to national banks, their departments and operating subsidiaries, OCC may examine the entity performing the expanded activity and may terminate the performance of any activity it has reasonable cause to believe constitutes a serious risk to the safety, soundness or stability of the bank. Generally, prior approval by any regulator, not just the Federal Reserve Board, has proven useful in the event of litigation. So, too, is clarification of the applicability of regulations available from all financial regulators.

The draft supports its conclusion that the holding company structure is superior with a series of case studies of bank activities undertaken in the varying structures. The sampling bias in the studies presented is significant, since most of the bank "subsidiaries" discussed do not appear to be true subsidiaries by any current definition, i.e., there is little separation of any kind.

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Now on p 40
Now on pp 3, 4, 20 22
See p 39
Now on pp 3 and 4

Finally, the definition and discussion of economic separation on page 49 of the Appendix, varies from the explanations provided on pages 4 and 26. Some of the parameters for separation on page 49 (e.g., that the bank obtain services from its affiliate at a market price) would seem to be irrelevant to the goal, expressed on page 4, of preventing the bank from coming to the aid of its affiliate.

The issues raised by your draft are part of a vitally important ongoing public policy debate. We believe the public would be best served if the issues were presented as objectively as possible. We appreciate the opportunity to review and comment. If your auditors have any questions or wish to discuss our comments further, we would be happy to continue our dialog with them.

Sincerely,

Judith A. Walter
Senior Deputy Comptroller for Administration

GAO Comment

OCC technical comments and suggestions were not included in the report but updated references and changes were generally made.

Glossary

Affiliate	Any related company. May refer to a parent company, subsidiary, or sister subsidiary.
Bank Department	A unit within the bank organized to perform a specific function.
Bank Holding Company	Generally, a company that owns or controls one or more banks.
Bank Holding Company Subsidiary	Any company that is directly or indirectly controlled by a bank holding company.
Bank Service Corporation	A special corporation established by one or more banks in accordance with the Bank Service Corporation Act to perform a particular activity.
Bank Subsidiary	A company that is controlled by the bank.
Bona Fide Subsidiary	A subsidiary of an insured nonmember bank that (for the purpose of acquiring or establishing a securities subsidiary) at a minimum meets specified FDIC requirements as a separate organization from the bank.
Commercial Paper	Short term promissory notes of prime business corporations.
Corporate Separateness	A legal premise that every corporation is a separately responsible "person" or entity.
Expanded Activities	Those activities generally considered to be outside the traditional deposit taking and loanmaking activities known to banks. These activities include securities underwriting and brokerage, insurance underwriting and brokerage, and mutual fund sponsorship, among others.
Insulation	The separation of a bank's insured deposits from the potential risks of expanded bank activities.

Member Bank	A bank that is a member of the Federal Reserve System. All national banks are required to be members, while state and mutual banks may elect to be members.
National Bank	A bank that is organized in accordance with the National Bank Act and chartered by the Office of the Comptroller of the Currency.
Nonbank Activites	Financial activities closely related to banking that may be engaged in by bank holding companies, either directly or through nonbank subsidiaries. The Federal Reserve determines which activities are allowable.
Nonmember Bank	A bank that is not a member of the Federal Reserve System.
Operating Subsidiary	A company in which a national bank owns at least 80 percent of the outstanding voting stock and which may perform only those activities permitted of the parent bank.
State Bank	A bank that is organized in accordance with state law and chartered by the state.
Subsidiary	A company that is controlled directly or indirectly by another company.

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