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Savings and Loan Associations: Changes Needed in the Regulation of Their Service Corporations. FOD-78-4; B-114827. June 14, 1978. 41 pp. + 4 appendices (14 pp.).

Report to the Congress; by Robert F. Keller, Acting Comptroller General.

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Federally chartered savings and loan associations were authorized to invest in service corporations by the Congress in 1964. Service corporations provide savings and loan associations with numerous ways of increasing revenues and profits from investments related to housing or complementary to the operations of associations. The Federal Home Loan Bank Board (FHLBB) regulates and supervises Federal savings and loan associations' investments in service corporations.
Findings/Conclusions: The savings and loan industry contends that service corporations have greatly increased association profits, but analyses indicate that associations with service corporations are not doing better than associations without service corporations, and service corporations are being increasingly cited as contributing to association problems. Although associations have expanded their financial and housing services through service corporations, this expansion has not emphasized low- and moderate-income housing. A close relationship between associations and their service corporations has given associations opportunities to engage in insider dealings for personal gain, manipulate the service corporation for tax advantages, and make biased investment decisions. Fundamental issues facing the savings and loan associations involve the competitive relationship with commerical banks, the competitive relationship with other industries, and the kind of competition that should be allowed. Recommendations: The Congress should: clarify the FHLBB's authority to regulate investments in service corporations; determine whether the

FHLBB's regulations on service corporation subsidiary location, ownership restrictions, and investment limitations comply with congressional intent; strengthen the Board's enforcement authority to deal with insider transactions; abolish the 1% of assets limitation on investments in service corporations; and establish penalties against associations that fail to receive FHLBB approval before investing more than the legal or regulatory limit in service corporations. The Chairman, FHLBB, should establish a second investment limitation based on an association's net worth position until the Congress acts on a recommendations to abolish the current investment limitation and establish a reporting system to allow the FHLBB to become involved in land-development projects before the land is purchased. (RRS)

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Savings And Loan Associations: Changes Needed In The Regulation Of Their Service Corporations

In 1964, the Congress authorized service corporations. These corporations permit savings and loan associations, which are usually restricted to lending money, to become involved in activities such as real estate and insurance. Some service corporations have succeeded; others have failed.

The Federal Home Loan Bank Board has established regulations to supervise investments in service corporations. These regulations contributed to corporation failure, in some instances, because they went beyond what the Congress originally envisioned, increased opportunities for insider dealings, and opened the door to high risk investments.

GAO presents numerous recommendations concerning the supervision and operation of service corporations. The principal one is for the Congress to pass additional legislation to control the investment in and supervision of service corporations.

UNITED STATES GENERAL ACCOUNTING OFFICE

FOD-78-4

JUNE [illegible], 1978

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-114827

To the President of the Senate and
the Speaker of the House of Representatives

Federally chartered savings and loan associations were authorized to invest in service corporations by the Congress in the Housing Act of 1964. Service corporations are generally wholly owned subsidiaries of one savings and loan association which are involved in activities the association is restricted from engaging in directly. Our review was made because of the increasing amount of resources (over $2 billion in 1976) invested by associations in service corporations.

The report describes several management problem areas and identifies issues for congressional action. A central concern is the need for the Congress to review the regulation of these corporations for consistency with the curent policies of the Congress.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

We are sending copies of this report to the Director, Office of Management and Budget, and the Chairman, Federal Home Loan Bank Board.

R F K 114

ACTING Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

SAVINGS AND LOAN ASSOCIATION: CHANGES NEEDED IN THE REGULATION OF THEIR SERVICE CORPORATIONS

D I G E S T

The Federal Home Loan Bank Board regulates service corporations' investments, ownership structures, and certain operations. This regulation has gone well beyond what the Congress initially envisioned when, in 1964, it amended the Home Owners' Loan Act of 1933 to allow Federal savings and loan associations to invest in service corporations. In addition, while the Board has determined it has the power to regulate service corporations, GAO believes the matter is subject to question. (See p. 4 .)

Wholly owned service corporations, whose entire stock is owned by one association, are the most common type of corporation today. At the end of 1976, 1,628 associations with aggregate assets of $277 billion owned 1,954 wholly owned service corporations with aggregate assets of $2.4 billion.

The savings and loan industry says that service corporations have greatly increased association profits. The Board's analyses of the service corporation industry show that the corporations lost money in 1975 and 1976 while making money in 1977. Our analyses indicate that:

--Associations with service corporations are not doing better than associations without service corporations.

--Within the minority of associations with problems, service corporations are being increasingly cited as contributing to the problems.

--Through service corporations, associations have expanded their financial and housing services. However, this expansion has not emphasized low- and moderate-income housing, as was intended by the Board.

An extremely close relationship between associations and their service corporations has evolved. Officers and directors and physical locations are often the same. This has given associations more opportunities to:

--Engage in insider dealings for personal gain.

--Manipulate the service corporation for parent association tax advantages.

--Make biased investment decisions regarding their service corporations.

The Board cannot effectively deal with these activities.

Many service corporations have become involved in land development activities. These activities have resulted in some spectacular successes and some spectacular failures. While the Board has taken positive actions to control this situation, problems remain.

Through regulation, the Board has sought to encourage more Federal associations to invest in service corporations. This encouragement was prompted by several fundamental competitive issues facing the savings and loan industry.

These include:

--The competitive relationship between the savings and loan industry and commercial banks.

--The competitive relationship between the savings and loan industry and other industries with which their service corporations may be competing.

--The amount and kind of competition that should be encouraged among associations within the savings and loan industry.

Service corporation operations have already begun to influence these competitive relationships, and this influence could increase in the future.

RECOMMENDATIONS

GAO believes the Congress should review the Board's regulation of service corporations. As envisioned some legislative changes and policy setting decisions are needed. Specifically, the Congress should:

--Clarify the Board's authority to regulate investments in service corporations. (See p. 5.)

--Determine whether the Board's regulation on service corporation subsidiary location, ownership restrictions, and investment limitations comply with current congressional intent. (See p. 12.)

--Strengthen the Board's enforcement authority to effectively deal with insider transactions. (See p. 30.)

--Abolish the 1 percent of assets limitation on investments in service corporations. In its place a percentage measurement tied to an association's ability to absorb losses--its net worth--should be established. (See p. 31.)

--Establish penalties against associations which fail to receive Board approval <u>before</u> investing more than the legal or regulatory limit in their service corporations. (See p. 31.)

In addition, the Congress should consider these questions when it reviews service corporation activities:

--What should be the competitive relationship between the savings and loan industry and commercial banks?

--What should be the competitive relationship between the savings and loan industry and other industries with which their service corporations may be competing?

--How much competition between associations is acceptable, and what relationship should the Board have with service corporations of State-chartered, federally insured institutions?

GAO recommends that the Chairman, Federal Home Loan Bank Board:

--Establish a second investment limitation based on an association's net worth position until the Congress acts on GAO's recommendation to abolish the current investment limitation. (See p. 31.)

--Reconsider the recommendations of its own task force and establish a reporting system which would allow the Board to become involved in the initiation of land development projects by associations before the land is purchased. (See p. 35.)

AGENCY COMMENTS

Board officials stated they share GAO's concern about many of the issues raised in our report and about the impact of service corporations upon their affiliated savings and loan associations. They stated that an in-depth and far-reaching study of service corporations is now underway and should be completed by mid-1978. At that time the Board will determine the need for statutory and/or regulatory amendments, including the ones raised by GAO.

In addition, Board officials strongly disagreed with GAO's conclusion that their statutory authority to regulate service corporations is questionable and that their regulations go beyond what the Congress initially envisioned when it considered service corporations in 1964. Further, the Board stated it had the legal authority to approve savings and loan investments in wholly owned service corporations.

GAO has re-examined the Board's statutory authority position and continues to believe its original position is valid. GAO's recommendation merely seeks to clarify the Board's legislative authority, as GAO believes there should be no misunderstanding that it has this authority.

GAO's opinion that the Board went beyond what the Congress initially envisioned when it considered service corporations should not be construed to imply that the Board is in violation of the 1964 statute. GAO believes the Congress never envisioned or even considered some of the actions the Board has now authorized through its regulatory powers.

Finally, GAO agrees that the Board can legally authorize investments in wholly owned service corporations. However, there is ample evidence that the Congress never even considered this matter when it passed the 1964 statute.

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CHAPTER 1

INTRODUCTION

The Government encourages home construction in several ways. One way is by regulating savings and loan associations, which provide mortgage loans. In the early 1930s, the Congress established three separate but interrelated organizations--the Federal Home Loan Bank Board, the Federal home loan banks, and the Federal Savings and Loan Insurance Corporation--to regulate savings and loan associations.

The Board's principal activities include:

--Regulating and supervising the Federal Home Loan Bank System, which includes 12 Federal home loan banks. These banks provide services, such as lending money, for savings and loan associations that are system members.

--Chartering Federal savings and loan associations.

--Directing the operations of the Federal Savings and Loan Insurance Corporation, which insures, up to $40,000, the account of each saver in all Federal savings and loan associations (and similar institutions upon their request and approval by the Board).

--Regulating and examining associations insured by the Federal Savings and Loan Insurance Corporation.

The Board is authorized to do its work by several Federal laws. One, the Home Owners' Loan Act of 1933 was amended in 1964 to permit Federal savings and loan associations to invest in service corporations (12 U.S.C. 1464(c)). The law was passed because in 1962 commercial banks were permitted to jointly own data processing centers. Members of the Congress felt savings and loan associations may have many of the same needs.

Service corporations, as viewed by the Board, provide savings and loan associations with numerous ways of increasing revenues and profits from investments related to housing or complementary to the operations of associations. The Board now regulates and supervises Federal savings and loan associations' investments in service corporations.

TYPES OF SERVICE CORPORATIONS

The Board has divided service corporations into three types.

"A" types, also known as statewides, are service corporations whose entire stock is owned only by associations, not more than 10 percent by any one association. Thus, "A" types are owned by 10 or more associations.

"B1" types are service corporations with between 5 and 10 owners, none of whom owns more than 40 percent of the capital stock.

"B2" types are service corporations with less than five owners or one where a single association owns more than 40 percent of the capital stock. Most "B2" types have a single owner and, thus, are frequently referred to as wholly owned service corporations.

Wholly owned service corporations are the most common service corporation today. At the end of 1976, 1,628 associations with aggregate assets of $277 billion owned 1,954 wholly owned service corporations with aggregate assets of $2.4 billion.

HOW ASSOCIATIONS BECOME INVOLVED IN SERVICE CORPORATIONS

The procedures Federal associations must follow to invest in service corporations vary with the activities the associations wish to engage in. Some activities have been preapproved by the Board, permitting a service corporation to be established without first notifying the Board. Other activities must first receive Board approval before an association can establish a service corporation to carry out that activity. Appendix I is a complete list of service corporation activities that have either been preapproved or subsequently approved by the Board upon receipt of an application.

If a Federal association wishes to form a service corporation to engage in an activity requiring Board approval, the association must write the Board's District Supervisory Agent, explaining the activity the corporation wishes to undertake and why it should be approved. After review, all applications are forwarded to Washington, D.C., where, after review by the Office of Industry Development, the Board approves or denies the application by specific resolution.

Service corporations owned by State-chartered associations with Federal insurance do not require Board approval. They must follow procedures set by the State for engaging in an activity. Some States require no prior approval; others require approval for everything.

SCOPE OF REVIEW

Our review, completed in April 1978, focused upon the activities of service corporations owned by federally insured associations. We extensively reviewed the Board's examination reports, interviewed Board officials, and made various statistical analyses of the results of the Board's service corporation regulations. Because of the confidentiality of examination reports, we have not identified the savings and loan associations discussed in this report.

Two samples were drawn at random to describe with a 95-percent level of confidence characteristics of both associations with service corporations and those without. We sampled 106 active associations from the population of 1,628 having wholly owned service corporations and 109 associations from the population of 2,391 which had no service corporations as of December 31, 1976.

CHAPTER 2

CHANGES IN SERVICE CORPORATION REGULATION

MERIT NEW CONGRESSIONAL SCRUTINY

Since 1965, Federal savings and loan associations' investments in service corporations have been guided by Federal Home Loan Bank Board regulations. The Board has assumed that it can issue these regulations. We believe the Board's assumption of authority to regulate Federal savings and loan associations' investments in service corporations is questionable.

These regulations have permitted investments which improved the financial positions of some associations but have also gone well beyond what the Congress initially envisioned. Consequently, Federal associations in general have incurred added risks resulting from

--the relationship between the association and its service corporation,

--the operations of these service corporations, and

--liberal Board interpretations of limitations on investments.

BOARD AUTHORITY TO REGULATE SERVICE CORPORATIONS IS QUESTIONABLE

Section 905 of the Housing Act of 1964, which is an amendment to the Home Owners' Act of 1933, does not specifically provide that Federal savings and loan associations' investments in service corporations are subject to Board regulations. However, the Board's Office of the General Counsel has taken the position that the Board can issue such regulations. This opinion is based on the premise that the 1964 statute did not preclude Board regulation of such investments. The General Counsel believes the Board's general rulemaking authority contained in the Home Owners' Loan Act of 1933 applies. Under this statute, the Board is authorized, <u>under such rules and regulations as it may prescribe</u>, to provide for organizing, incorporating, examining, operating, and regulating Federal savings and loan associations.

We believe the Board's position is questionable. The House version of section 905 was changed by an amendment introduced by Congressman Widnall. The amendment deleted language specifically granting regulatory authority over investments in service corporations. The legislative history indicates that the sponsor of the amendment intended the amendment to preclude the Board's power to regulate investments in service corporations. However, the Board appears to use a "plain meaning" approach to support its regulatory activity of service corporations.

Under this approach, legislative history is not considered when the statute is plain and admits no more than one meaning. However, the Supreme Court has rejected the plain meaning rule as a device to disregard the legislative history of a statute when discerning its meaning. See Train v. Colorado Public Interest Research Group, 426 U.S. 1 (1976). When reading just the statute, reasonable arguments may be made for both positions. However, the Supreme Court's view of the plain meaning rule removes any doubt that congressional intent may be resolved through resort to legislative history.

In our view, the best evidence of congressional intent regarding the Board's authority over service corporations is the history of the Widnall amendment. Nevertheless, the Board's exercise of regulatory authority in the service corporation area has received widespread acceptance for a long time, apparently without objection from the Congress.

Conclusion and recommendation

The Board has taken the position that it is authorized to regulate investments in service corporations. We believe the Board's position is questionable. However, the Board has been regulating such investments since 1965 without objection from the Congress. Also, because we believe the Board should have this authority, we recommend that the Congress amend the statute to explicitly give the Board authority to regulate investments in service corporations by Federal associations.

Agency comment

The Board in its comments on the report draft restates its position that its regulation of service corporations is fully authorized under the Home Owners' Loan Act of 1933, as amended. We have examined the Board's comments. However, it remains our position that the statutory basis for regulation of investments in service corporations is unclear and, consequently, the Congress should amend the statute to explicitly authorize Board regulation of investments in service corporations.

The primary argument against the Board's position is based upon the statement by Congressman Widnall in support of the amendment to strike the phrase "subject to the rules and regulations of the Board" from the proposed bill and change the maximum permissible investment from 2 percent of assets to 1 percent. Widnall stated in part:

> "By eliminating the power to regulate such investments, we make certain that the New Jersey corporation will not be discriminated against solely because its charter might permit it to do a wider variety of things than a Federal agency might consider proper.
>
> "To give assurance that this will have no significant effect on the basic purpose of Federal savings and loan associations, my amendment would also reduce from 2 percent to 1 percent the portion of assets that may be invested. In other words, it would reduce the amount that a Federal association could invest in State corporations to such a small percentage of its assets that it would not be necessary to prescribe further restrictions and regulations." (110 Cong. Rec. 19332-33 (1964))

Thus the legislative history suggests that the purpose of the amendment was to eliminate the Board's regulatory authority over service corporations and to reduce the effect of the elimination of the Board's regulatory authority through a reduction in the amount of permissible investment in service corporations.

Also the Board cites Rettig v Arlington Heights Federal Savings and Loan Association, 405 F. Supp. 819 (N. D. Ill. 1975), and Smith v Jaques C. A. No. 75-939 (D. Oregon 1976), as cases which specifically sustained the Board's authority. However, the issue of the Board's authority to regulate service corporations was tangential to the primary holdings of the cases. Although the cases are not, in our view, dispositive of the issue, they suggest tht the Board does have authority to indirectly regulate the activities of service corporations.

NEW CONGRESSIONAL SCRUTINY NEEDED

Assuming the Board has authority to regulate Federal association investment in service corporations, we believe the Board has encouraged activities that go beyond what the Congress initially envisioned.

Section 905 of the Housing Act contains a provision authorizing Federal savings and loan associations to invest in "service corporations." The statute is conspicuously broad. Associations can invest in any corporation provided:

--The corporation is incorporated in the State in which the home office of the association is located.

--The stock of the corporation is available for purchase only by savings and loan associations of that State.

--The aggregate investment by an association under section 905 does not exceed 1 percent of the association's assets.

The Congress intended to permit Federal associations to invest in corporations owned by and providing services to several associations. This is apparent from comments in the committee reports on providing services, such as data processing, and on corporations, such as the Central Corporation of Savings and Loan Associations of New Jersey.

The initial impetus for service corporation legislation stemmed from changes in banking laws. In 1962, commercial banks were authorized to jointly own data processing centers. The purpose of that legislation was to allow small banks to compete with larger banks which could buy their own electronic data processing equipment. Members of Congress felt that savings and loan associations had many of the same needs for cooperative data processing services as did commercial banks.

The Central Corporation of Savings and Loan Associations was developed by the New Jersey Savings and Loan League to implement the concept that small financial entities, by pooling their resources, could provide large financial services. The Congress felt that such corporations helped associations extend thrift and home financing services and were in the public interest. Therefore, the Congress thought Federal associations should be allowed to modestly invest in such corporations.

Furthermore, associations were not to be permitted to invest in purely profitmaking corporations unrelated to the savings and loan business. For example, House Report No. 1703, 2nd Session, 88th Congress (1964), stated that

"* * * and the committee does not contemplate that an association would be permitted to invest in ordinary profitmaking corporations or corporations not closely related in purpose to the savings and loan business."

Also, Senate Report No. 1265, 2nd Session, 88th Congress (1964) stated

"* * * and the committee does not contemplate that an association would be permitted to invest in corporations which do other than provide such services (data processing and other needed services) to savings and loan associations."

Although the Housing Act of 1964 raises questions about whether the Board has regulatory jurisdiction over investments in service corporations, it did attempt to define restrictions on ownership and investments. In each of these areas, we believe that Board regulations permit investments which go well beyond what the Congress expected to be accomplished.

Type of corporation

Current Board regulations permit Federal associations to invest in service corporations which vary from statewide, multiowned corporations (type "A") to wholly owned corporations with joint ventures and/or subsidiaries (type "B2"). Most service corporations today are type "B2," wholly owned corporations.

The evolution of the service corporation from a corporation owned by and providing services to many associations into a wholly owned subsidiary with partnerships and subsidiaries of its own stemmed from changes in the Board's regulations.

Until 1970, and in spite of savings and loan leagues' preferences for wholly owned corporations, service corporations generally fit the pattern the Congress had in mind. The Board's General Counsel responded to league preferences stating:

"It would seem that an operation open to investment by all savings and loan association interested therein would be most clearly in line with congressional understanding. An individual subsidiary approach would go far beyond this in my opinion."

However, in July 1970 under the direction of a new Board Chairman and without any changes in the statute, service corporation regulations were amended.

The amendments permitted individual Federal associations to set up their own service corporations for activities already approved by the Board, and they authorized Federal associations to invest in a wide variety of activities including land development, also without the Board's prior specific approval. The Board hoped these changes would

--help savings and loan associations experiment in providing needed services as efficiently and economically as possible and

--provide a profitable way to develop or rehabilitate low- and moderate-income housing units and to sponsor other housing developments.

These actions created a new concept for service corporations. Rather than being limited to the concept of a corporation serving several associations, Federal associations could now create their own service corporations which could undertake a variety of "business" type activities; in particular, land development.

Ownership concessions

According to the U.S. League of Savings and Loan Associations, joint ventures, among all other second-tier structures, have probably become the most widely used by service corporations. This came about because of the popularity of land development, growing out of the Board's 1970 changes. Joint ventures are generally tied to land development. They usually take the form of a partnership between an association's wholly owned service corporation, which provides the capital, and a developer or contractor, who provides the experience. Joint ventures evolved from the associations' desire to invest in land and their lack of experience in doing so.

The Board's regulations concerning service corporation subsidiaries have been toned down as the approval process was streamlined and location and ownership restrictions lifted. Once land development became an approved activity, the Board could not promptly respond to the growing requests by associations to form joint venture partnerships. At first, the Board responded by delegating its authority to the 12 Federal home loan banks. However, even this was not sufficient. Finally, joint ventures in land development were included as preapproved activities.

Concerning restrictions, early Board policy stated that service corporations could not own subsidiaries unless they were wholly owned and the powers of a subsidiary could not exceed those of its parents. Joint ventures were required to be of limited duration. The Board's General Counsel at that time stated:

> "I am of the opinion that the purchase by a service corporation, in which a Federal association has an investment, of a portion of the stock of a subsidiary corporation, which subsidiary has as its purpose a 'perpetual activity,' could well be regarded by a court as a bold circumvention of the quoted statutory limitation. I am further of the opinion that a comparable arrangement which does not take a corporate form, but takes the form of a partnership, joint tenancy, or tenancy in common could be similarly regarded by a court. A court might well treat the authorization of such perpetual activity joint ventures as a 'boot-strapping' method of avoiding the statutory limitation that investments in service corporations must be solely by savings and loan associations."

Current regulations do not reflect this original concern. The capital stock of service corporations must be available for purchase only by savings and loan associations. Under current Board regulations, however, service corporation subsidiaries may be corporations partially owned by other than savings and loan associations.

In February 1973, a different General Counsel to the Board overruled the earlier opinions and determined that joint ventures with the service corporation of a Federal association need not be of limited duration. The reasoning was that stockholders in the second-tier corporation would not by reason of their status as second-tier stockholders have the classic rights of stockholders with respect to the first-tier corporation.

In September of 1973, the Board's regulations on joint ventures were amended to include any joint undertaking with one or more persons or legal entities in any form, <u>including corporations of unlimited life</u>. In addition, the

Board amended its regulations to permit service corporation subsidiaries of Federal associations to have offices anywhere in the Nation.

Investment limitation concessions

Amendments to regulations governing the 1-percent investment limitation have also led to a more lenient application of the service corporation statute. The statute states that:

> "* * * no association may make any investment under this sentence if its aggregate outstanding investment under this sentence, determined as prescribed by the Board, would thereupon exceed 1 percentum of its assets."

The Board interpreted the statute by establishing the following regulation:

> "Limitations. A Federal association may make any investment under this section if its aggregate outstanding investment in the capital stock, obligations, or other securities of service corporations would not thereupon exceed 1 percent of the association's assets. For the purposes of this section, the term "aggregate outstanding investment' means the sum of amounts paid for the acquisition of capital stock or securities and amounts invested in obligations of service corporations less amounts received from the sale of capital stock or securities of service corporations and amounts paid to the Federal association to retire obligations of service corporations."

These regulations were amended in 1971 to permit conforming loans, which are defined as those types of loans made to service corporations under other types of statutory authority. The 1-percent limitation only applies to investments made under section 905. The Board reasoned that loans made to multiowned service corporations under the authority of other regulations (i.e., conforming loans) were not subject to the 1-percent limitation. Notably, wholly owned service corporations were excluded, ostensibly because they could not objectively lend money to themselves.

Later, the Board Chairman asked the Office of General Counsel to find ways of getting around the 1-percent restriction on assets. As a result, current regulations permit, with certain debt restrictions, conforming loans by the association to its wholly owned subsidiaries and their subsidiaries or joint ventures.

Conclusions and recommendations

We believe that in passing the 1964 statute the Congress intended to permit Federal savings and loan associations to invest in service corporations owned by and serving a number of associations. Evidence of this is contained in the legislative history surrounding the statute. Although we agree with the Board that there is no statutory requirement that a service corporation must be owned by more than one association, we believe that the Board's regulations encouraging investment in wholly owned service corporations have changed the original concept.

In addition, without any changes in the statute, the Board has issued increasingly liberal amendments to its regulations concerning both the applicability of location and ownership restrictions to service corporation subsidiaries and the investment limitation. We believe that having a service corporation serve merely as a conduit for investment in subsidiary corporations may, in some instances, circumvent ownership restrictions. Similarly, the extensive use of conforming loans to service corporations in effect circumvents the 1-percent investment limitation.

We recommend that the Congress examine (1) the Board's relaxed restrictions on service corporation subsidiary location and ownership and (2) the use of conforming loans to bypass the investment limitation, to ascertain if these actions are consistent with current congressional intent. If not, the Congress should then clarify legislative intent in these areas by amending the statute.

Agency comments

The Board states that

"there is nothing in either the legislative history or in the service corporation amendment itself precluding a single Federal association from operating a wholly owned service corporation."

We agree with the Board that there is no statutory requirement that a service corporation must be owned by more than one association. However, the legislative history speaks in terms of multiowned corporations. There is no indication that the Congress considered the question of wholly owned corporations and their attendant problems. For example, during legislative hearings the service corporation concept was portrayed as a corporation, owned by several savings and loans, performing a service for all of these associations. Board regulations encouraging a savings and loan association to own an entire service corporation have changed this concept. And, since this is now the normal way of doing business, the Congress needs to review this practice.

The Board also disputes what it views as our suggestion that the use of conforming loans to service corporations in effect circumvents the 1-percent investment limitation of the statute. We agree with the Board that conforming loans are permissible under the statute. We merely intended to point out that the practical effect of extensive use of conforming loans may be a circumvention of the investment limitation because it exposes the association to greater risk. The very purpose of the investment limitation is to reduce this risk.

CHAPTER 3

SERVICE CORPORATIONS HAVE

ACHIEVED MIXED RESULTS

The Board has sought to use service corporations to increase federally insured savings and loan association earnings and to expand association financial and housing services to their communities. According to the U.S. League of Savings Associations, this has happened. In 1976, it stated that "if net profits are the basis for measuring success, the more successful associations will have a service corporation."

Our assessment of the Board's success in promoting these goals was limited because information on service corporation performance was available for only 1975 and 1976, thereby making long-term evaluations impossible. However, within this constraint, our analyses suggest that:

--Associations with service corporations are not doing better than associations without service corporations.

--Within the minority of associations classified as problems, service corporations are increasingly being cited as contributing to the problems.

--Service corporations have expanded some association involvement in the land development/housing market. However, this expansion has not been concentrated in low- and moderate-income housing, as was intended by the Board.

BOARD ANALYSES: SERVICE CORPORATIONS HAVE VARIED EFFECT ON EARNINGS

In 1977, the Board made its first analysis of service corporations. This analysis concentrated on wholly owned service corporations, which dominated service corporation activities. In 1975 and 1976, the service corporation industry lost $35.4 million and $5.5 million, respectively. Individual losses in 1976 varied greatly. Forty percent of the companies were losing money. Conversely, 38 percent of them were earning a profit over 10 percent. The improvement from the 1975 to the 1976 loss position was attributed to a lowering in industry's interest costs coupled with a rejuvenation in the real estate market.

This analysis is limited, because the report system is still new which may cause some inaccurate reporting. Also, the corporation's actual contribution to the parent association (in terms of profit) may be distorted because service corporation earnings are often shifted to the association to gain tax advantages. Shifting the earnings would lower the service corporation's profits. (Ch. 4 further discusses tax questions.)

At the end of our review, the Board completed an analysis of 1977 service corporation profits. The service corporation industry earned $33 million in profits in 1977 which is a significant improvement over the preceding 2 years. However, individual results continued to vary greatly. Forty-three percent of the corporations earned profits in excess of 10 percent while 32 percent of them operated at a deficit. Board officials stated that the overall improvement in service corporation performance was attributed to the continuing growth of the real estate market.

OUR ANALYSIS: SERVICE CORPORATION INFLUENCE ON PROFITS SEEMS WEAK

As a supplement to the Board studies, we analyzed wholly owned service corporations' effect on associations. Our analyses focused on parent associations' profits and were essentially tests of the assertion that "the more successful associations will have service corporations." We wanted to know if having service corporations produced higher income and net worth levels for the associations involved.

One of our analyses centered around a recent Board study of the characteristics of high profitmaking associations. In the supporting analyses, 347 high- and 347 low-performing associations were identified.

Using these associations, we compared the number of high-performing associations having service corporations against the number of low-performing associations having service corporations. This comparison showed that

--46 percent of the high-performing associations had service corporations, while

--56 percent of the low-performing associations had service corporations.

Thus, service corporations appear to be more closely associated with low-performing associations than with high-performing associations. This is exactly opposite to the League's position that the more successful association will have a service corporation.

From a different perspective, we also analyzed the League's position using a statistical test to compare the performance of associations with service corporations against associations without service corporations. Both aggregate and individually paired comparisons were used to see if the performance of associations with service corporations was the same as associations without service corporations. (See app. II.) As indicators of performance we used two ratios which are also used by the Board in its performance evaluations.

--The ratio of net income to average assets (average assets being the average total assets of the association over the last 12 months).

--The ratio of net worth to total assets.

If the League's position were correct, the ratios for associations with service corporations should be significantly higher than for associations without service corporations.

Our tests indicate that associations with service corporations:

--Are not performing significantly better than associations without service corporations.

--Had weaker net worth positions than associations without service corporations.

SERVICE CORPORATIONS CONTRIBUTING TO ASSOCIATION PROBLEMS

Service corporations are increasingly being cited as contributing to the problems of those few associations classified as problem associations. This is shown in both the list of identified problem institutions and in the Board's default prevention activities.

Problem institutions

To make sure that institutions are appropriately supervised, the Board's Office of Examinations and Supervision has developed procedures for identifying and classifying those institutions showing signs of weakness and trends which could later involve the Federal Savings and Loan Insurance Corporation. The most serious cases are classified as category I, financially critical, and the next most serious cases are classified as category II, not financially critical but requiring aggressive supervisory attention.

While only 40 percent of the federally insured associations have invested in wholly owned service corporations, 68 percent of the identified problem associations have service corporations. Examiners say service corporations are contributing to the problems of these associations more and more, as shown on page 18.

Default prevention

If an association is experiencing financial problems because of poor loans or bad investments, the Federal Savings and Loan Insurance Corporation may step in. It may make contributions or loans to the association or purchase association assets to rehabilitate it or help it merge with another association. In every case, such financial assistance must be determined to be less costly than liquidation.

For the past several years, contributions to facilitate mergers have been used frequently to prevent associations from going out of business. This method compensates the resulting institution for certain losses acquired from the problem institution. Since 1974, the Board has made 10 contributions to help merge associations. Of these associations, six had service corporations. In four of these associations, where the Federal Savings and Loan Insurance Corporation estimated it could lose about $70 million, $9 million may be needed for losses incurred through service corporations. In one instance, a service corporation was the primary cause for a $150 million association going out of business.

Service Corporation Involvement

With Problem Institutions, 1975-77

Category	Problem institutions where service corporations contribute to problem (total associations)			Estimated insured savings deposits of problem institutions where service corporations contributed to problem		
-	9/30/77	12/31/76	12/31/75	9/30/77	12/31/76	12/31/75
				(millions)		
I	1 (13)	1 (13)	0 (15)	$ 67.5	$ 66.3	$ 0.0
II	22 (68)	20 (70)	10 (48)	5,735.6	5,467.8	1,284.7
Total	23 (81)	21 (83)	10 (63)	$5,803.2	$5,534.1	$1,284.7
Percent total	28%	25%	16%			

ASSOCIATION EXPANSION INTO HOUSING THROUGH SERVICE CORPORATIONS

One objective of Board regulation is to respond to the internal and external competitive needs of the savings and loan industry. Because of this goal, the Board advocated using service corporations as a way to compete with commercial banks. Competition was to be met by expanding associations' financial and housing services through service corporations.

Service corporations are now offering these services. To identify the activities of federally insured associations, we randomly sampled 106 associations with wholly owned service corporations, shown below.

Service Corporation Activity

Activity	Number of associations engaged in activity (note a)	Percent of total activities
Real estate development and sales	64	26
Insurance agency	39	16
Mortgage lending	33	14
Real estate rentals	16	7
Appraisal services	15	6
Mortgage banking and brokering	13	5
Property management	11	5
Mobile home lending	6	3
Consumer lending	5	2
Advertising for association	4	2
Safety deposit box, travelers checks, and money order services	4	2
Equipment or personal property leasing to parent	4	2
Accounting and tax services	2	1
Data processing services	1	-
Other (including motel management, abstracting title insurance, printing services for parent, country club operation in connection with land development activity, etc.)	19	7
Inactive	8	2
Total	244	100

a/Most associations sampled were engaged in more than one activity.

The largest activity of service corporations is real estate development. Next comes insurance and mortgage lending, which are related to housing.

When the Federal Home Loan Bank Board established the preapproved activity list for service corporations in July 1970, it indicated that "the service corporation is an almost heaven-sent opportunity for an association or group of associations to participate in programs for low- and moderate-income housing." Despite this emphasis, service corporations are not concentrating on low- and moderate-income housing.

A 1976 U.S. League of Savings Associations study indicated that, of the 939 land ownership and development activities reported by association service corporations, only 23 were related to low- or moderate-income housing. The examination reports of the associations we sampled showed the following breakdown of the 64 associations involved in real estate development and sales:

Land for association office/branch	5
Low- and moderate-income housing in urban areas	3
Unimproved/raw land development	39
Property management	4
Other (including purchasing commercial and developed properties)	15
Inactive	8
Total (note a)	74

a/Some associations were involved in more than one activity.

Activity in low- and moderate-income housing in urban areas has not been stressed. Board officials said the high risk of such ventures and the lack of Federal incentives have discouraged activities in this area. In our opinion, the future use of service corporations for low- and moderate-income housing rests upon the Board's willingness to enact regulations which will encourage the industry to concentrate its service corporation activities in this area.

CONCLUSIONS

This chapter begins discussion on the effect of the Board's regulation of service corporations. In essence, regulation of service corporations has been only slightly successful.

--Associations with service corporations are not doing much better than associations without service corporations. In fact, the opposite may be true.

--Service corporations are being cited more often as contributing factors to problems of those few associations with problems.

--Associations have expanded into the housing market. In general, this expansion has not been in the low- and moderate-income housing section, which was a major Board concern.

Other equally serious effects are discussed in the next chapter.

CHAPTER 4

SEP ~~ CORPORATIONS HINDER MANAGEMENT OBJECTIVITY

A principal ingredient for a successful service corporation is management objectivity. In other words, association managers should remain independent when dealing with their wholly owned service corporations. Otherwise, they can find themselves in the compromising position of dealing with themselves, of being unable to look at a financial situation without bias. Failure to maintain independence increases the potential for questionable insider dealings and poor investment decisions. This can lead to the association and/or the service corporation having financial difficulties.

MANAGEMENT OBJECTIVITY

A major cause of service corporations' problems is the increased loss of management objectivity created when a savings and loan association owns its own service corporation. The Board's ability to effectively deal with this has been limited.

Measuring management objectivity is difficult. However, the role and/or involvement of an association's managers in one of its service corporations could indicate the degree of objectivity. The extent of interlocking directorates (that is, how many people in an association's management structure are actually involved in a service corporation) shows management involvement. Further indicators are the positions managers occupy in both management structures and the locations of each principal place of business activity.

Extent of interlocking directorates and common business activity

The role of association managers and directors in wholly owned service corporation operations was examined by randomly sampling 106 associations having one or more wholly owned service corporations. This sample identified about 900 service corporation officers and directors of which about 89 percent also held positions with their parent associations. More importantly, however, is that 91 percent of the service corporation presidents and treasurers also held positions with their parent associations. The following chart shows the interrelationships between service corporation presidents and treasurers and their positions in parent associations.

Percentage of Service Corporation Presidents and Treasurers Serving as Association Officers

Office in parent association	Service corporation president	Service corporation treasurer
Chairman of the board	8%	0%
President	51	5
Treasurer	3	40
Executive vice president	7	7
Managing officer	0	1
Vice president	17	14
Controller	0	4
Secretary	2	3
Director	2	10
Other	2	10
Not related	8	6

In 62 percent of the cases examined, association chairmen of the board, presidents, and treasurers also served as service corporation presidents. In 45 percent of the cases examined, association presidents and treasurers also served as service corporation treasurers. This sharing of officers can encourage association bias when dealing with its service corporation.

In addition to sharing officers, many service corporations share office space with their parent associations. Seventy-four percent of the service corporations sampled had offices at the same address as the parent association In some cases, the relationship was so close that only a partition in the room or a sign on the desk of one of the officers identified the service corporation.

Other examples of close interrelationship are that many service corporations in our sample and in the Board's problem cases allow their parent associations to keep their financial and other records for which they usually pay a fee. Business is sometimes conducted concurrently. In one case, the service corporation's business was conducted in the board of directors meeting of the association. In another case, crucial documents were missing; even loan applications to the service corporation could not be located. In still another case, an association guaranteed the loans of its service corporation.

Obviously, the situation today is one in which the subsidiary shares officers and office space with its parent association. The relationship in some cases is so close that the service corporation seems to function as a department of the parent rather than as a separate entity. This is unhealthy, because it forces the managers of the association who are also the managers of the subsidiary to deal objectively with themselves. This is difficult at best. Several examiners in their reports commented on the general lack of corporate identity. In several cases, the comments indicated that the corporations were so close that legal problems could result from the relationship. In these cases, the examiners were concerned that service corporation creditors might be able to recover losses from the association due to the close relationship. This, then, defeats one purpose of forming a corporation, which is to limit liability. Two outcomes of this relationship have been questionable insider dealings and biased investment decisions.

INSIDER DEALINGS

The lack of management objectivity allows the opportunity for many problems to exist, usually involving "insiders." These are managers or persons in some way involved with the service corporation or the parent association or both. Review of the Board examination reports did not uncover widespread use of any particular type of insider dealing; however, instances of abuse were uncovered in 14 percent of the associations in our sample. These Board-examiner identified abuses included association officers using service corporations for personal benefit and manipulating service corporation income and expenses to gain tax advantages for the association. The Board has indicated that its powers to deal with situations where abuses are taking place need to be strengthened.

Using service corporations for personal benefits

Association officers have used service corporations for their personal benefit in several ways. For example,

--In violation of a current cease and desist order, an association president and chairman of the board sold his insurance agency to the association's service corporation for approximately $60,000 over its fair market value.

--An association president, who was also the service corporation president, had a personal interest in several communications areas. He involved the service corporation in activities unrelated to a savings and loan (including TV broadcasting and magazine publishing) resulting in losses over $3 million. These losses were absorbed by the parent association.

--Association directors with business interest in a hotel/casino operation involved the data processing staff of one of their service corporations in the development of a computerized system for sports and race betting. The corporation provided these services free to the hotel.

--An association president, who also served as the service corporation president, used corporation resources to invest into a resort ranch. The corporation subcontracted the ranch's management to a private property management company owned exclusively by the president. Total management fees received by this private company during December 1974 through May 1976 were $40,000. The service corporation's investment began losing money and the Board urged the association to get rid of the investment. Negotiations dragged on for over 2 years with the service corporation continuing to lose money. Meanwhile, the president's private company continued to receive income. A central issue on delaying the negotiations was the management contract with the president's company.

--An association president who also served as the service corporation president used the service corporation to provide excessive salaries and expense accounts and payments to himself for personal items such as automobiles, clothing, jewelry, loan payments, and an investment in a company owned by his wife. Association insolvency resulted, and the FBI is investigating possible criminal activities.

Other, more involved examples of insider dealings were also identified. A service corporation entered into an agreement with a construction company. Under the agreement the company bought lots and received $6,000 in administrative expenses as construction progressed ($1,000 at the time the lot was purchased and $5,000 when the house went up). This fee covered various administrative construction costs. Because of a severe winter that caused a slowdown in construction, the service corporation advanced the $6,000 to the builders, although no work had been done. Not until the builder's outstanding balance rose to over $75,000 was the contract terminated. (The service corporation only had a note from the builder for $50,000.) Later, the builder was found to be the brother-in-law of the secretary/treasurer/director of both the association and the service corporation.

All of these instances were identified by Board examiners and corrective actions attempted. The Board had indicated that its power to deal with personal gain resulting from insider deals is limited. In addition, knowing that abuse exists is important but raises an equally important question. How many insider deals have not been identified?

Using service corporations for tax advantages

Various income tax considerations make manipulation of income and expenses profitable to the association. A general rule, put forth by the U.S. League of Savings and Loan Associations and many independent certified public accountant firms, is that income should be shifted to the association and expenses to the service corporation, if possible. This rule is followed because association income is taxed at a lower effective rate since for tax purposes the association is allowed a favorable bad debt deduction (a percentage reduction against income). Expense is shifted to the service corporation because it is considered a normal corporation and, consequently, does not enjoy the tax advantages given to an association. This keeps taxes paid at a minimum for all entities.

Manipulating expenses can be done in several ways. One is to use management fees paid by the service corporation to the association for services such as management and bookkeeping. Compensation and related expenses, including management fees paid, exceeded 20 percent of service corporation expenses in 1975 and 1976. Compare this to the average in the savings and loan industry, which was about 8 percent for the same period.

Another income tax strategy is to start the service corporation with a mixture of stock owned by the association and loans made by the association. This process creates interest income for the association (which is taxed at a lower effective rate) and creates an interest expense for the service corporation when interest is paid on the loan. This strategy appears to be used in many situations. In 1976, one-half of the total, nationwide, wholly owned service corporations' debt was loaned by the associations. In addition, the single largest expense for service corporations for the years ended December 31, 1975 and 1976, was interest. In 1975, interest accounted for 27 percent of all expenses; in 1976, 25 percent.

While both tax strategies are acceptable, opportunity for abuse is also present. In several instances, expenses paid to the association by the service corporation appeared to have no relationship to the services performed. For example, an association president, who was also the president of the service corporation, received all of his salary (over $50,000) plus a luxury car for his personal use from the service corporation. He received no salary from the association.

In another instance, an association executive vice president, who was also the president of the service corporation, received all of his salary (over $75,000) from the service corporation. He received no salary from the association.

A second type of abuse involves the manipulation of the capital structure of the service corporation. According to industry sources, a debt-to-equity ratio of between 4 and 9 to 1 is generally considered safe for tax purposes. However, of the unsecured debt-to-equity ratios of the service corporations sampled, ratios grew to 126 to 1,240 to 1, and 2,000 to 1. In one example, an association had invested $10 in capital stock and $1.4 million in unsecured loans to the service corporation, leaving an unsecured debt-to-equity ratio of 145,000 to 1. In all of these cases, interest expense to the service corporation is high and, because of interest payments, income to the association is high.

Board unable to act against insiders and service corporations

The Board, through its powers under 12 U.S.C. 1464(d)(2)(A) can issue cease and desist and removal and suspension orders against an association and not individuals accused of insider activities. According to the Board, it can do little to prevent abuses from happening because it has no specific authority to bring enforcement action directly against a service corporation or against individuals.

In cases where parent or subsidiary directors and officers misappropriate funds, the most direct remedy the Board has is to issue a cease and desist order against the association rather than the executive. In order to have any funds repaid, the Board must convince the association to sue the accused officer. Frequently, the association does not want this because it may still be controlled by the executive or it fears the publicity connected with a lawsuit.

BIASED INVESTMENT DECISIONS

Federal associations can invest 1 percent of their assets in service corporations. However, this is allowed regardless of an association's ability to absorb loss. This is important because one of the purposes of service corporations, according to the Board, is to become involved in more profitable and, hence, more risky activities not allowed to associations.

Net worth is simply the difference between assets and liabilities. If this is a positive number, and it should be, then net worth represents the association's ability to absorb a loss without a loss to its depositors. An association which has a lot of its net worth invested in its service corporation could be in trouble if the corporation should fail.

In 1970, the average net worth as a percent of total assets was about 7 percent, so that 1 percent of assets was about 14 percent of the assocation's net worth. In 1976, however, the average net worth as a percent of total assets was 5.5 percent, so 1 percent of assets equaled about 18 percent of net worth.

Many associations identified as problem institutions invested less than 1 percent of their assets in service corporations but still had severe financial problems. In our random sample, the average investment as of December 31, 1976, was 0.4 percent of assets, or 11 percent of net worth. Clearly, associations are investing increasing amounts of their net worth in subsidiaries whose purpose is to invest in more risky activities.

Lack of management objectivity can and has affected the investment in service corporations through the Board's regulation of conforming loans. A conforming loan made by the association to its corporation is treated as a loan made to an unrelated person or entity. The Board considers these loans investments not subject to the 1 percent of assets limitation. According to the regulation, an eligible association can invest as much as 20 percent of its net worth in these loans.

About 21 percent of our sample had invested in their service corporations under the conforming loan provisions. Through conforming loans these associations increased their investment in service corporations by an average of 12.5 percent of their net worth and 1.2 percent of their assets. In one case, an association using conforming loans increased the percent of its net worth invested in its service corporation from 34 to 98 percent.

The main problem of conforming loans, when a wholly owned service corporation is involved, is the association's ability to objectively determine an applicant's qualification for a loan. Several Board officials have expressed concern over the ability of management to deal objectively with itself when making investment decisions. Wholly owned service corporations provide an opportunity for biased transactions in a business (the savings and loan industry) which depends on independent business dealings.

The failure of management to deal objectively with itself in the form of its wholly owned service corporation has caused problems. For example, the average investment in service corporations for the 55 associations in the problem book with wholly owned service corporations is 0.8 percent of assets. However, if conforming loans are added to the total investment, the average increases to 1.08 percent of assets. The average total invested (including conforming loans) as a percent of net worth is about 30 percent.

Other examples include an instance where an association increased the percent of net worth invested through conforming loans from 75 to 107 percent, 78 to 149 percent, and 148 to 196 percent.

Board unable to effectively control investment

Federal insurance regulations state that no association may invest in its service corporation beyond the legal limit without Board approval. In doing this, the Board expressed its desire to become involved in the decision to invest money in service corporations beyond the legal limit. Salvage is the term used to describe an investment above the legal limit. The term usually applies to additional investments in order to save or salvage a corporation from bankruptcy.

Experience in the area of salvage shows these regulations to be weak. As of December 31, 1976, 33 associations had invested over the legal limit. Officials in the Board's Office of Examination and Supervision could only recall eight salvage applications since 1970 that actually went before the Board for action.

In our search of Office of Examination and Supervision files we found three other associations who submitted salvage applications; however of all 11 applications, we could not locate 2. Of the nine applications located, five associations had already exceeded the legal limit when the application was submitted. The present regulatory frame work seems ineffective in stopping association investments beyond the legal limit. One Federal Savings and Loan Insurance Corporation official said that, if an association had to decide whether to invest in its service corporation, the association would invest first and submit a salvage application later, if that became necessary. If the additional investment turned out to be poor, the Board would be powerless to do anything but watch to see what happened.

CONCLUSIONS

Federal Home Loan Bank Board actions have encouraged the growth of wholly owned service corporations, and parent associations can lose objectivity when dealing with these subsidiaries. This has led to questionable insider dealings and investments in high risk activities. Board controls and powers in these areas are weak.

RECOMMENDATIONS TO THE CONGRESS

Since the Board has not dealt effectively with insider transactions, we recommend that it be given more enforcement authority in this area. We, therefore, support legislation that would give the Board authority to issue cease and desist orders to individuals.

We recommend also that the Congress:

--Abolish the 1 percent limitation on investments in service corporations. In its place a percentage measurement tied to an association's ability to absorb losses--its net worth--should be established.

--Establish penalties for associations which invest more than the legal or regulatory limit in their service corporations before receiving Board approval.

RECOMMENDATIONS TO THE CHAIRMAN OF THE FEDERAL HOME LOAN BANK BOARD

We also recommend that the 1-percent investment limitation be supplemented with a second risk assessment based on an association's net worth position. This supplement could take the form of a strict net worth limitation or measure whereby all funds either invested or loaned to a service corporation would be subject to certain net worth limitations. This could be used until the Congress abolishes the 1-percent investment limitation.

CHAPTER 5

LAND DEVELOPMENT ACTIVITIES--A SPECIAL PROBLEM AREA

Land development activity, including development of raw land, property management, etc., is the most popular area into which association service corporations have expanded. In some instances, this expansion has created exceptional profit opportunities and in other instances exceptional problems. While the Board has taken some actions to alleviate the problems, we believe these actions do not go far enough. Additional controls on land development activities are needed.

THE BOARD STUDY OF LAND DEVELOPMENT--SUCCESSES AND FAILURES

In 1976, the Board asked its Office of Examination and Supervision to study both successful and unsuccessful land development projects undertaken by associations through their service corporations. The study concluded that (1) numerous associations had successful land development activities and (2) many service corporations involved in land development acted in an "unsound, inept and often naive manner." The study noted that, in 1976, at least 32 associations with aggregate total assets of approximately $10 billion had service corporations with serious land development problems.

The study identified 10 attributes of successful land development operations:

--Active management which sought apportionments to generate profit on land development, construction loans, and permanent financing.

--At least one experienced land development individual on the staff.

--Management participation in all phases of the project.

--Prior planning, including research into such areas as zoning laws, required approvals, soil tests, engineering reports, utilities, market feasibility, and cash flow.

--Expected investment returns high enough to compensate for risks.

--Joint venture partners usually having an equity investment in the project, with profits being shared at the completion of the project.

--Prime locations within the metropolitan areas familiar to management.

--Monthly cost accounting and strict disbursement controls.

--Projects usually completed in 3 years.

--Experience gained from smaller projects before a major effort.

Conversely, problem land development projects were characterized by passive association management, lack of land development experience, minimal planning, and lack of effective cost and time controls.

The Office of Examination and Supervision felt that the land development problems identified required restrictive regulatory amendments. Policy alternatives advanced to the Board included:

--Prohibiting service corporations from involvement in <u>any</u> land development projects.

--Prohibiting service corporations from involvement in land development projects with either remote recreational subdivisions or particularly risky major community development.

--Requiring prior Board approval upon submission of a detailed application.

--Requiring notification and submission of certain documentation to the Board 30 days before the land to be developed is bought, thus permitting the Board 30 days in which to object.

--Requiring notification only 30 days before the land is bought, so an examiner can be sent and a report made on the adequacy of documentation.

In addition, the Office of Examination and Supervision strongly recommended some specific procedures for land development projects. It wanted all land development projects to be limited to 3 years from the date of acquisition. Data would be required before obtaining title. Quarterly progress reports would be required. Projects below a certain dollar amount would be excluded from regulations. Uniform salvage regulations would be established. A series of educational articles would be planned to coincide with the amendments.

In response, the Board did the following:

--Issued a series of educational articles on land development.

--Established uniform salvage applications.

--Issued an additional regulation requiring a 5-year limit on land development projects (from the date of land acquisition) and the notification to the Board within 30 days after the purchase of land for development.

--Developed additional training materials for its examiners in land development.

--Issued an R-memorandum (R-38)--a memorandum clarifying a regulatory position--outlining data which examiners should expect to find concerning land development projects.

While these are positive steps, the Board did not adopt the major policy alternatives recommended, such as Board intervention before the purchase of land. The Board was reluctant to require notification before purchase because it did not want to become involved in making business decisions. Therefore, it called for notification within 30 days after purchase.

The Board's willingness to participate in business decisions, however, appears to be flexible. For example, the Board requires that appraisals meet certain standards. This willingness may also depend upon who is the agency head. A former Board chairman summed up his philosophy on business decisions by saying, "if (Board intervention) is required to control the problems then we must do it."

LAND DEVELOPMENT STILL CAUSES LARGE PROFITS AND PROBLEMS

Board officials believe that many land development problems have been resolved. However, much of this may be due to the recovery of the housing market in general. Opportunities for spectacular successes and spectacular failures still remain. Our random sample of 106 associations with service corporations identified 64 involved in land development. Of these 64 associations representing 75 service corporations, 42 reported profits, 32 reported losses, and 1 broke even during 1976. Profits ranged from $233,000 and 23,000 percent return on equity to $380 and 1 percent return on equity. Losses ranged from $208,000 and 1,000 percent loss on equity to $3 and .01 percent loss on equity.

Our review of problem associations identified by the Board in 1977 also indicated that land development problems continue. Of the 23 associations with service corporations that contributed to their problems, 16 were engaged in land development activities. Problems within these associations included poor initial planning and lack of effective management control.

CONCLUSIONS AND RECOMMENDATIONS

Service corporation land development activities have created special opportunities and problems for associations. Problems center on poor planning and lack of effective management control. While the Board has taken positive actions to control this situation, problems remain.

We recommend that the Board reconsider the recommendations of its own task force and establish a reporting system which would allow the Board to become involved in associations' land development projects before the land is purchased. Reporting requirements should be established to identify

--associations that have low net worth positions in relation to project size, lack experience in land development activities, and low supervisory ratings and

--associations that are participating in land development activities defined as particularly risky (i.e., remote recreational developments, "new town" developments, etc.).

CHAPTER 6

SERVICE CORPORATIONS: A LOOK AT THE FUTURE

Through regulation, the Board has sought to encourage more Federal associations to invest in service corporations. The encouragement was prompted by several fundamental competitive issues facing the savings and loan industry. These include:

--The competitive relationship between the savings and loan industry and commercial banks.

--The competitive relationship between the savings and loan industry and other industries with which their service corporations may be competing.

--The amount and kind of competition that should be encouraged among associations within the savings and loan industry.

Service corporation operations have already begun to influence these competitive relationships, and this influence could increase in the future. Consequently, any congressional consideration of service corporation operations must also consider these fundamental competitive issues.

COMPETITION WITH COMMERCIAL BANKS

Competition between commercial banks and the savings and loan industry for funds has always been fierce. This is magnified during periods of credit restraint. During such times, both the Board and the savings and loan industry have said that commercial banks have competitive advantages which allow them to operate more effectively.

One advantage identified by the Board in a 1975 study was the broad powers of banks to provide a wide range of financial services to their customers. To offset these advantages, the Board advocated "* * * measures designed to transform Federal savings and loan associations into family finance centers * * *. These [powers] include checking accounts and other third party payment powers for households and real estate-related businesses and the ability to make all types of consumer loans. They include, as well, financial counseling, personal trust services, and tax preparation and planning." In addition, the ability to offer mutual fund shares and a limited amount of life insurance to savings account holders, comparable to that permitted mutual savings banks in certain States, was advocated. These powers would put savings and loan associations in direct competition with commercial banks in several new areas.

The Board did not receive the statutory authority to directly broaden association financial services. However, this has been done indirectly through service corporations. The current list of approved activities for service corporations (see app. I) shows the many services associations now may compete directly with banks.

Service corporations were directly linked to the family finance center concept in a 1973 speech by a Board member. He noted that service corporation activities had been expanded to include homeowners' loans, and he implied that automobile financing might be a possibility. He concluded by stating:

> "Without playing the blue skies game and getting further into what I see as family centered financing possibilities for the future, it should be sufficient to say that such possibilities are myriad and exciting."

During 1976 and 1977, savings and loan associations experienced large savings deposits. However, should a future period of credit restraint be necessary, the use of service corporations to increase association competition with commercial banks may be expanded. As it now stands, this would not require any congressional approval.

COMPETITION WITH OTHER INDUSTRIES

Housing and insurance-related activities are two major services into which associations, through their service corporations, have expanded. This expansion has been resisted by groups within these industries who do not relish the competition. Specifically, the following actions have taken place.

- --The National Association of Realtors issued a 1978 policy statement opposing the expansion of service corporations into real estate brokerage, leasing, management, and other real estate services.

- --The National Association of Homebuilders have urged restrictions on service corporation expansion into home construction.

--For the past 3 years, the National Association of Insurance Agents has waged a war against savings and loan association and commercial bank insurance operations. The Association has sought to deny insurance agents' and brokers' licenses to these entities and otherwise to bar them from the insurance business in actions before (1) the National Association of Insurance Commissioners, (2) the Federal Reserve Board and the Federal Home Loan Bank Board, and (3) various State legislatures. This organization, which is now known as the Independent Insurance Agents of America, continues to oppose lending institution expansion into the insurance business.

--Several title companies have sued service corporations involved in these activities, alleging violations of the Sherman Antitrust Act.

Consequently, while associations have gotten involved in more activities, as the Board wanted, several industries have reacted against this involvement. Although the affected industries' opinions can be viewed as somewhat biased, the fundamental issue is sound. What should be the competitive relationship between the savings and loan industry and other business-related institutions?

COMPETITION WITHIN THE SAVINGS AND LOAN INDUSTRY

Service corporations' effect on competition within the savings and loan industry revolves around two areas. One is their effect on the normal lending area. The other is the range of activities available to State versus Federal associations.

Both State and Federal savings and loan associations are chartered with the understanding that they will primarily serve a particular area. Should they desire to expand this area by branching, for example, then they must go through a hearing and approval process.

Service corporations are not subject to such limitations. Their service area is anywhere in the State. Those that are subsidiaries of a Federal association may have offices anywhere in the Nation.

While the associations have restricted their use of this power, competitive expansions of lending area activities have occurred. For example, a Federal association opened a service corporation office in the trade territory of two other associations. These other associations sued in State court alleging that the service corporation was really a branch office and, therefore, should not be permitted without the normal approval and hearing process. This case is yet to be resolved.

Other examples include:

--A large, midwestern association that established service corporations engaging in mortgage banking and land development in two western States.

--A large, midwestern association that established a service corporation engaged in condominium development in the south.

--An eastern association that, through its service corporation, became involved in motel operations in the midwest.

All of these activities are well outside the normal lending areas of the associations involved.

Allowing service corporations to expand into other geographical areas may circumvent the intent of present congressional legislation. The Congress, when it created savings and loan associations, restricted their area of operations. Service corporations can now go beyond these geographic boundaries.

The second aspect of intraindustry competition is the flexibility available to State versus Federal association service corporations. State-chartered associations receive their authority from several sources. Most States have "tie-in" regulations with Federal laws. These regulations authorize State associations to do whatever Federal associations may do. However, State associations are permitted more flexibility to invest in service corporations. For example, investment limitations are as high as 10 percent of savings in New Hampshire and whatever the Commissioner approves in Kentucky. This is also true about activities. Permissible activities in both Kentucky and Texas are determined by the State commissioner rather than specific State regulations. Despite these differences, a State association may be a member of the Federal Savings and Loan Insurance Corporation and pay no more for insurance than its more rigorously regulated Federal counterparts.

From a competitive perspective, this situation means the Board is in the position of being unable to totally control either service corporation activities or association investment in service corporations. Lack of these controls allows State-chartered, federally insured associations to influence and even accelerate the expansion of Federal service corporation operations. Once State-chartered associations become involved in new activities, Federal associations may also want the same powers to remain competitive. Consequently, State-chartered associations may influence the future direction of Federal associations' service corporation activity.

THE SERVICE CORPORATION CONSORTIUM-- A CLOSE ENCOUNTER WITH THE FUTURE

The potential influence of service corporation operations on competition in the savings and loan industry is best illustrated by a corporation which began in 1973. At that time, 19 associations in 13 States with over $15 billion in assets formed a corporation. This consortium was formed by having the associations' service corporations buy stock in a consortium corporation. In effect, this consortium became a second-tier operation of the 19 investing associations. According to the Board, the operations of this consortium were beyond its examining and supervisory authority under the statute.

The business objectives of this consortium were to

--create an organization to lend, invest, and engage in business activities in which the owners had a community of interest;

--create new business opportunities to increase profits, in order to provide economical home financing services to the public;

--marshal lending resources and engage in real estate lending and investing nationwide so more funds would be available in areas beyond the normal abilities of individual lenders; and

--do work leading to the possible formation of other organizations which might undertake other business opportunities relating to real estate ownership, development, and financing; family financial service needs; and other needs of the savings and loan businesses.

The nature and scope of these operations raises many questions. The more serious are:

--Could these types of companies be used as devices to circumvent antitrust and restraint of trade laws?

--Could such companies acquire the ability, by virtue of the vast sums of money their parents command, to dominate and influence individual housing, mortgage, and savings markets?

--Should the Board have regulatory control over these types of operations?

This particular consortium is now owned by its president, who bought out the participating savings and loan associations. While we are not aware of another similar organization, the mechanism to dramatically alter the competitive environment of the savings and loan industry remains available for future use.

CONCLUSIONS AND RECOMMENDATIONS

Service corporations are expanding their operations and their spheres of influence. Thus far, this expansion remains relatively unchecked. The continued expansion of service corporation activities raises some fundamental questions about the future role of savings and loan associations. We recommend that the Congress consider the following questions when it reviews service corporation activities.

--What should be the competitive relationship between the savings and loan industry and other financial institutions such as commercial banks?

--What should be the competitive relationship between the savings and loan industry and other industries with which their service corporations may be competing?

--How much competition between associations is acceptable and what relationship should the Board have with State-chartered, federally insured institutions?

LIST OF PREAPPROVED OR APPROVED SERVICE CORPORATION ACTIVITIES AS OF APRIL 1978

1. Originating, purchasing, selling, and servicing any of the following:

   a. Loans, and participants in loans, secured by real estate.

   b. Loans, and participants in loans, secured by first liens upon mobile homes.

   c. Loans, with or without security, for the altering, repairing, improving, equipping, or furnishing of any residential real estate.

   d. Educational loans.

   e. Consumer loans.

2. Performing the following services, primarily for savings and loan associations:

   a. Clerical services, accounting, data processing, and internal auditing.

   b. Credit information, appraising, construction loan inspection, and abstracting.

   c. Development and administration for personnel benefit programs including life insurance, health insurance, and pension or retirement plans.

   d. Research, studies, and surveys.

   e. Purchasing of office supplies, furniture, and equipment.

   f. Operation of storage facilities for records.

   g. Advertising.

3. Acquisition of unimproved land for development or resale to others for development.

4. Development and subdivision of real estate.

5. Property management.

6. Serving as an insurance broker or agent.

7. Serving as trustee under deeds of trust or escrow agent.

8. Preparation of tax returns for account holders or borrowers.

9. Mortgage banking.

Other activities which have been approved for individual associations by the Board include:

1. Collection agency.

2. Currency exchange.

3. Acquisition and operation of nursing homes.

4. Rental of safety deposit boxes.

STATISTICAL ANALYSIS OF SERVICE CORPORATION IMPACT ON ASSOCIATION PERFORMANCE

STATISTICAL TESTS USED

We used two separate applications of the "T" test to evaluate the impact of service corporations on association performance. We compared the 1976 net income to average assets ratios and the net worth to total assets ratios for two groups:

--A randomly drawn sample of associations with service corporations compared to a randomly drawn sample of associations without service corporations.

--All associations with service corporations capable of being paired, on the basis of size, location, type, and charter, with an association without a service corporation.

We wanted to know if the effect of service corporations would result in higher income and net worth levels for the associations involved. The statistical measure used to make this determination was the "T" test.

"T" test on random samples

The T test is used to provide a measure of the probability that the items being compared are statistically the same for the variable being evaluated. Consequently, to determine if service corporations were having a positive influence on the association involved, we

1. chose a random sample of 106 associations from the population of associations with service corporations;

2. chose a random sample of 109 associations from the population of associations without service corporations; and

3. tested the hypothesis that the Net Income/Average Assets (NI/AA) and Net Worth/Total Assets (NW/TA) ratios for associations with service corporations is no different than that of associations without service corporations.

If we could reject this hypothesis with a 95-percent level of confidence, then we would be justified in saying that the service corporation appears to have an effect, and the average difference between the associations would enable us to determine if the effect was positive.

T test on paired observations

The T test is used on paired observations to provide a measure of the probability that the items being paired are statistically the same for the variable being evaluated. We reviewed the 1,628 associations identified as having service corporations as of December 31, 1976, and identified 307 as capable of being matched by an association similar in size, 1/ location (same county), charter, and type but without a service corporation. We then tested the hypothesis that the NI/AA and NW/TA ratios of an assocation with a service corporation are no different than that of an association without a service corporation. If we could reject this hypothesis with a 95-percent level of confidence, then we would be justified in saying that the service corporation appeared to have an effect, and the average difference between the associations would enable us to determine if the effect was positive.

Results of T test

Table 1 shows that the T statistic calculated for both the aggregate and paired tests for the NI/AA ratios is below that needed to reject the hypothesis being tested. Therefore, we must conclude that the service corporations had no statistically demonstrable effect for the given time period.

Table 1 also shows that the T statistic calculated for both the aggregate and paired tests for the NW/TA ratios is above that needed to reject the hypothesis. The statistic exceeds the negative test parameter. Therefore, we must conclude that the service corporation appears to have a statistically demonstrable negative effect for the given time period.

1/Size is determined by asset class. Six classes have been defined by the Board as: (1) 0 to 9.9 million; (2) 10 to 24.9 million; (3) 25 to 49.9 million; (4) 50 to 99.9 million; (5) 100 to 249 million; and (6) 250 million and above.

Table 1

Results of "T" tests

"T" test on random sample

Ratio tested:	Test results			
NI/AA	-1.96	+.94	+1.96	Accept Ho
NW/TA	-1.96	-2.32	+1.96	Reject Ho

"T" test on paired observation

Ratio tested:	Test results			
NI/AA	-1.96	-1.72	+1.96	Accept Ho
NW/TA	-1.96	-4.66	+1.96	Reject Ho

320 First Street, N W
Washington, D.C. 20552

Federal Home Loan Bank Board

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

April 27, 1978

David P. Sorando, Manager
U. S. General Accounting Office
Penn Park Building, 5th Floor
803 West Broad Street
Falls Church, Virginia 22046

Dear Mr. Sorando:

The General Accounting Office is to be commended for its comprehensive report on the activities and operations of service corporation affiliates of federal savings and loan associations. The staff believes that because of its scope and thoroughness, the report will be of valuable assistance to the Bank Board in its review of the effectiveness of its regulation and supervision of service corporations.

The Bank Board shares the GAO's concern about many of the issues raised in the report and about the impact of service corporations upon their affiliated savings and loan associations. We recognize that a review of the functions and usefulness of service corporations is in order, particularly in view of the rapid growth of the activities of such corporations during the 1970's.

In this connection, the Chairman of the Bank Board requested the staff in January, 1978, to conduct an in-depth and far-ranging study of service corporations. The purpose of the study is to consider possible statutory and regulatory amendments governing the activities of these entities as they relate to the safe and sound operations of the savings and loan associations. It is anticipated that this study will be completed by mid-year, at which time the Bank Board will determine the need for statutory or regulatory amendments, including those recommended in the GAO report.

We are concerned, however, about the conclusions expressed in chapter 2 of the report, which question the Bank Board's statutory authority to regulate federal association investments in service corporations. In view of our serious disagreement with the major thrust of the GAO conclusions, which we believe to be legally unsupportable, we have outlined herein the basic considerations which clearly demonstrate, in our judgment, that 1) the Bank Board's regulation of service corporations is fully authorized under the Home Owners' Loan Act of 1933, as amended ("HOLA") (12 U.S.C. 1461 et seq), 2) the Bank Board has statutory authority to permit federal associations to invest in wholly-owned service corporations, and 3) the Bank Board's regulations are consonant with the Congressional intent regarding service corporation investments.

1). In concluding that the Bank Board's authority to regulate service corporations is questionable, the GAO fails to recognize the force of the Bank Board's plenary authority over the activities and operations of federal associations under the HOLA. Specifically, in Section 5(a) of the HOLA (12 U.S.C. 1464(a)), Congress has authorized the Bank Board, "under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation and regulation" of federal associations.

Pursuant to this Congressionally delegated authority to "make policy", the Bank Board has issued "comprehensive" regulations, policy statements, and rulings which govern "the powers and operations of every federal savings and loan association from its cradle to its corporate grave." California v. Coast Federal Savings and Loan Association, 98 F. Supp. 311, 316 (S.D. Cal. 1951); Meyers v. Beverly Hills Federal Savings and Loan Association, 499 F.2d 1145, 1147 (9th Cir. 1974); Kupiec v. Republic Federal Savings and Loan Association, 512 F.2d 147, 150 (7th Cir. 1975); Rettig v. Arlington Heights Federal Savings and Loan Association, 405 F. Supp. 819, 823 (N.D. Ill. 1975).

The case law makes it very clear that the Bank Board's regulatory scheme exclusively governs all aspects of the operations of federal savings and loan associations, including investments by such associations. See e.g., Meyers, supra, 499 F.2d at 1147; Coast Federal, supra, 98 F. Supp. at 318-319; Kupiec, supra, 512 F.2d at 152; Lyons Savings and Loan Association v. Federal Home Loan Bank Board, 377 F. Supp. 11, 17 (N.D. Ill. 1974); City Federal Savings and Loan Association v. Crowley, 393 F. Supp. 644, 655 (E.D. Wis. 1974); Rettig, supra, 405 F. Supp. at 823; Elwert v. Pacific First Federal Savings and Loan Association, 138 F. Supp. 395, 399-400 (D. Ore. 1956); Washington Federal Savings and Loan Association v. Balaban, 281 So.2d 15, 17 (Fla. 1973).

Since the enactment of the service corporation amendment to Section 5(c) of the HOLA in 1964 (added by section 905 of the National Housing Act of 1964, P.L. 88-560, 12 U.S.C. 1464(c), para. 11), the Bank Board's authority under section 5(a) of the Act to regulate all aspects of the operations of service corporations of affiliated federal associations has been virtually unquestioned. Moreover, the Bank Board's authority has been specifically sustained in the only cases in which the courts have passed upon the matter -- Rettig v. Arlington Heights Federal Savings and Loan Association, 405 F. Supp. 819, 824 (N.D. Ill. 1975), and Smith v. Jaques, C.A. No. 75-939 (D. Oregon 1976). 1/

In both Rettig and Smith, not only was the Bank Board's authority to permit federal associations to operate insurance agencies through service corporations upheld, but the Bank Board's authority to require federal associations in certain instances to establish such corporations in order to avoid usurpation of a corporate opportunity also was affirmed. In this regard, the Rettig court held as follows:

> "Although the Bank Board does not regulate the service corporation per se, in exercising its plenary authority over the parent association, the Bank Board delineates those pre-approved activities which qualify such corporations as permissible investments, and, to the extent the service corporation participates in activities which are not pre-approved, such investments may be made only with the Bank Board's consent. If the service corporation is conducting non-permissible activities, unless such activities are discontinued, the savings and loan association

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1/ In one other case, National State Bank of Elizabeth, New Jersey v. Smith, No. 76-1479 (D. N.J., filed September 16, 1977), appeal pending, the Bank Board's authority to approve a federal association's service corporation investment in a national bank whose powers were limited to providing trust services was questioned. However, the court did not decide this issue since it ruled that the Comptroller lacked authority to approve a limited national bank charter in the first instance.

> must divest itself of its investment in the service corporation. Consequently, a federal savings and loan association could not invest in a service corporation acting as an insurance agency without prior approval of the Board." (405 F. Supp. at 824). (Emphasis added).

In Smith v. Jagues, supra, the court totally rejected the contention that the Bank Board lacked statutory authority to regulate service corporations. Referring to the Bank Board's section 5(a) regulatory authority over federal associations, the court observed that:

> "It would not be possible [for Congress] to give a much broader mandate."

The GAO asserts (Report, pp. 5-7) that the Bank Board's regulatory authority over service corporations is questionable as a result of the enactment of an amendment to the service corporation bill (H.R. 12175 as introduced, 88th Cong., 2d Sess. (1964)), offered by Congressman Widnall of New Jersey which struck the language "Subject to rules and regulations of the Board" from the bill. However, GAO overlooks the limited purpose behind the Widnall Amendment. That amendment was never intended to divest the Bank Board of its authority to regulate service corporations. In the words of Congressman Widnall:

> ". . . the purpose of this amendment is simply to make it clear that Federal savings and loan associations may invest in the securities of certain State chartered corporations whose purpose is to supplement and facilitate the services of the savings and loan associations. In my State, the Central Corporation of Savings and Loan Associations, organized under State law, has served a useful purpose and we want to make sure that Federal savings and loan associations in New Jersey may invest in that corporation if they wish to." (110 Cong. Rec. 9332-33 (1964).

The Bank Board had indicated that it looked with disfavor upon participation by federal associations in corporations like the Central Corporation, which operated under a state charter giving it a plethora of corporate powers. 2/ And we think that it is clear from the legislative history that the expressed purpose of the Widnall amendment was not, as the GAO asserts, to preclude Bank Board regulation of service corporations; rather, it was designed to indicate a Congressional intent that the Bank Board allow federal association investment in service corporations with broad operational authority. Without question, the Bank Board, in its service corporation regulations, has, endeavored to carry out this purpose. See 12 C.F.R. §545.9-1(a)(4)(ii) and (b)(2).

We may add that each General Counsel who has served with the Bank Board since 1964 has concluded, after careful study of the legislative history of the Widnall amendment, that it did not deprive the Bank Board of the statutory authority to regulate in the area of service corporation investments by federal savings and loan associations. For example, former General Counsel Kenneth E. Scott concluded in an opinion dated November 4, 1966, that the deletion by the Widnall amendment of the words, "Subject to rules and regulations of the Board", resulted in the removal of "surplus language without effecting a denial of the Board's power to regulate such investment" under Section 5(a) of the HOLA.

Indeed, Congress has recognized the Bank Board's statutory authority to promulgate regulations governing service corporations. Thus, it is significant that although section 5(c) of the HOLA has been amended eight times since 1964 to alter the investment authority of federal associations, Congress has not taken exception to the Bank Board's interpretation of the service corporation amendment to section 5(c) and its exercise of implementing regulatory authority.

2/ The charter of the New Jersey Central Corporation provided in part that the corporation would be authorized ---

> '...to carry on any or all of its operations and business, and without restriction or limitation as to amount, to purchase, lease, or otherwise acquire, hold and own, and to mortgage, sell, convey, lease or otherwise dispose of, real or personal property of every class or description, in any of the states or Territories of the United States and in the District of Columbia, and in any and all foreign countries, subject to the laws of such state, district, territory or country."

In addition, the Bank Board has kept Congress fully informed of the scope of authorized service corporation activities. For example, in its Annual Reports for the years 1965-1975, the Bank Board from time to time informed Congress of its regulatory amendments authorizing service corporations to engage in a variety of activities, including (1) making consumer loans, (2) tax return preparation services, (3) acquiring, maintaining and managing real estate used for offices and related facilities of a parent association, and (4) services as insurance agent or broker.

More recently, the Bank Board's authority to regulate service corporations has been recognized implicitly in the current session of Congress. Thus, S.71, a bill introduced by Senator William Proxmire, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, and passed by the Senate, would give the Bank Board authority to issue cease and desist orders against service corporations. The House version of S.71 is currently under consideration.

We submit that the Congressional response to the Bank Board's actions in this area constitute evidence of Congressional acquiescence in the Bank Board's interpretation of its authority under the HOLA. See, e.g., Red Lion Broadcasting Co. v. FCC, 395 U.S. 367, 381 (1969); Zemel v. Rusk, 381 U.S. 1, 12 (1965); American Federation of Government Employees v. Resor, 387 F. Supp. 63, 75 (D.D.C. 1974).

2. The GAO report also asserts that, "in passing the 1964 statute the Congress intended to permit federal savings and loan associations to invest in service corporations owned by and serving a number of associations." (Report, p. 14). While it is true that the legislative history of the statute refers to a service corporation owned by a number of associations and the Central Corporation of New Jersey was cited as an example -- there is nothing in either the legislative history or in the service corporation amendment itself precluding a single federal association from operating a wholly-owned service corporation. In fact, the words of the statute (12 U.S. 1464(c), para. 11) could not be clearer; it provides as follows:

> "Any [federal] association is authorized to invest in the capital stock, obligation, or other securites of any corporation organized under the laws of the State, District, Commonwealth, territory, or possession in which the home office of the association is located, if the entire capital stock of such corporation is available for purchase only by savings

> and loan associations of that State, District, Commonwealth, territory, or possession and by Federal savings and loan associations having their home offices therein, but no association may make any investment under this sentence if its aggregate outstanding investment under this sentence, determined as prescribed by the Board, would thereupon exceed 1 per centum of its assets."

The language of this authorization is crystal clear: any federal association may, under this provision, invest up to 1 per cent of its assets in any corporation which is organized under the laws of its home state, so long as the stock of said corporation is available for purchase only by savings and loan associations in the same state. These restrictions, as well as those imposed by the Bank Board pursuant to its general authority to regulate federal associations, are the only limitations upon the authority of federal associations to invest in service corporations.

In summary, there is no statutory requirement that a service corporation must be owned by more than one association, and the GAO's attempt to read such a requirement into the statute must fail under the most basic and fundamental principle of statutory construction, namely, that where the language of a statute is clear and unambiguous on its face, the statute must be construed to mean exactly what it says. See e.g., Caminetti v. United States, 242 U.S. 470, 485 (1916); Essex County & Vicinity Dist. Council of Carpenters & Millwrights, United Brotherhood of Carpenters & Joiners of America, AFL-CIO v. National Labor Relations Board, 332 F.2d 636, 641 (3rd Cir. 1964). As the Supreme Court held in Caminetti, supra:

> "[I]t is elementary that the meaning of a statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain, and if the law is within the constitutional authority of the law-making body which

> passed it, the sole function of the court is to enforce it according to its terms." 242 U.S. at 485. 3/

3. In regard to the GAO's contention that Congress did not intend service corporations to engage in profit-making functions (Report, p. 8), we simply note that the service corporation, the Central Corporation of New Jersey, which in many respects was a model for the 1964 legislation, was a profit making concern. See note 2, supra. As discussed above, the Widnall amendment was designed specifically to insure that the Board would permit federal corporations to invest in such profit making corporations.

Also, we dispute the GAO's suggestion that the use of conforming loans to service corporations in effect circumvent the one per cent investment limitation of the statute (Report, p. 14). As the report acknowledges, the " 1- percent limitation only applied to investments made under [the service corporation amendment]" (Report, p. 13). Thus, the plain language of the statute -- limiting investments to those made "under this sentence" -- supports the Bank Board's action in permitting conforming loans to service corporations authorized under separate statutory authority.

In conclusion, the Bank Board is well aware of certain problems that have resulted over the years from investments by federal associations in service corporations, and is currently studying various measures to prevent a recurrence of such problems in the future. As noted above, the Bank Board has broad authority under section 5(a) of the HOLA to regulate and supervise service corporations. Whether additional authority is needed will be determined when the Bank Board's study is completed.

Sincerely,

Anne P. Jones
General Counsel

3/ The GAO intimates (Report, p. 6) that the Supreme Court abandoned this rule of statutory construction in Train v. Colorado Public Interest Research Group, 426 U.S. 1, 10 (1976). However, that is not the case. In Train, the Court simply held that the courts may resort to legislative history where such history "sheds . . . light" on the meaning of the statute being construed. As discussed above, the legislative history is silent as to any requirement for multiple ownership of service corporations and, therefore, does not qualify the "plain meaning" of the statute in any way.

GAO note: Page references in this appendix refer to our draft report and may not correspond to the page of this final report.

PRINCIPAL OFFICIALS OF THE FEDERAL HOME LOAN BANK BOARD RESPONSIBLE FOR THE ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office From	To
BOARD OF DIRECTORS:		
John Horne, Chairman	Aug. 1963	Nov. 1968
John deLaittre	Sept. 1962	June 1966
Michael Greenbaum	Apr. 1965	June 1969
Robert Rand (note a)	Oct. 1966	Mar. 1969
Preston Martin, Chairman	Mar. 1969	Dec. 1972
Carl O. Kemp, Jr. (note b)	May 1969	Aug. 1973
Thomas Hal Clarke	July 1969	June 1973
Thomas R. Bomar, Chairman	May 1973	June 1975
Grady Perry	June 1973	July 1977
Garth Marston (note c)	Apr. 1974	Present
Robert McKinney, Chairman	Aug. 1977	Present

a/Acting Chairman from November 1968 to March 1969.

b/Acting Chairman from December 1972 to May 1973.

c/Acting Chairman from April 1974 to December 1976, Chairman from December 1976 to January 1977, Acting Chairman from February 1977 to August 1977.

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