Dual Banking and State Bank Insurance Powers: Diversifying Financial Services Through the Back Door

Michael E. Schrader

Indiana University School of Law

Follow this and additional works at: https://www.repository.law.indiana.edu/ilj

Part of the Banking and Finance Law Commons

Recommended Citation
Available at: https://www.repository.law.indiana.edu/ilj/vol66/iss1/7
Dual Banking and State Bank Insurance Powers: Diversifying Financial Services Through the Back Door

MICHAEL E. SCHRADER*

INTRODUCTION

The dual nature of the American banking system, providing for both state and federal chartering and regulation of depository institutions, has long been defended for its ability to encourage innovation within the regulatory system.1 In recent years, however, there has been concern that state regulations expanding bank powers beyond traditional depository and lending functions have become too innovative.2 Among the innovations of concern to the Board of Governors of the Federal Reserve System (the “Federal Reserve Board” or the “Board”), and the insurance industry generally, are the actions of several states to expand state bank insurance powers beyond both traditional and federally-recognized limits.3

* J.D. Candidate, 1990, Indiana University School of Law at Bloomington; B.A., 1986, Brigham Young University.

1. See G. BENSTON, R. EISENBEIS, E. KANE & G. KAUFMANN, PERSPECTIVES ON SAFE AND SOUND BANKING 276-78 (1986); W. BROWN, THE DUAL BANKING SYSTEM IN THE UNITED STATES 59, 64-65 (1968); Miller, The Future of the Dual Banking System, 53 BROOKLYN L. REV. 1, 1-2 (1987); Scott, The Dual Banking System: A Model of Competition in Regulation, 30 STAN. L. REV. 1, 13 (1977); see also Interrelationship of the Banking and Insurance Industries: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 41, 47-48 (1987) (oral testimony of Jill M. Considine, New York State Superintendent of Banks); Letter from Adrian W. DeWind to Governor Mario M. Cuomo (Feb. 15, 1984) (discussing recommendations of Temporary State (New York) Commission on Banking, Insurance and Financial Services (DeWind Commission) to allow banks and insurance companies to expand their services by entering the domain of each other), reprinted in THE STATE BANKING REVOLUTION AND THE FEDERAL RESPONSE: NEW FRONTIERS OF FINANCIAL SERVICE EXPANSION 5 (J. Hawke & P. Wallison eds. 1984) [hereinafter BANKING REVOLUTION]; cf. New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (powers must be reserved to states to remold through experimentation, economic practices and institutions to meet changing social and economic needs).

2. See, e.g., Strengthening the Safety and Soundness of the Financial Services Industry: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 30 (1987) (emphasis in original) (statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System) (South Dakota statutes granting bank powers far beyond those allowed for federally chartered institutions create “potentially destructive interstate competition” and “clearly jeopardize the safety and soundness of banks”).

3. In the past year the Delaware and Illinois legislatures tackled the issue of whether the powers of their state-chartered banks should be expanded to include insurance agency and brokerage activities as well as underwriting authority. The Delaware legislature recently enacted a bill that gives Delaware-chartered banks, as well as approximately 40 out-of-state credit card
State banking laws, like their national counterpart,⁴ "generally authorize banks to engage in a series of specified traditional activities and in other activities that are 'incidental' or 'closely related' to banking."Ⅴ Many state laws also contain competitive equality (or wild card) provisions that give state-chartered banks power to engage in any activity permitted to national banks.⁶ A growing number of states, however, have granted powers in the area of insurance,⁷ as well as securities⁸ and real estate,⁹ that go well beyond the powers given to national banks. It is on these expanded banking powers that a great deal of regulatory debate is focused.

The Federal Reserve Board, because of its power to control bank holding companies,¹⁰ is in the middle of this debate. Today, as most state-chartered banks are also part of a bank holding company,¹¹ the Federal Reserve Board

banks operating there, power to underwrite and sell insurance on a nationwide basis. Insurance Compromise is Nearing in Delaware, Am. Banker, Jan. 29, 1990, at 1, col. 5; Act of May 30, 1990, tit. 5, ch. 7, Pub. Act No. 224 (1990) (LEXIS, Codes library, Deals file). In the Illinois legislature a much narrower bill which would have allowed bank subsidiaries to either acquire or contract with existing insurance businesses failed to win approval. State Senate Blocks Bank Insurance Role, Chicago Tribune, June 29, 1990, at 10, col. 5; see also Firmer Grasp on Insurance Powers, Am. Banker, Feb. 28, 1990, at 1, col. 3 (Board approval of Bank of America acquisition of state-chartered Oregon bank that could obtain insurance agency license under Oregon law); Banks Gain New Insurance Powers, Am. Banker, Feb. 26, 1990, at 1, col. 3 (noting that general insurance services are presently offered in California by BankAmerica, First Interstate Bancorp and Security Pacific Corp. in response to the 1988 passage of Proposition 103, a California state insurance-reform referendum).


7. See infra notes 73-81 and accompanying text.

8. See Wallison & Touney, supra note 5, at 14, col. 3 nn.11-12 (underwriting of certain securities, not permitted for underwriting by national banks, are authorized for state-chartered banks in Alaska, California, Connecticut, Georgia, Massachusetts and North Carolina).

9. See Whiting, Real Estate Activities of Banking Organizations, in Banking Law and Regulation 637, 655, 671-72 (F. Puleo & B. Smith eds. 1987) (Federal Deposit Insurance Corp. (FDIC) survey indicating that 22 states authorize equity participations, 19 states authorize real estate development activities and 10 states authorize real estate brokerage activities).

10. The Bank Holding Company Act of 1956 ("BHC Act"), ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-1850 (1988)), imposed federal control over companies that had interests in state, national or savings banks, as well as trust companies. The coverage of the Act has been expanded and retracted by amendment, but as a general matter limits the activities of bank holding companies to managing and controlling banks. The Board of Governors is the sole administrator of the Act. See infra note 23.

11. FDIC statistics show that in the year ending June 30, 1987, there were 13,955 insured commercial banks, of which 9,208 were state-chartered institutions. Bureau of the Census, U.S. Dept. of Commerce, Statistical Abstracts of the United States: 1989, at 490 (109th ed. 1989) [hereinafter Statistics]. Federal Reserve figures for 1987 (as of Dec. 31) show that there were 6,503 bank holding companies controlling 9,316 of the nation's commercial banks (roughly 67% of the banks) and $2,371.5 billion in assets (91.1% of all commercial bank assets). Id. at 491.
can construe limitations on holding company activities broadly to severely restrict the power of states to define the permissible range of activities in which their own institutions can engage. This raises fundamental federalism questions concerning state powers and the continued viability of a dual banking system. On the other hand, the Federal Reserve Board can construe the holding company restrictions narrowly and grant state regulators broad license to undermine long-established national regulatory policies which separate banking and commerce.

This Note analyzes a small portion of the debate concerning state powers by examining the power of state-chartered banks to engage directly in insurance activities that are prohibited to bank holding companies and national banks. By focusing on the limited scope of the “closely related to banking” exception to the nonbanking limits of the Bank Holding Company

12. Section four of the BHC Act, 12 U.S.C. § 1843 (1988), prohibits BHCs from either owning or controlling any company which is not a bank, id. at (a)(1), or engaging in any activity other than managing or controlling banks (and other authorized subsidiaries) or activities that are found to be closely related and incidental to banking. Id. at § 1843(a)(2), (c)(8). If the Board construes BHC activities broadly to include the activities of a BHC as well as those of its bank subsidiaries, the powers of the chartering authority (national or state) to define the range of permissible bank activities will be effectively subordinated to the Federal Reserve Board—by means of the nonbanking limitations of the BHC Act.


Federal Reserve Board authority over state banks also arises where the state bank is a member of the Federal Reserve system. 12 U.S.C. §§ 321-327 (1988). Additionally, federal power is exerted over almost all state banks because of the practical need for deposit insurance. The FDIC insures 98% of all banks, accounting for 99% of all deposits. N. LASH, BANKING LAWS AND REGULATIONS: AN ECONOMIC PERSPECTIVE 29 (1987). FDIC regulation of state bank insurance powers, in part because of its focus on risk assessment, permits insured banks to engage in a range of insurance activities, including (if grandfather provisions are met) the underwriting of life insurance—provided that there are adequate safeguards in place. Id. at 138; 12 C.F.R. § 332 (1990); see also Powers Inconsistent With Purposes of Federal Deposit Insurance Law: Hearing on Proposed Regulations, 50 Fed. Reg. 23,963 (1985) (notice of public hearing to amend 12 C.F.R. § 332). As a general rule, the FDIC has placed few restrictions on the range of activities that can be conducted by federally insured state-chartered banks. See Bachman, Robinson & Hamlin, Banking Law: New Wave of Acquisitions Raise Regulatory and Structural Issues, Nat'l L. J., at 29, col. 4 n.3 (June 11, 1990).


From the inception of this nation's national banking system, our bank regulatory legislation steadfastly has maintained a separation between the business of banking and other forms of commerce. Except for a brief period during the first quarter of this century, the activities of banks have been limited to the deposit-taking and lending functions that have long characterized the banking business.
the Note concludes that the Federal Reserve Board's current (and proposed) regulatory position represents a statutorily-based middle ground that is consistent with traditional state insurance powers and a dual system of banking. This conclusion is based on an analysis of Federal Reserve Board orders involving applications by Citicorp\(^6\) and Merchants National Corp.\(^7\) to engage in insurance activities through state-chartered banks, as well as from an overview of the District of Columbia Circuit Court of Appeal's AMBAC decision\(^8\) and the Federal Reserve Board's proposed regulatory response.\(^9\)

An overview of the basic jurisdictional structure of banking regulation is set out in Part I. The parameters of holding company state bank insurance powers are defined in Part II. Part III discusses the nature of state banking powers. Finally, this Note suggests that current administrative and judicial positions indicate that insurance powers can be granted by state legislatures to state-chartered banks without compromising or usurping federal regulatory power—consistent with a dual banking system.

I. JURISDICTIONAL STRUCTURE

The regulation of America’s banking system did not evolve from an ordered or centralized plan, but instead was formed by a series of responses to severe economic emergencies.\(^20\) While most of these regulatory responses
tightened regulation and centralized authority, most recent legislation\textsuperscript{21} has moved in the opposite direction—toward deregulation.\textsuperscript{22} This trend toward deregulation has raised important questions about the allocation of regulatory powers.

Complicating the allocation of power questions is the forbidding jurisdictional web of federal and state banking agencies. As a general matter, the regulation of the nation's banks is divided among the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC) and state regulatory agencies, with the role each agency plays depending primarily on the context in which the regulatory matter is raised.\textsuperscript{23} The jurisdiction of the respective agencies is determined by a number of the characteristics of the particular bank: the source of the institution's charter (national or state), the bank's membership

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
Decision & National Banks & State Member Banks & Insured Nonmember State Banks & Noninsured Nonmember State Banks \\
\hline
Chartering & OCC & State & State & State \\
\hline
Supervision & OCC & State, Board & State, FDIC & State \\
& Examination & & & \\
\hline
Branching & OCC & State, Board & State, FDIC & State \\
\hline
Mergers & OCC & State, Board & State, FDIC & State \\
& Acquisitions & & & \\
\hline
Bank Holding & Board & Board & Board & Board \\
Co. Activities & & & & \\
\hline
\end{tabular}
\caption{Division of Labor among Various Regulators}
\end{table}

Source: Adapted from \textit{Hearings on Financial Structure and Regulation before the Subcomm. on Financial Institutions of the Senate Comm. on Banking, Housing and Urban Affairs, 93d Cong., 1st Sess. 619 (1973)}; and N. \textsc{Lash}, \textit{supra} note 20, at 33 (Table 2-1). \textit{See also} Hood, \textit{Statutory Framework}, in \textit{Banking Law and Regulation}, \textit{supra} note 9.
in the Federal Reserve system, the presence of federal deposit insurance and, of particular importance, the existence of a parent holding company. Because the Federal Reserve Board is vested with the power to directly regulate holding company activities, the question of whether a bank is or is not a part of a holding company may have an important impact on the scope of the bank’s powers.

The number of bank holding companies has grown in recent years. Bank holding companies have become the dominant form of banking organization in the United States and presently control ninety-one percent of all commercial bank assets. Originally, bank holding companies developed as a means for banks to avoid the limitations on nonbanking activities imposed by the Glass-Steagall Act’s separation of banking and commerce. Because a bank holding company was not a regulated entity, institutions were free to diversify their operations by creating a parent corporation. In response to the development of holding companies, and the corresponding combination of banking and nonbanking activities, Congress passed the Bank Holding Company Act of 1956 (the “BHC Act”).

24. The body of law which governs a bank’s insurance powers reflects these basic jurisdictional distinctions, but is also complicated by various policy choices and compromises that have been incorporated into the laws which control the power of commercial banks to engage in insurance activities. The extent of a bank’s insurance powers depends upon several factors including (1) whether a state or nationally-chartered bank, or holding company subsidiary, is involved in the insurance activity, (2) whether the bank or its branches are located in a small town, (3) the type of insurance activity involved, (4) the total assets of the institutions involved in the activity and (5) if the entity has previously engaged in insurance activities. See generally R. Whiting & J. Scott, A GUIDE TO THE FEDERAL LAW OF BANKING AND INSURANCE (1989).

25. A bank holding company is statutorily defined as any company which has control over any bank or over any company that is, or becomes, a holding company by virtue of the provisions of the BHC Act. 12 U.S.C. § 1841(a)(1) (1988); 12 C.F.R. § 225.2(c) (1990).

26. Federal Reserve Board statistics indicate a tremendous growth in the holding company form of organization over recent years—increasing from 121 such companies in 1970 to 6,503 such companies in 1987. STATISTICS, supra note 11, at 491 (Table 795).

27. This 91% figure aggregates commercial bank assets held by both one-bank and multi-bank holding companies. Id. Multi-bank holding companies (for the year ending Dec. 31, 1987) controlled 72.9% of commercial bank assets. Id. (Table 796).


29. Ch. 240, 70 Stat. 133 (1956) (codified as amended at 12 U.S.C. §§ 1841-1850 (1988)). In Florida Dept. of Banking v. Board of Governors, 760 F.2d 1135, 1141 (11th Cir. 1985), vacated on other grounds sub nom., United States Trust Corp. v. Board of Governors, 474 U.S. 1098 (1985), the court concluded that the legislative history of the BHC Act revealed that the legislation had three purposes: (1) to prevent bank holding companies from acquiring additional banks in a way that would concentrate banking resources in a particular area, (2) to prevent the combination of banking and nonbanking enterprises that would enable holding companies to use bank deposits to finance nonbanking ventures, and (3) to prevent the creation of interstate deposit-taking networks by bank holding companies without specific state approval.
bank holding company can engage only in the business of banking or of managing and controlling banks. Engaging in "nonbanking" activities that are not "closely related or incident to banking" or acquiring ownership or control of a company which is not a bank is prohibited.\(^{30}\)

Although the BHC Act removed many of the early advantages associated with the holding company form of organization, bank holding companies remain a viable tool for financial institutions to diversify through nonbanking activities and geographic expansion.\(^{31}\) As a general rule, since the Act’s passage the Federal Reserve Board has adopted a flexible approach in determining whether an activity is closely related to banking.\(^{32}\)

In its original form the BHC Act provided that nonbanking activities “of a financial, fiduciary or insurance nature”\(^ {33}\) could be determined “to be so closely related to the business of banking . . . as to be a proper incident thereto.”\(^ {34}\) The Garn-St. Germain Depository Institutions Act of 1982\(^ {35}\) amended (and severely restricted) the BHC Act’s “closely related” exception. Title VI of the Garn-St. Germain Act sharply curtailed bank holding company insurance activities by taking the position, with certain exemptions,\(^ {36}\) that insurance

---

32. A two-part test is generally employed to determine whether an activity meets the exception provided by § 4(c)(8) of the BHC Act, 12 U.S.C. § 1843(c)(8). First, the activity must be determined to be closely related to banking. The test adopted in National Courier Ass’n v. Board of Governors, 516 F.2d 1229 (D.C. Cir. 1975), is the generally accepted standard for determining whether an activity is “closely related.” Under the test, courts will give deference to the Board's finding that an activity is “closely related” if:
   1. Banks generally have in fact provided the proposed services.
   2. Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed service.
   3. Banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.
   

   The second part of the test, derived from the "proper incident" requirement, is a public benefits test. The test requires that the Board weigh the perceived advantages of the activity—increased convenience to customers and increased competition—against possible adverse effects such as conflicts of interest and unsound banking practices. See Bogaard, Bank Holding Companies: Definition, Regulation and Permissible Activities, in BANKING LAW AND REGULATION, supra note 9, at 164-68.
34. Id.; see also Chittenden, Bank and Bank Holding Company Insurance Powers, in BANKING LAW AND REGULATION, supra note 9, at 492.
36. The major exemptions (A, B, C, D & G) allow (1) underwriting and distribution of Credit Insurance (exemption A), (2) selling of limited property insurance (exemption B) (limited to property securing loan), (3) insurance agency activity in places with populations of less than 5,000 persons (exemption C) and (4) any insurance activities engaged in prior to designated periods (exemptions D & G) (scope of “grandfather” rights dependent on whether activities
activities are not closely related to banking.\textsuperscript{37}

The Garn-St. Germain Act’s amendment of section 4(c)(8) has done little to end the political and regulatory debates concerning the permissible scope of bank insurance activities.\textsuperscript{38} In fact, the Act has transformed the debate from one focusing on an acceptable meaning of “closely related to banking” to one raising basic federalism issues that implicate the continued viability of the dual banking system. Because Garn-St. Germain precludes a Board determination that general insurance activities are “closely related,” the precise reach of the BHC Act’s nonbanking prohibitions is the central factor in determining the power of states to define the permissible activities of state-chartered banks that are part of a bank holding company.

\section*{II. How Wide Is the State Powers Door Open?}

The power of a state to regulate its own institutions and the power of the Federal Reserve Board to control holding company activities have come into conflict in holding company applications to acquire and retain state banks under section three of the BHC Act.\textsuperscript{39} Sharp conflicts between federal and state power have resulted from state legislation designed to expand bank insurance powers beyond both the limits of Garn-St. Germain and traditional banking functions.\textsuperscript{40}

\begin{footnotesize}
\textsuperscript{37} Title VI of the Garn-St. Germain Act amended § 4(c)(8) to provide that “it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent or broker . . . .” Pub. L. 97-320, § 601, 96 Stat. 1469, 1536-38 (1982).

\textsuperscript{38} Garn-St. Germain’s amendment of § 4(c)(8) and the subsequent insurance powers moratorium of the Competitive Equality Banking Act of 1987, infra note 59, are only part of a continuing effort by the insurance industry to maintain the separation of banking and commerce that has been a feature of the financial marketplace through most of this century. One author recently characterized the debate as “a protracted war . . . now over three decades old” between the banking and insurance industries to which “no end is in sight.” Huber, Insurance Powers of Banking Organizations, 8 ANN. REV. BANKING L. 147, 147 (1989).


\textsuperscript{40} The perceived state-bank insurance loophole, see infra note 109 and accompanying text, has generated several proposed legislative responses. See, e.g., Financial Modernization Act of 1987, S. 1886, 100th Cong., 1st Sess. (1987) (allowing state law to determine the permissible range of insurance activities provided that insurance activities are conducted within the home-state); Bank Holding Company and National Bank Amendment Act of 1987, S. 706, 100th Cong., 1st Sess. (1987) (closing the state bank loophole by limiting insurance activities of holding company banks to those activities that are permissible for the holding company under the BHC Act); Financial Services Competitive Equity Act, S. 2851, 98th Cong., 2d Sess. (1984) (extending the Garn-St. Germain Act’s insurance restrictions to all state-chartered bank holding company subsidiaries). See generally Reform of the Nation’s Banking and Financial Systems: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs, 100th Cong., 2d Sess., pt. 3 (1988); Interrelationship of the Banking and Insurance Industries: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. (1987).
\end{footnotesize}
The parameters of a state bank's power to engage in insurance activities is perhaps best defined by two Board determinations concerning applications by Citicorp41 and Merchants National Corp.42 to engage in insurance activities authorized by South Dakota43 and Indiana,44 respectively. While the Citicorp and Merchants National applications are distinguishable in a number of respects, each raises the central issue of whether the nonbanking prohibitions of section four45 of the BHC Act reach state banks that are part of a holding company. The Board's approval of Merchants National's request required a finding that section four did not restrict state bank activities. The Board's earlier order concerning Citicorp suggested, but did not actually reach, a contrary result.

Citicorp applied in June, 1983 for Board approval to acquire all of the outstanding shares of American State Bank of Rapid City, a state-chartered South Dakota bank. In connection with its application Citicorp requested that the Board allow it to conduct nationwide insurance activities through the state bank.46 South Dakota law had recently been amended to allow state-chartered banks to engage in all aspects of the insurance business,47 giving Citicorp and other large banks incentives to expand their operations in the state.48

On its initial review of the application the Board noted that the proposed acquisition "raised significant legal questions concerning the applicability of the Bank Holding Company Act to state-chartered holding company banks" and expressed only a "tentative judgment that it could not approve the proposed bank acquisitions . . . ."49 The Board delayed a determination of the issue until Citicorp reactivated its application in early 1985. In an August, 1985 order the Board denied the application on the ground that the acquisition was designed solely to allow Citicorp to engage in insurance activities beyond those authorized by the provisions of the BHC Act. Reserving the precise issue raised concerning the reach of the BHC Act,50 the Board stated that approval would not be "warranted [as] the proposal would result in a violation or evasion of the nonbanking provisions of section four of the Act."51

44. IND. CODE § 28-1-11-2 (1986).
50. Id. at 791 n.6.
51. Id. at 790.
The rationale underlying the Citicorp order, because of the Board's refusal to reach the BHC Act issue, is not clear. At least three lines of reasoning support the result reached. First, if Citicorp were utilizing South Dakota law to "evade" the prohibitions of section four, then it might follow that state banking powers are effectively preempted by the insurance limitations of the Garn-St. Germain Act. This would resolve the BHC Act issue raised and addressed in Governor Rice's concurring statement. Rice noted that "the nonbanking prohibitions of the Act apply to investments made by bank holding companies, even when those investments are made through a subsidiary bank."52 Such a reading is inconsistent with both the language of the order (expressly reserving the BHC Act "scope" issue) and the "non-comprehensive" nature of the Act evidenced by its legislative history.53 An alternative rationale for the order would be to read into it a finding that the proposed acquisition was the de facto purchase of an insurance subsidiary, rather than the acquisition of a bank.54 This alternative is feasible given the Board's concern with the limited range of banking activities that would be conducted and the "preponderance of insurance activities proposed for [the] Bank."55 A third reading of the order would justify the Board's determination on the basis of geography. This view would effectively nullify South Dakota's scheme on the ground that while it authorizes Citicorp to engage in nationwide insurance activities, it strictly limits its ability to conduct banking and insurance activities in South Dakota. Governor Seger's concurring statement supports a geographic reading of the order as she preferred to base the scope of the BHC Act on a territorial limitation.56

52. Id. at 792.
54. In support of this rationale the order states that:
In these circumstances, it is important to note that Bank will serve primarily as an insurance subsidiary of Citicorp and will conduct relatively insignificant banking activities. . . . Under the South Dakota statute, Bank and its insurance subsidiaries must be licensed and supervised by the South Dakota Department of Insurance as well as the state insurance departments in each state in which Bank conducts its insurance activities.
55. Citicorp, 71 Fed. Res. Bull. at 791 & n.4; see also Chittenden, supra note 34, at 499 (emphasis in original) ("In effect, the Board decided that Citicorp was buying a direct non-bank subsidiary to engage in prohibited activities, and not a bona fide state-chartered bank.").
56. Governor Seger stated in part:
I wish to emphasize that I do not object to proposals under which a state bank engages in activities authorized by the state for its banks provided those activities may be conducted within the state without restriction. I believe that states should
Such a reading also reinforces the rationale for a dual system of regulation, and offers a reasonable basis for making the Citicorp order consistent with subsequent Board positions and legislative proposals.

The BHC Act "state powers" question again came before the Federal Reserve Board in 1987 when Merchants National Corp., an Indiana based bank holding company, sought to be released from commitments not to conduct insurance agency activities through two recently acquired state-chartered banks. Reaching a result which appears inconsistent with the result it had reached in Citicorp, the Board granted Merchants National's request to resume direct insurance agency activities through the two banks. Distinguishing the application from Citicorp as not involving "evasion" of section four, the Board's order focused directly on the scope of the BHC Act's nonbanking provisions.

57. A geographically-based limitation on state bank insurance powers reinforces the rationale underlying dual regulation that powers are reserved to the several states to develop new financial services. Such a limit also reflects the "intrastate"-"interstate" distinction so important in the analysis of federalism principles under the commerce clause.


60. Merchants National's previous commitment not to conduct insurance agency activities through the Anderson Banking Co. and the Mid-State Bank of Hendricks County (the banks acquired) illustrates how the state powers question is complicated by the regulatory practice of "regulation by commitment." Under this "philosophy," administrative delays in application processing are avoided through the extraction of "so-called 'voluntary commitments' from applicants that they will divest bank subsidiaries of certain nonbanking activities or limit the conduct of such activities." Fisher, supra note 13, at 327 (footnotes omitted). As the ultimate determination in Merchants indicates, extraction of such commitments may, in effect, be ultra vires regulation by the Board—abrogating the resolution of state powers questions.

61. See supra notes 50-53 and accompanying text.
The order noted that there are two kinds of BHC Act prohibitions on involvement in nonbanking: restricting control of nonbanking entities and prohibiting certain nonbanking activities. Rejecting the arguments that support a unified reading of the prohibitions, the Board reasoned that the structure and language of the BHC Act dictated that the prohibitions be read as separable and independent. With respect to the prohibition on controlling nonbanking entities, the Board (relying on the language of section 4(a)) ruled that no entity within a holding company can retain ownership of voting shares in an entity engaged in activities not "closely related" to banking. Ownership or control limitations, whether direct or indirect, were held to apply to any part of the bank holding company. The nonbanking activity provisions of section 4(a)(2), however, only limit the holding company's nonbank subsidiaries to banking, managing or controlling banks and other authorized subsidiaries, and other activities deemed by the Board to be "closely related to banking." In short, the Merchants National order indicates that the BHC Act's limitations on activities apply only to the bank holding company itself and its nonbank subsidiaries—not to subsidiary banks. Read broadly, the order supports the proposition that the powers of a bank, even when that bank is part of a holding company, are subject only to the control of the national or particular state authority granting its charter.

In short, the Merchants National order indicates that the BHC Act's limitations on activities apply only to the bank holding company itself and its nonbank subsidiaries—not to subsidiary banks. Read broadly, the order supports the proposition that the powers of a bank, even when that bank is part of a holding company, are subject only to the control of the national or particular state authority granting its charter. The Board in Merchants National recognized the relatively independent position of holding company banks. Such an independent position had been previously advocated by Citicorp and other holding companies that sought to acquire and operate state banks pursuant to South Dakota's insurance statutes. Even though the divided Board in Citicorp found it unnecessary to address the BHC Act issue, it is clear that the determination (because the application was denied)

63. The arguments for an expansive reading of the nonbanking prohibitions were advanced by a number of insurance trade organizations in comments protesting the application and the request to reissue the earlier order. The argument advanced was that the nonbanking "activities" limitation in 12 U.S.C. § 1843(a)(2) applied not only to direct conduct of the BHC, but also to conduct engaged in indirectly through holding company subsidiaries, including subsidiary banks. Id.
64. Id. at 391-92.
69. See Hinkle, supra note 59, at 138 n.3.
70. See, e.g., Excerpt from First Interstate's Brief in Support of its Application for Federal Approval to Acquire a Bank in South Dakota, reprinted in Banking Revolution, supra note 1, at 37.
71. Citicorp, 71 Fed. Res. Bull. at 791 n.6 (because Citicorp's proposed acquisition was designed to "evade" the nonbanking provisions of the Act, it was unnecessary to make the determination concerning the contention that nonbanking and insurance provisions of the Act do not apply to holding company banks).
imposed some limits on a state's discretion to define bank insurance powers. What those federal limits on state power might be is not clear. *Merchants National's* passing reference to *Citicorp* as involving "purposeful evasion" indicates only that the degree or scope of the state authorization for insurance or other non-traditional activity is a relevant factor that the Board will consider.

A comparative overview of state banking regulations indicates that the statutes in question in *Citicorp* and *Merchants National* represent the end and middle of a wide spectrum of state-granted bank insurance powers. Of states with measures addressing bank insurance powers, South Dakota's legislation authorizing state institutions to engage in "all facets of the insurance business" on a nationwide basis (but with strict limits on intrastate activities) is the broadest and most controversial. Indiana law, allowing the "solicitation and writing of insurance as agent or broker" for any insurance company authorized to do business in that state (excepting life insurance companies) represents a regulatory middle ground, as do the statutory provisions of several other states. In four states, along with South Dakota, state-chartered banks are permitted to engage in insurance underwriting. Fourteen states, by following the national bank rule allowing banks to sell insurance only in towns with populations of less than

---

72. The Board stated in the second *Merchants National* order that: [A] bank holding company that controls an institution that qualifies as a "bank" under the definition in the Act is not required, in order to acquire or retain the shares of the institution, to limit the institution's activities to those permitted under the closely related to banking standard of section 4 (or one of the other limited exceptions in the Act), except where the record demonstrates an evasion of the Act, such as presented in the *Citicorp* (South Dakota) case. *Merchants*, 75 Fed. Res. Bull. at 391 (emphasis added).


76. While the Board's result in *Merchants National* was not based on an "underwriting" and "agency" distinction, the limited nature of the powers granted by Indiana law (beyond the federal standards, but far short of South Dakota's nationwide insurance powers) very likely played a role in the result reached. In the policy debate concerning whether or not banks should enter into the insurance business, a sharp distinction is drawn between banks as "agents" and banks as "underwriters." See Huber, supra note 38, at 149 (1989) (arguing that the brokerage and underwriting distinction should serve as a controlling factor in determining the proper scope of insurance activities of banking organizations).

77. Implications of the *Merchants National* Case: Hearing Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs, 101st Cong., 2d Sess. 75 (1990) (Table included in April 4, 1990 statement of James E. Gilleran on behalf of the Conference of State Bank Supervisors indicating that twelve states allow state-chartered banks to engage in general insurance brokerage activities).

78. *Id.* (Indicating that North Carolina, South Carolina and South Dakota allow banks generally to engage in underwriting, while Delaware and Utah grant grandfathered institutions underwriting powers).

79. *Id.*
5,000 people, 80 evade the state powers question by reflecting the BHC Act standard. 81

An alternative approach to the direct bank insurance activity at issue in the Citicorp and Merchants National petitions is indirect involvement through the creation or acquisition of an insurance subsidiary by a holding company bank. Until recently, the express policy of the Board 82 promoted the use of subsidiaries by allowing state banks, through their affiliates, to engage in any activity—without Board approval—that could be conducted by the parent bank directly. 83 Garn-St. Germain’s removal of most insurance powers from the scope of the “closely related” exception of the BHC Act in 1982, and a perception by regulators that further expansion of state powers would completely undermine the nonbanking restrictions of the BHC Act, influenced the Board’s proposal in 1988 to rescind state bank authority to acquire operating subsidiaries without Board approval. 84

The complexity of the bank-insurance subsidiary question is illustrated by the recent AMBAC case 85—the catalyst for the Board’s rescission proposal. The AMBAC case arose out of a challenge by the American Insurance Association to an interpretive letter of the Comptroller of Currency 86

80. The scope of the National Bank Act provision, 12 U.S.C. § 92 (1988), allowing insurance agency activities for national banks in towns with populations of less than 5,000, has been the subject of considerable debate. The Office of the Comptroller of the Currency (OCC) has adopted the position that the market area for the sale of insurance under the rule is not geographically restricted. The only restrictions are that (1) the office out of which the insurance product is offered be located in a town with a population of less than 5,000 persons, and (2) the bank not sell insurance for a company to customers in a state where the insurance company is not authorized to do business. Comptroller Staff Interpretive Letter No. 366, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,536 (Aug. 18, 1986). This interpretation of § 92, known as the Comptroller’s loophole, is currently being challenged by the National Association of Life Underwriters, an insurance industry trade group. See M. Capatides, A GUIDE TO THE CAPITAL MARKETS ACTIVITIES OF BANKS AND BANK HOLDING COMPANIES 247 (1990).

81. Exemption C of the Garn-St. Germain Act amended the BHC Act to include an insurance agency exception for banks located in small towns with populations of less than 5,000. 12 U.S.C. § 1843(c)(8); 12 C.F.R. § 225.25(c)(8)(iii) (1990).

82. The Board’s policy was to allow state banks to acquire wholly owned operating subsidiaries without Board approval under the BHC Act so long as the wholly owned company engaged only in activities that could be conducted directly by the state bank. Rescission Proposal, 53 Fed. Reg. 48,915, 48,916 (1988). The Board’s state bank operating subsidiary rule, 12 C.F.R. § 225.22(d)(2)(ii) (1990), was adopted in 1971, 36 Fed. Reg. 9292, to allow competitive equality between independent and holding company banks and because there was no evidence that acquisitions were resulting in “evasions” of nonbanking restrictions. Rescission Proposal, 53 Fed. Reg. at 48,916.


84. Id. at 48,915.


approving Citibank’s proposed acquisition of the American Mutual Bond Assurance Corporation (AMBAC). The Comptroller had approved the acquisition on the ground that AMBAC’s guarantee insurance on low-risk municipal bonds was functionally equivalent to issuing a standby letter of credit, a traditional banking activity. Additionally, and more important for analytical purposes, the Comptroller also concluded that even if the service amounted to an insurance activity, the operation of AMBAC could be approved because the nonbanking limitations of section four of the BHC Act are, by means of section 4(c)(5), not applicable to the operating subsidiaries of national banks. The Comptroller determined that the relevant limitations on banking powers, with respect to nationally-chartered banks, are found in the National Bank Act, not the BHC Act.

The Court of Appeals for the D.C. Circuit disagreed with the second ground that the Comptroller had advanced in support of the determination that the BHC Act’s nonbanking provisions were inapplicable. Concerning the BHC Act issue, the court initially determined that Citibank, as a subsidiary of a bank holding company, fell within the general restriction of section 4(a)(1) and therefore could acquire AMBAC only after receiving Board approval under the “closely related” standard of section 4(c)(8). On rehearing, the court held that the nature of AMBAC’s guarantee insurance was a question appropriate only for the Board’s consideration, and vacated its earlier findings concerning the BHC Act.

In the wake of the uncertainty left by the AMBAC case, the Board proposed to rescind the provision of Regulation Y that permits a state
bank owned by a bank holding company to acquire, without Board approval, any nonbank company that engages in activities permissible under state powers, even if the activity is prohibited under the BHC Act. Approval of this proposal, reversing a regulation that has been in place for nearly twenty years, would significantly expand the regulatory domain of the Federal Reserve Board by extending the meaning of "holding company activity" to include the activities of the operating subsidiaries of holding company banks. Such a result, while consistent with a strict reading of part of the language of the Board's *Merchants National* order, would significantly reduce both the amount and the breadth of *banking* activity under state control.

III. Is the State Door Half Open or Half Closed?

Because the regulation of insurance has long been recognized as primarily within the domain of state regulators it is perhaps not surprising that

---


100. While *Merchants National* makes a sharp distinction between *nonbank* subsidiaries and *bank* subsidiaries it expressly avoids disclosing the Board's views concerning whether § 4 provisions cover the activities of operating subsidiaries of state banks. *Merchants*, 75 Fed. Res. Bull. at 395.

101. In December 1988 the Board requested public comment on whether § 22(d)(2)(ii) of Regulation Y, 12 C.F.R. § 225.22(d)(2)(ii), "continues to be valid and appropriate in light of" the Garn-St. Germain Act and the AMBAC decision. *Rescission Proposal*, 53 Fed. Reg. 48,915. While an informal public hearing was held on the proposal on April 7, 1989, the Board has yet to determine whether it will adopt the proposal and thereby rescind the state-bank subsidiary rule. The Board is scheduled to determine what, if any, further action will be taken on the proposal in October of this year. *Id.*

Despite the fact that the bank operating subsidiary rule remains in effect, a recent ruling by the Federal Reserve Board ordering a Citicorp subsidiary to suspend its insurance activities indicates that the rule is to be narrowly construed. Narrow construction of the rule, like the proposal for rescission, reinforces the direct/indirect distinction of the *Merchants National* order. In its September 5, 1990 order the Board directed Citicorp to force Family Guardian Life Insurance Company, a subsidiary of Citicorp's Citibank Delaware subsidiary, to suspend any insurance activities not permitted under § 4(c)(8). The Board's decision came in response to a challenge by the Alliance for the Separation of Banking and Insurance to Citicorp's attempt to take advantage of a recently-enacted Delaware statute which allows state-chartered banks to sell insurance through a separate division, department or subsidiary. The Board concluded that even though Delaware's statute "on its face . . . authorizes state-chartered banks to provide a full range of insurance services . . . the . . . practical effect of the Delaware statute is to sanction expanded insurance activities only for an entity that in substance is a separate corporation and that is not a bank." *Fed Orders Citicorp Subsidiary to Rein in Insurance Activities*, 55 Banking Rep. (BNA) 363 (Sept. 10, 1990). While banking industry trade groups were highly critical of the Board's decision, they did not believe the order undermined the *Merchants National* decision authorizing direct insurance activities. *Id.* at 364.

some power, as illustrated by the *Merchants National* order, has been reserved to the states to define the scope of permissible insurance activities for the banks they charter. However, as the *Citicorp* order illustrates, the federal deference is limited. In the context of bank holding companies, there is an absence of authority addressing whether state banking powers are actually reserved to the states, or whether such powers are the result of federal deference and therefore subject to preemption. Continued adherence to the *direct* and *indirect* standard of *Merchants National* would indicate that the powers are reserved—consistent with principles of dual power. Expansion of the "evasion" rationale represented by *Citicorp* would suggest a strong federal hand in maintaining the commerce-banking distinction, at the expense of state powers. Passage of the rescission proposal, dictated by the initial AMBAC decision, would enhance the power of the Federal Reserve Board to reach operating subsidiaries of banks, yet would affirm the idea of reserved state powers by excluding direct state bank activities from the scope of the BHC Act.

In evaluating the merits of recent positions taken by the courts and regulators, it is important to distinguish the political debate from the legal debate and to note that the states have played a central role in the development of the nation's banking system. What are now perceived as basic fixtures of the financial marketplace—branch banking, real estate lending, trust department operations and transaction accounts—were originally the experimental innovations of the states. The dual system of banking has long been valued for its ability to strike a balance between innovation and safe and sound banking practices. Given the present demands on financial institutions to compete across both state and national lines, the need for innovation in the dual banking system remains compelling.

---

the Act reads in part:

The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance.

15 U.S.C. § 1012(a), (b).

For support of the argument that state banking powers are subordinate to federal powers, see Butler & Macey, *The Myth of Competition in the Dual Banking System*, 73 CORMEL L. REV. 677 (1988); see also Statement by Paul A. Volcker, *supra* note 2, at 202 (emphasis in original) ("[I]t should be clear that new powers [to state-chartered institutions] . . . that clearly . . . violate the basic separation of commerce and banking . . . can be curtailed or overridden by the appropriate federal authorities.").

104. See *supra* note 62 and accompanying text.


Because the vast majority of state banks are affiliated with holding companies, the resolution of issues concerning the reach of section four of the BHC Act is very much a reflection of the viability of the dual banking system. If state powers are, by nature, reserved powers, state banks are restricted primarily by the law of the state granting their charter and are generally free to ignore the strict limits on insurance activities imposed on bank holding companies by the Garn-St. Germain Act. If state banks in a holding company are at present simply the beneficiaries of federal deference, then dual banking, like federalism in other contexts, is "reduced to [a] weak essence." \[107\] All exercises of power beyond the scope of national standards would be subject to federal preemption. All that is clear at present is that bank holding companies can diversify their services through state banks, beyond federal limits. How far they can be allowed to go beyond federal limits is not clear.

**CONCLUSION**

Against the backdrop of the Federal Reserve Board's determination in *Merchants National* that the restrictions of section four of the BHC Act do not reach bank subsidiaries of a holding company, the Board's rescission proposal does not close the door on the power of a state bank to engage in insurance activities. While the Board's determination in *Citicorp* did impose limits on state powers, as subsequent developments indicate, those limits are most reasonably viewed as territorial restrictions on a state bank's market, not as strict limits on state discretion. These developments indicate that while a state cannot expand its economic laboratory to national proportions, a state can conduct financial experiments in a limited market without severe federal restrictions—provided that the activities are engaged in directly by the bank and are not inconsistent with safe and sound banking practices. In short, bank holding companies can diversify into nontraditional areas of financial services, beyond federally imposed limits, through state banks—wherever state laws permit.

By recognizing that the language of the BHC Act distinguishes between *control* and *activities* limitations, as well as between *bank* and *nonbank* holding company subsidiaries, the Board has articulated a workable structure that both reserves powers to the states and protects the power of the Federal Reserve Board to define permissible holding company powers. As this Note has shown, the distinction between direct and indirect bank powers dictated the result in the *Merchants National* order and appears to provide an underpinning for the rescission proposal. This distinction promotes dual banking by sharply defining federal and state domains. This reasonably

---

bright line between holding company _bank_ and _nonbank_ subsidiaries eliminates much of the threat posed to dual regulation by the merger of competing state and federal regulatory structures.¹⁰⁸ Additionally, it forecloses the need for administrative and legislative gap-filling to close what were perceived to be jurisdictional loopholes in the BHC Act.¹⁰⁹

The regulatory middle ground on which the Federal Reserve Board now appears to stand, while not protecting the commerce-banking distinction at the state level, is consistent with the deeply-rooted tradition of dual banking regulation. It also affirms, at least indirectly, the long-recognized power of states to regulate and make fundamental policy choices concerning insurance. Whether state banks retain only traditional _bank_ powers, or whether they acquire expanded insurance powers, is a matter properly reserved to the legislatures of the several states. In sum, while adoption of the rescission proposal may partially close the door on state powers by limiting the ability of a state bank to conduct insurance activities through subsidiaries, the Federal Reserve Board has left the door open for state banking authorities to define direct state bank insurance powers. The Federal Reserve Board's present regulatory position—as reflected in _Merchants National_ and the rescission proposal—allows bankers to enter the insurance business, albeit through a back door opened by individual states, rather than through the front door of federal legislation which has gradually limited the power of banks to engage in general insurance activities.

---

¹⁰⁸. Cf. Note, _The Merger of Banking and Insurance: Will Congress Close the South Dakota Loophole?_, 60 _NOTRE DAME L. REV._ 762, 773 & n.77 (1985) (South Dakota law would merge competing regulatory structures into a hybrid scheme of favorable aspects of national and state law contrary to the dual banking system).

¹⁰⁹. Reference to state bank legislation as exploiting a state bank "loophole" in the BHC Act, a "gap" in federal power, improperly characterizes the state powers question by treating state banking powers as essentially competing with Board holding company powers. More precisely, the regulatory issue is the respective domains of complementary authorities.