FEDERAL DEPOSIT INSURANCE CORPORATION

12 C.F.R. Part 332

POWERS INCONSISTENT WITH PURPOSES OF FEDERAL DEPOSIT INSURANCE LAW

AGENCY: Federal Deposit Insurance Corporation ("FDIC").

ACTION: Notice of Proposed Rulemaking.

SUMMARY: The FDIC is proposing to amend Part 332 of its regulations to: (1) subject to certain exceptions, prohibit any insured bank (including insured nonmember banks, national banks, state banks that are members of the Federal Reserve System, insured branches of foreign banks, and federally chartered savings banks insured by FDIC) from directly engaging in the following: underwriting insurance, developing real estate, reinsurance, guaranteeing or becoming surety upon the obligations of others, insuring the fidelity of others, or engaging in a surety business, (2) require any subsidiary of an insured bank that conducts any of the prohibited activities to meet the criteria for a bona fide subsidiary set out in the regulation, (3) require notice to the FDIC of intent to invest in any such subsidiary or become affiliated with any company that engages in such activities, (4) place certain restrictions on the affiliation of an insured bank with a company that engages in any of the prohibited activities, (5) place certain restrictions on extensions of credit and other transactions between insured banks and their subsidiaries or affiliates that engage in any of the prohibited activities, (6) require all insured banks that prior to the publication of this proposal established or acquired a subsidiary or became affiliated with a company that engages in the prohibited activities to conform to the regulation (with certain exceptions) within one year from the effective date of the regulation, (7) require any insured bank that as of the publication date of the proposal is directly engaging in any of the prohibited activities to conform to the regulation within one year of the effective date of the regulation with the exception that ongoing real estate developments may be completed, and (8) exclude a bank's direct investment in a subsidiary that engages in prohibited activities from the bank's consolidated capital.

DATE: Comments must be received by [insert date 45 days after publication in the Federal Register].

ADDRESS: Send comments to Hoyle L. Robinson, Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429. Comments may be hand delivered to and reviewed in Room 6108 between the hours of 8:30 am and 5:00 pm.

FOR FURTHER INFORMATION CONTACT: Pamela E. F. LeCren, Senior Attorney, Legal Division, (202) 389-4171, Robert E. Feldman, Attorney, Legal Division, (202) 389-4171, or Ken A. Quincy, Examination Specialist, Planning and Program Development Branch, Division of Bank Supervision, (202) 389-4141, 550 17th Street, N.W., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION: On November 26, 1984 the Board of Directors of the FDIC adopted a Notice of Proposed Rulemaking soliciting comment on a proposed regulation governing the direct and indirect involvement of insured banks in real estate brokerage and underwriting, insurance brokerage and underwriting, data processing for third parties, travel agency activities, and other financially related services (49 FR 48552 December 13, 1984). The notice set forth a proposed amendment to Part 332 of the FDIC's regulations ("Powers Inconsistent with the Purposes of Federal Deposit Insurance Law"). In brief, that proposal would have: (1) prohibited any insured bank (including insured nonmember banks, national banks, state banks that are members of the Federal Reserve System, insured branches of foreign banks, and federally-chartered savings banks insured by the FDIC) from directly engaging in insurance underwriting, underwriting or developing real estate, reinsurance, insuring, guaranteeing, or certifying title to real estate, guaranteeing or becoming surety upon the obligations of others, insuring the fidelity of others, or engaging in a surety business, (2) required any subsidiary of an insured bank that conducts any of these activities to meet the criteria for a bona fide subsidiary set out in the regulation, (3) required notice to the FDIC of intent to invest in any such subsidiary, (4) placed certain restrictions on the affiliation of an insured bank with a company that engages in any of the prohibited activities, (5) placed certain restrictions on extensions of credit and other transactions between insured banks and their subsidiaries or affiliates that engage in any of the prohibited activities, (6) required all insured banks that established or acquired a subsidiary or became affiliated with a company that engages in the prohibited activities prior to the effective date of the regulation to conform thereto within one year, (7) required any insured bank that as of the effective date of the regulation was directly engaging in any of the prohibited activities to conform to the regulation within two years, and (8) placed certain restrictions on insured banks that provided electronic data processing (EDP) services to persons or companies other than banks, or acted as agent or broker for insurance, real estate, securities, or travel services.

In proposing this regulation the FDIC acknowledged that the environment in which insured banks function is rapidly changing and that traditional boundaries separating "banking" from other "financial services" and from "commerce" are beginning to erode. The FDIC specifically noted in the preamble of the prior Federal Register notice the ever-increasing number of cross-industry acquisitions; the wide array of commercial enterprises affiliating with banks as a result of the "loophole" in the Bank Holding Company Act which permits the phenomenon of the nonbank bank; the expansion by banks into new product markets; and the changes in state law authorizing banks to engage directly, or indirectly through subsidiaries, in activities heretofore not open to banks. As stated in the prior notice, the FDIC monitors developments in the banking industry and related changes in state law

in order to assess the potential impact on bank safety and soundness and on the deposit insurance system.

The proposed regulation was published for a 60-day comment period which closed on February 11, 1985. Five hundred seventeen comments were received over the comment period. An overall summary of comments is set forth below. Upon consideration of the comments, the FDIC has determined to issue a revised proposed regulation for further comment. The FDIC has also determined to hold a one-day public hearing on the proposal the details of which are set forth in a notice of hearing published elsewhere in today's Federal Register.

Comments Addressing Insurance Activities (Brokerage and Underwriting)

The FDIC received a total of 81 comments that addressed whether insured banks should be permitted to directly or indirectly engage in insurance activities. The majority of the comments addressing this issue were from insurance agents, insurance trade associations, or insurance companies. The majority of these comments were opposed to any bank entry into any aspect of the insurance industry. The concerns of this group related to: express or implicit tying arrangements; potential conflicts of interest inherent in banks conducting insurance activities; potential slackening of credit standards in reliance on insurance issued by a bank's subsidiary; and banks having an unfair competitive advantage due to their status as grantors of credit.

A significant minority of comments addressing insurance activities (approximately 20%) were from banking organizations. While a few banks expressed concerns similar to the ones noted above, most banks supported bank involvement in insurance activities. These banks indicated that they have engaged in such activities (as permitted by state law) and, in their experience, insurance activities have not created any safety and soundness problems. Supporters of bank insurance activities were nonetheless critical of the proposed regulation for the following reasons: (1) the regulation would disrupt established activities that have been safely conducted over a number of years; (2) insurance powers have generally not been abused nor have supervisory concerns been raised to warrant a broad, restrictive regulation; and (3) compliance with the regulation would generally increase costs to the consumer.

Comments Addressing Real Estate Activities (Brokerage and Development)

The FDIC received approximately 300 comments addressing bank real estate development activities. These comment letters exhibited a pattern similar to that noted above for insurance activities. That is, realty companies and related trade associations opposed any bank entry into real estate activities. The concerns of this group were: (1) express or implicit tying arrangements; (2) potential conflicts of interest inherent in banks conducting real estate activities; and (3) banks would have an unfair competitive advantage because they are grantors of credit and have tax advantages not available to independent real estate firms. These comments did, however, support the bona fide subsidiary requirement; placing limitations on the volume of business financed by the parent bank; establishing a prohibition on

joint advertising; prohibiting the use of bank customer information for the purpose of soliciting real estate business; and requiring separate accounting and recordkeeping. One national association did generally support the proposed regulation (especially the bona fide subsidiary requirement) as preferable to the patchwork of state laws that currently govern bank real estate investment activities.

The comments received from banks were supportive of bank involvement in real estate activities, but critical of the proposed regulation. Banks that have historically had real estate powers or that recently obtained such powers were particularly critical of the bona fide subsidiary requirement as an expensive form of organization and as actually weakening the bank's control over real estate activities. Many comments felt that the existing limitations in state authorizing statutes were sufficient to control any risk to the institution. These comments cited the historical lack of safety and soundness problems associated with bank real estate activities as an argument against a broad regulation and argued that in any event, the FDIC has adequate enforcement powers to deal with potential problems on a case-by-case basis.

Comments Addressing Travel Agency Activities

The FDIC received 144 comment letters from travel agencies or related organizations opposing any bank involvement in travel agency activities. The concerns of these comments were: (1) bank travel agencies have a competitive cost advantage due to any funding received from the bank; (2) bank travel agency customers may erroneously assume deposit insurance affords some additional protection in the purchase of tickets; (3) travel agency activities are not incidental to the conduct of a banking business; and (4) travel agency activities may have a potential negative impact on banks.

Comments Addressing Electronic Data Processing Services

The FDIC received one comment letter addressing banks providing electronic data processing services. The comment indicated that although there are no safety and soundness considerations regarding such services, a prohibition on tie-ins would be reasonable. The comment objected to the requirement in proposed section 332.8 concerning the remission of commissions to the bank.

Alternative Approaches

In addition to the comments discussed above, the FDIC received many comments suggesting alternatives to the proposed regulation. Dropping the rule in its entirety was one alternative proposed by those who perceived the rule to encourage banks to enter into unfamiliar areas which would not only jeopardize bank safety but would, in some cases, result in unfair competition. The FDIC cannot emphasize enough that neither the original proposal nor the revised proposal is in any way an authorization for banks to enter into the activities at issue. Nor is the regulation properly characterized as an attempt to encourage banks to do so. The proposal is simply a recognition that the authority granted insured banks by their respective chartering authorities may create a need for the FDIC to establish appropriate safety and soundness limitations to govern the exercise of those powers.

Several comments suggested that the FDIC calculate insurance assessments on a risk-related basis in lieu of adopting the proposal. The FDIC has for some time favored implementation of an insurance assessment system based on risk. However, the current system for assessing all insured banks equally on a straight percentage basis was established by Congress and can only be changed by legislation. (It should be noted that the FDIC has sought legislation which will permit risk-related assessments, see S. 760 and H.R. 1833.)

Other comments requested that the FDIC not act on the proposal but let Congress resolve the issues involved. Congress can, of course, adopt the course it deems best for the nations's banks. Until such time as Congress directs otherwise, however, the FDIC is bound to enforce the provisions of the Federal Deposit Insurance Act relating to safety and soundness and those provisions relating to the protection of the deposit insurance fund in the way it deems best through its accumulated expertise.

Still other comments urged the FDIC to rely on its cease-and-desist authority to address problem situations on a case-by-case basis rather than adopting a regulation that would be generally applicable to all banks. The FDIC fully intends to utilize its section 8 authority whenever appropriate on an individual enforcement basis. As discussed more fully below, however, in view of among other things, the nature of the activities involved and the related risks to the functioning of the deposit insurance system, the FDIC has determined that it is appropriate to establish standards by way of regulation designed to prevent problem situations before they occur.

Some comments while agreeing that there is a need for the FDIC to address the risks presented by the activities covered by the regulation, urged the FDIC to adopt guidelines rather than a formal regulation. The FDIC has rejected that suggestion as well; the abuses that the FDIC is seeking to have banks avoid and the related safety and soundness and deposit insurance concerns are of sufficient magnitude that a binding regulation establishing enforceable standards is appropriate. Additional comments suggested that the FDIC follow the approach adopted by the Federal Home Loan Bank Board ("FHLBB") in its recently issued regulation governing the direct investment powers of institutions insured by the Federal Savings and Loan Insurance Corporation ("FSLIC"). If authorized by applicable law, FHLBB-regulated institutions are permitted thereunder to exercise certain investment powers to a threshold amount which may be exceeded with FSLIC's prior approval. Presumably these comments favor such an approach as it seems to be more flexible than the FDIC's original proposal. As described below, the FDIC's revised proposal permits insured banks, where authorized under applicable law, to (1) engage directly in real estate development up to the limits contained in section 332.3(b)(2)(i), (2) underwrite life insurance and annuities pursuant to the conditions contained in section 332.3(c)(2)(i), and (3) issue guarantees and act as surety pursuant to section 332.3(a)(2)(i). By permitting FDIC-insured banks to conduct these activities in-house, the FDIC is proposing an approach analogous in some respects to that recently adopted by the FHLBB.

Statutory Authority

Many of the comments asserted that the application of the proposed regulation to all insured banks exceeded the FDIC's statutory authority. Generally, the comments fell into two groups: (1) those contemplating that the application of the proposed rule to state-chartered institutions is an undue infringement on the regulatory power of the states under the dual banking system, and (2) those contemplating the application of certain aspects of the proposal to insured banks other than insured state nonmember banks is an infringement upon the regulation of national banks by the Comptroller of the Currency, state member banks and bank holding companies by the Board of Governors of the Federal Reserve System, and federal savings banks by the Federal Home Loan Bank Board.

The FDIC has reviewed and considered all of these comments and after doing so continues to believe that the proposed rule is within the FDIC's authority. The FDIC has broad general authority to issue regulations "as it may deem necessary to carry out the provisions of the [Federal Deposit Insurance Act] or of any other law which it has the responsibility of administering or enforcing . . ." 12 U.S.C. 1819 Tenth. It is settled that binding legislative-type rules based on general rulemaking authority may be issued so long as the rules are reasonably related to the purposes of the enabling legislation containing the general rulemaking authority. Mourning v. Family Publications Services, 411 U.S. 336, 369 (1973) (quoting Thorpe v. Housing Authority of the City of Durham, 393 U.S. 268, 280-281 (1969)). Despite criticism to the contrary, the proposed regulation does not strain to further a purpose of the Federal Deposit Insurance Act ("FDI Act"). On the contrary, one need look no further than the preamble of the legislation placing federal deposit insurance on a permanent basis to discover the nexus between the proposed rule and the FDI Act. The preamble states that the Banking Act of 1935 was "[t]o provide for the sound, effective, and uninterrupted operation of the banking system . . ." Pub. L. No. 74-305, 49 Stat. 684 (1935). The clear goal of the FDI Act as demonstrated by the express language of the statute and its legislative history is to protect the safety and soundness of insured banks. The ability of a federal bank regulatory agency to make, based on general rulemaking authority, regulations in harmony with safety and soundness concerns was judicially recognized long ago. Continental Bank and Trust Company v. Woodall, 239 F.2d 707, 710 (10th Cir.), cert. denied, 353 U.S. 909 (1957). Inextricably connected therewith is the safety and soundness of the deposit insurance fund, Federal Deposit Insurance Corporation v. Citizens State Bank, 130 F.2d 102, 104 n.6 (8th Cir. 1942), and the FDIC's authority to protect the fund. Section 11(f) of the FDI Act is a Congressional mandate that FDIC pay insured deposits whenever a bank is closed "on account of inability to meet the demands of its depositors." 12 U.S.C. 1821(f). The FDIC, therefore, must preserve the solvency of the insurance fund in order to fulfill its mandate when called upon.

Even more importantly, the FDIC "protects the medium of payment from disruption caused by bank failure." H.R. Rep. No. 1792, 88th Cong., 2d Sess. 3 (1964). The recent failure of a state deposit guarantee fund to preserve public confidence in itself clearly demonstrates that financial havoc can result from the loss of public confidence. In order to preserve public confidence in the banking system on a national scale, it is clear that the

FDIC must protect the insurance fund. The Senate Committee on Banking and Currency has recognized that the FDIC's supervisory responsibilities do in fact relate to actions having "a direct bearing on its role as insurer." S. Rep. No. 1821, 86th Cong., 2d Sess. 3 (1960). The Board of Directors has determined that this proposed regulation relates directly to the FDIC's role as insurer, and that it will help preserve public confidence in the banking system. Furthermore, the FDIC's interpretation of its own statute is entitled to great weight. Jones v. FDIC, 748 F.2d 1400, 1404 (10th Cir. 1984) (citing Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 557 (1980)); see also FDIC v. European American Bank & Trust Co., 576 F. Supp. 950 (S.D.N.Y. 1983). This deference is particularly appropriate in defining unsafe and unsound banking practices since the courts have recognized that "[o]ne of the purposes of the banking acts is clearly to commit the progressive definition and eradication of such practices to the expertise of the appropriate regulatory agencies." Groos National Bank v. Comptroller of the Currency, 573 F.2d 889, 897 (5th Cir. 1978); First National Bank of LaMarque v. Smith, 610 F.2d 1258, 1265 (5th Cir. 1980).

In addition to the FDIC's general rulemaking authority, the FDIC in taking this action is relying upon sections 8(a) and 6 of the FDI Act. Section 8(a) of the FDI Act provides that the FDIC may involuntarily terminate the deposit insurance of any insured bank which has engaged or is engaging in unsafe or unsound practices or is in an unsafe or unsound condition. 12 U.S.C. 1818(a).Section 6 sets forth six safety and soundness concerns[1] which must be satisfied in order for deposit insurance to be granted.[2] (12 U.S.C.

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[1]Those concerns are the following:

> The financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the convenience and needs of the community to be served by the bank, and whether or not its corporate powers are consistent with the purposes of this Act.

[2]Several comments noted that deposit insurance is automatic for national banks (when commencing business) and state member banks (when becoming a member of the Federal Reserve System) upon certification by the Comptroller and the FRB, respectively, of satisfaction with the factors enumerated in section 6, 12 U.S.C. 1814(b). These comments argued that, therefore, any concerns FDIC might have about the factors in section 6 are limited to insured state nonmember banks. The certifications made by the Comptroller and the FRB, however, must comport with the standards of analysis adopted for the six factors by the FDIC. The former two agencies cannot establish the standards to be followed in section 6 but, rather, must adhere to those established by the FDIC. That this could not be otherwise is clear because the FDIC bears the insurance risk. Additionally, under section 8(a), the FDIC can terminate the deposit insurance of any insured bank in an unsafe and unsound condition. It would be self-defeating for the Comptroller and the FRB to apply standards to the certification process unacceptable to the FDIC as the FDIC would merely step in and terminate insurance.

1816). Specifically, section 6 requires the FDIC to consider "whether or not [the bank's] corporate powers are consistent with the purposes of this Act." Therefore, while it may be clear that a bank's powers are conferred by its chartering authority, there can be no doubt that the FDIC is required by the FDI Act to consider fully whether or not those powers are consistent with the FDI Act and that it is the role of the FDIC to define those purposes.

The FDIC has the authority to promulgate regulations pursuant to sections 8(a) and 6 that are reasonably connected to furthering bank safety and soundness and preserving the insurance fund. See Mourning, supra. The fact that section 8(a) literally deals with a particular type of proceeding is no bar to relying on that provision of the FDI Act as authority for the proposed regulation. Any analysis of authority rests only on the reasonableness with which the regulation furthers the purposes of sections 8(a) and 6. The regulation accomplishes this by decreasing the need for involuntary termination proceedings against banks engaged in the activities prohibited thereunder, i.e., activities that would violate the standards of section 6 and jeopardize the deposit insurance fund. This preventive approach to ensuring safety and soundness and preserving the fund has a reasonable nexus with FDIC's general rulemaking authority and the stated purposes of the FDI Act.

The FDIC cannot be expected to proceed solely on a case by case basis. Cf. Independent Bankers Association v. Heimann, 613 F.2d 1164, 1169 (D.C. Cir. 1979), cert. denied, 449 U.S. 823 (1980) (Comptroller entitled to accomplish his regulatory responsibilities over unsafe and unsound practices by rules as well by cease-and-desist proceedings). The FDIC must have the ability "to forewarn by specifying and clarifying the nature and scope of [its] concerns" in order to "minimize the necessity for recurrent and costly investigation into the conduct" of insured banks. Id. The FDIC has the right to choose between rulemaking and adjudication in eradicating unsafe and unsound banking practices that threaten the viability of the deposit insurance fund. Although several comments asserted that the FDIC could not promulgate regulations based on section 8(a), no comment has mentioned any compelling evidence--nor is there anything compelling in the FDI Act or its legislative history--that would limit the FDIC's power to its enforcement function or prevent the FDIC from making that function more effective through rulemaking. The FDI Act establishes the FDIC as an administrative agency, not solely as an administrative court passing on whether to terminate insurance. Congress gave the FDIC extensive powers of inquiry and investigation (see 12 U.S.C. 1820(b), (c), and the power to publish reports of insured bank noncompliance with FDIC recommendations, id. 1828(f), as well as the power to terminate insurance). It is therefore plain that Congress did not wish to limit the FDIC to a judicial method of legal administration by precluding preventive measures other than enforcement proceedings.

The FDIC's authority is also supported by considerations of fairness and practicality. See National Petroleum Refiners Association v. Federal Trade Commision, 482 F.2d 672, 683 (D.C. Cir. 1973), cert. denied, 415 U.S. 951 (1974). This seminal case held that the Federal Trade Commission could police "unfair and deceptive" practices through rulemaking or through enforcement proceedings. The FTC's authority to implement its mandate over "unfair and

deceptive" acts or practices is "closely analogous" to a federal banking agency's role with respect to unsafe and unsound banking practices. Heimann, 613 F.2d at 1169. Rulemaking, according to the National Petroleum Refiners decision, engenders fairness by putting an entire segment of society on notice of how the agency will act in the future. 482 F.2d at 682. It permits the public to participate in the process of establishing the rule, unlike the adjudicatory process. Rulemaking also is practical in that it can prevent increased numbers of termination proceedings against banks encountering difficulties. (The FDIC's "heavy and profound regulatory responsibilities" cannot be disrupted by an entirely preventable increase in its enforcement caseload. See Investment Company Institute v. FDIC, 728 F.2d 518, 526 (D.C. Cir. 1984).

Some comments argued that the exception clause of section 9 "Tenth" of the FDI Act which limits the Board of Directors' authority to issue regulations "to the extent that authority has been expressly and exclusively granted to any other regulatory agency," 12 U.S.C. 1819 Tenth, removes the authority from the FDIC to adopt these regulations. The exception clause does not remove the FDIC's authority to adopt regulations with respect to state-chartered banks even if those regulations conflict with state laws. Validly promulgated FDIC regulations clearly preempt any state law to the contrary. See Fidelity Federal Savings Bank v. de la Cuesta, 458 U.S. 141 (1982); Conference of State Bank Supervisors v. Conover, 710 F.2d 878 (D.C. Cir. 1983). In fact, the FDIC has long prohibited insured state nonmember banks from doing a surety business, insuring the fidelity of others, insuring, guaranteeing or certifying titles to real estate, and guaranteeing or becoming surety upon the obligations of others. 12 CFR 332. With respect to real estate and insurance activities, the FDIC cannot be accused of overriding state laws in the many states that do not permit such activities. Even in those states where such activities are permitted, the FDIC is simply prescribing procedures for their safe and sound conduct which procedures may or may not be more restrictive than procedures established by state law. For example, California-chartered commercial banks may have direct real estate investments not to exceed the total shareholders' equity in the bank (Cal. [Fin.] Code § 751.3). With respect to national banks, state member banks, federal savings banks, and insured branches of foreign banks, the Board of Directors believes that the authority to issue regulations governing the safety and soundness of such entities with a mind toward protecting the FDIC's paramount interest in the deposit insurance fund has nowhere been expressly and exclusively delegated to the Comptroller of the Currency, the FRB, or the Federal Home Loan Bank Board. Nonetheless, the proposed regulation does not address areas of activity to which the latter three agencies have already spoken. Currently, national banks and state member banks may not engage in real estate development, insurance underwriting, or reinsurance activities. By the same token, FDIC-insured federal savings banks also may not directly engage in such activities except to the extent that they were authorized to do so under state law prior to their conversion to federal charters. See 12 U.S.C. 1464(i)(5). The FDIC's regulation of such grandfathered activities is not inconsistent with federal law as the FDIC has the retained authority, as clearly demonstrated above, to prohibit unsafe and unsound practices. The FDIC's proposed regulation does not conflict with the recently-issued FHLBB regulation governing the regulation of direct investment by FSLIC-insured

institutions because that regulation specifically excludes FDIC-insured federal savings banks from its scope. (50 FR 6,912). Although FHLBB is the primary regulator of FDIC-insured federal savings banks, FDIC's paramount interest in preserving its insurance fund is again a sufficient nexus to give FDIC the ability to provide for the safety and soundness of such institutions. This is especially the case where FHLBB is silent on the issue of investment powers with respect to Federal savings banks while imposing safety and soundness guidelines on all other FHLBB-regulated, but FSLIC-insured, institutions.

Finally, the proposed regulation's provisions on affiliation and on restrictions on transactions with affiliates do not interfere with the FRB's regulation of bank holding companies and their nonbank subsidiaries. Those provisions of the proposed rule would apply solely to the insured banks in furtherance of safe and sound banking practices. No regulation of the affiliate (i.e., bank holding company or nonbank subsidiary) is involved; only the insured bank is within the ambit of the regulation.

Bases for Concern

Real Estate Development

The FDIC believes there is a strong factual basis for regulating real estate development activities by insured banks. This belief arises from the nature of real estate development activities as well as from more general distinctions that can be made between equity investments and lending activities.

Risk Comparison of Equity Investments vs. Lending. It is more risky to make equity investments in any given industry than it is to make loans to individuals or business entities engaged in the same types of activities. Traditionally, in our economic system, investors have been risk takers fully aware of the rewards and losses which can accrue as a result of their decisions. Lenders, on the other hand, have traditionally made an effort to minimize risk. While loans can be very risky, they are often repaid in full even if a project shows no profit or a negative profit. Returns to equity investments, however, are dependent upon the eventual success of a project. A project that does not show a profit can result in a total loss for the equity holder. Moreover, real estate projects offered to financial institutions for direct investment are likely to be riskier than projects for which straight loans are sought, since developers will be less willing to share the rewards to equity provided by their "best" investments. A recent study based on a sample of Texas-chartered savings and loan institutions lends further support to the view that real estate equity investments by financial institutions generally have greater risk than real estate loans.[3] In recognition of the

[3]J. Crockett, C. Fry & P. Horvitz, Equity Participation in Real Estate by Savings and Loans: Implications for Profitability and Risk (University of Houston 1985).

fact that equity investments are likely to be riskier than loans, the FDIC traditionally has not permitted banks to make equity investments. To the extent that equity investments in real estate are permitted by state law, the proposal would limit a bank's exposure, in the aggregate, and with respect to any one investment.

Cyclical Nature of Real Estate Markets. Beyond the general distinctions that can be made between loans and equity investments, there is sufficient evidence of riskiness in real estate development itself to warrant concern. One needs only to look at the current vacancy rates for office buildings (See Chart 1), apartments and commercial buildings in major cities across the country to see the risks inherent in real estate development activities. Downtown office vacancy rates in Houston, Denver, Dallas and Los Angeles as of year-end 1984 were 20.9, 23.7, 17.2 and 11.8%, respectively, while the suburban vacancy rates in these same metropolitan areas were even higher.[4] Apartment vacancy rates are up to 20% in Houston, 11.2% in Phoenix, 9% in Dallas-Ft. Worth, and 24% in Denver. In Oklahoma City, apartment owners are offering free trips to Hawaii in an effort to work off inventory.[5] The nationwide mortgage banking firm of Lomas & Nettleton projects that a rental oversupply will arrive in Atlanta, Austin, Orlando and Tampa within a year. The time lag between initial construction and the final completion of real estate development projects may contribute to the cyclical nature of the real estate markets since projects often are initiated when markets are strong, but completed after they have weakened. (See Charts 2 and 3 for evidence of the cyclical nature of real estate markets.)

The real estate downturn of the mid-1970s caused serious distress for many financial institutions which were creditors for real estate projects, difficulties which would have been even greater had they had equity positions in the underlying properties. By March 1976, at least 32 savings and loan associations with aggregate assets of $10 billion had service corporations with serious real estate problems. Real estate losses were contributing factors in the failures of five S&Ls with aggregate assets of over $700 million during the mid-1970s.

The virtual collapse of the REIT industry during this period presented similar problems for commercial banks. For the three-year period ending December 31, 1977, the 20 largest banking companies had charge-offs on loans to REITs in excess of $750 million. While there were differences in the overall

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[4]Coldwell Banker, Office Building and Real Estate Data (1985).

[5]How Tax Laws Pushed Apartment Builders into Overdrive, Business Week 124 (May 13, 1985).

portfolios of the various REITs in existence at this time, in the aggregate their most important investment category was short-term development/ construction loans. Many real estate developers had difficulty repaying these loans as interest rates rose and construction costs steadily increased during the mid-1970s. For REITs this created cash flow problems and a large number of bankruptcies.

While the financial problems of S&Ls and REITs during the mid-1970s can be partly attributed to the cyclical nature of the real estate market, there were several other reasons for their problems, which help illustrate some of the reasons why more direct bank participation in real estate-related activities could increase overall bank risk. One major problem, highlighted during Congressional hearings on the REIT issue, was that unrealistic property appraisals were made in numerous cases, which resulted in loan to value ratios that were often greater than 100 percent.[6] While fraud can be involved in inflated property values, inexperience and poor judgment are more often the underlying cause of problems due to inaccurate real estate appraisals. The appraised value of a property should be the present value of the net cash flow stream. To give just one example of how an inaccurate appraisal may arise, if the so-called appraised value was based on the gross sellout value, which did not take into account sales expenses, taxes, etc. and did not bring the cash flow back to a present value figure, the appraisal could easily be overvalued by 50% or more. There are a number of other legitimate appraisal methods which may create problems when applied in the wrong situations.[7]

The FDIC has found numerous cases where inappropriate appraisal methods have led to large losses for financial institutions. This illustrates that the inexperienced real estate investor is much more apt to run into financial difficulty than is the experienced investor. Since direct investment in real estate is an area in which many banks would have to be considered inexperienced, pitfalls that arise for the experienced real estate investor (due to the natural riskiness of the activity) would be magnified for banks participating in this area.

Another risk that would be inherent for most banks that engaged in direct real estate investment is that it would be difficult for banks to diversify their risks geographically. This was also pointed out during Congressional testimony as a factor contributing to the real estate problems of depository

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[6] Real Estate Investment Trusts and the Effect They Have Had and May Be Expected to Have on the Banking System: Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 297 (1976) [hereinafter cited as Hearings].

[7] These include: appraisals based on a valuation "when completed and occupied on a fully stabilized basis" when a project is not completed or fully stabilized; valuations based on sales at "typical terms" when such typical terms are not carefully specified; "in use" valuations when a property is out of use; and valuations based on "the highest and best use".

institutions in the mid-1970s.[8] The values of local real estate investments are strongly correlated, since they are dependent upon the same economic factors. Since many banks operate within relatively small geographic markets, they would find it difficult to diversify their risks. Banks that do attempt to diversify these risks by obtaining out-of-territory loans face a different type of risk due to their inexperience in real estate markets outside their own territory.[9]

There are other potential pitfalls that await depository institutions as relatively new entrants into the equity market for real estate. One aspect of real estate markets which elevates their potential riskiness is the inefficiency created by information gaps. While millions of active traders and frequent transactions keep stock prices near their "true" (realizable) values, the thinness of real estate markets makes them more prone to pricing errors. Knowledge about a given property is likely to be highly specialized and costly to obtain because there may be a mere handful of potential buyers having true interest in a property's value at any given time. Further, few transactions involving similar, neighboring properties may have transpired in the recent past so that buyers and sellers have little guidance as to what prices are "realistic." Locating those who have the best information may be difficult, especially if the potential buyer (or seller) is not familiar with the local real estate market, and the high cost of obtaining adequate information creates a significant probability that uneconomic purchases and sales will be made. This problem is compounded by the need to diversify real estate investments geographically for safety purposes. Real estate investors must look to markets about which they have little first-hand knowledge, and this exposes them to the information problems just discussed.

Another safety and soundness concern is that real estate investments are not liquid. In periods of economic distress when cash flow considerations are most likely to necessitate selling the asset, it might be particularly difficult to liquidate the asset.

Empirical Evidence. A number of studies offer additional factual evidence of the risks inherent in real estate-related activities. These studies utilize several methods for examining the risks real estate activities pose for banking organizations.[10] One method is to compare an activity's variability of earnings and failure rate with those of banks. A second method is to look at the effect of diversification on a banking organization's cash flow. The

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[8] Hearings, supra note 6, at 297.

[9] See Banks Warned to Avoid Risky Real Estate Swaps, American Banker, May 2, 1985, at 1, col. 2, for a view on one type of problem that can arise from the purchase of out-of-territory real estate loans.

[10] The discussion of methods that can be used in measuring risk is taken largely from L. Wall & R. Eisenbeis, Risk Considerations in Deregulating Banking Activities, Federal Reserve Bank of Atlanta Economic Review 6, 12-13 (May 1984).

second method accounts for the fact that some "risky" activities can actually reduce risk by reducing the variability of the combined organization's cash flow. This would occur if the "risky" activity produced most of its cash flow when bank cash flow is weak but produced little when a bank's cash flow was strong. In such a case the combined cash flow would be less variable than either of their individual flows. One way to examine the diversification effects is to look at the level and variance of earnings of banking and other activities, and then look at the correlation between those earnings. Equity investments in real estate could reduce bank risk if either (1) the earnings from a nonbank activity are less volatile than in banking, or (2) earnings from the nonbanking activity are negatively correlated with those of banking. A bank's risk could increase if it engages in financial activities that have more volatile earnings than banking and whose returns are highly correlated with banking. The studies reviewed in the following paragraphs discuss measures of variability of earnings and correlation in examining the risks equity investments in real estate may pose to banks. While none of the studies alone provides conclusive evidence that a bank's real estate equity investment activity should be placed in a bona fide subsidiary, in the aggregate these studies, along with the additional evidence presented in this section, present a strong case in favor of the FDIC's proposed regulation.

Wall and Eisenbeis (1984) examined annual returns from 1970 to 1980 and found that exposure to real estate could have posed significant risks to banking institutions over this period.[11] Two types of evidence supported this conclusion: comparisons of earnings variability between banking and real estate-related activities, and measures of the correlation between annual real estate earnings and bank returns. The ratio of net income to assets was used to measure earnings for both activities, and data were drawn from the real estate and banking subsidiaries of U.S. bank holding companies. Individual holding company data were aggregated to obtain measures of average industrywide earnings for banking and (each of) several real estate-related functions. The authors used these industrywide averages to calculate statistical measures of relative risk.

Relevant findings from this study are summarized in Table 1. The measures of earnings variability ("coefficients of variation") show that five of the six real estate activities examined had more variable earnings than banking over the sample period. Moreover, the correlation measures ("coefficients of determination") show that the earnings of all but one real estate function were positively and strongly correlated with bank returns during the 1970s. This suggests that a strong move into real estate investments could have aggravated the volatility already present in a "typical" bank's earnings during this period. The combined earnings of all individual real estate activities ("All Real Estate" in Table 1) were significantly more variable than bank returns in the sample and showed a strongly positive coefficient of

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[11] Id. at 6-19.

Table 1

Risk Measures: Aggregate Bank Holding Company Data, 1970-1980

Type of Activity	Coefficient of Variation	Coefficient of Determination
Real Estate Operators, Lessors of Buildings	.200242	+.645042
Condominium Management and Co-op Housing Associations	.542500	+.928662
Lessors of Mining, Oil, etc.	.434163	+.370005
Subdividers and Developers	.306568	+.560607
Lessors of Railroad Property and Other Property Not Allocable	.124316	-.36543
Other Real Estate	.184351	+.310724
All Real Estate	.216494	+.605346
Banking (Banks, Trusts, and Mutual Savings Banks)	.173503	+1.0

Notes: Data are annual, constructed from the Corporate Source Book of Income which uses federal tax returns to compute firms' profits. Coefficient of variation measures the variability of earnings and is thus indicative of the risk of the activity by itself. Coefficient of determination measures the correlation of the activity's earnings with bank earnings and thus measures the degree of portfolio risk that the activity may bring to banks. A coefficient of determination of +1.0 means that the activity's earnings oscillate exactly as bank returns do, and inclusion of the activity in a bank's portfolio would increase the amplitude of swings in bank returns, i.e., banks receive no diversification benefits from such an investment.

Source: Wall and Eisenbeis 15 (1984).

determination. Such evidence indicates that, from 1970 to 1980, even a bank whose real estate interests were well-diversified by type of activity may not have been able to avoid a substantial increase in earnings volatility as a result of its exposure to real estate.

Boyd, Hanweck, and Pithyachariyakul (1980) also examined rate-of-return variability in real estate and banking.[12] Two different methods of measuring this variability (i.e., standard deviation) were used for annual data spanning the 1971-77 period. The first method followed that of most other studies and used industrywide average rates of return to compute a standard deviation statistic for each industry (e.g., real estate and banking). A standard deviation thus compiled was called an "industry statistic." The second method initially computed a rate-of-return and its standard deviation for each individual firm. These statistics were then pooled into (unweighted) averages to derive a measure of the industry's rate-of-return variation. Standard deviation statistics computed in this manner were called "individual firm" statistics.

Both methods used data collected from bank holding company subsidiaries. Individual firm statistics reflected intra-industry (inter-firm) variability in rates-of-return while industry statistics did not. The standard deviation of an individual firm's rate-of-return received no weight in industry statistics, because earnings were aggregated before any standard deviation was computed. Individual firm statistics provided a broader measure of risk by incorporating the entire spectrum of individual performances and then weighting them equally to represent the industry's rate-of-return variation.

Both measures employed in this study suggest that real estate returns were vastly more variable than bank earnings over the sample period. Table 2 reveals that the "industry" standard deviation for real estate returns was 182 times as large as the analogous measure of variability for bank earnings. Similarly, the "individual firm" statistic suggests that real estate returns were 62 times more variable than bank returns during this six-year period. In a separate exercise it was shown using "industry" data that the correlation coefficient between real estate returns and bank returns over this period was +.8322. The coefficient constructed from individual firm data appeared weakly negative at -.1383. While the alternative measures disagree as to the diversification benefits available from real estate investment, the weight of the evidence appears to favor a positive correlation of returns. At best, the individual firm data suggest a weak offsetting of bank earnings variability by real estate returns, while the industry data indicate that the diversification benefits available to banks through real estate investment were negligible. When these findings are combined with Table 2's evidence, the summary statistics indicate a strong possibility that real estate investment would raise the risk exposure of commercial banks.

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[12] J. Boyd, G. Hanweck & P. Pithyachariyakul, Bank Holding Company Diversification, Proceedings of a Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago 105-121 (1980).

Eisemann (1976) used monthly rate-of-return data to investigate earnings volatility in many different industries.[13] Rates of return were calculated

Table 2

Risk Measures: "Industry" and "Individual Firm" Methods
(1971-77 annual data)

	Standard Deviations for Rates of Return	
	Industry	Individual Firm
Leasing, Land, Real Estate	.0728	.0802
Commercial Banks	.0004	.0013

Notes: Rates of return are defined as the ratio of after tax profits to total assets.

Source: Boyd, Hanweck and Pithyachariyakul (1980), 118-19.

from indices of stock market performance and thus reflected the investor's point of view. Dividends and capital gains rather than corporate profits per se were the primary elements in the rate-of-return calculation. Rates of return for individual firms were aggregated and weighted by the firm's share of the industry's market value in order to obtain an "industry" rate of return. Monthly data from December 1961 to December 1968 were compiled for the analysis and standard deviations were computed on the basis of the aggregate (industry) rates of return.

[13] P. Eisemann, Diversification and the Congeneric Bank Holding Company, Journal of Bank Research 68-77 (Spring 1976).

The results using monthly data corroborate the findings of annual studies. For banking, the standard deviation of returns was .04578 over the sample period, while three real estate-related industries showed substantially greater earnings variability: returns to land development, leasing, and property management had standard deviations of .10710, .09060, and .13044, respectively. Hence, the average "risk" associated with real estate investments was more than twice as great as the banking risk reflected in monthly standard deviations.

Sirmans (1984a and 1984b) examined the components of risk in a hypothetical portfolio which included direct investment in real estate.[14] In addition to real estate, the assets comprising the assumed portfolio included commercial loans, fixed and adjustable rate mortgages, and Standard and Poor's 500 Index Fund. Two alternative indices were used to measure quarterly rates of return to real estate. The first index reflected net operating income from apartments, hotels, shopping centers, industrial plants and office buildings plus any quarterly changes in the appraised values of such properties. The alternative measure reflected actual market rates of return to a popular real estate investment trust (REIT) index fund. Rates of return were calculated as the ratio of dividends plus capital gains to beginning-of-quarter share prices. Quarterly yields on the portfolio's other assets were also obtained for the sample period, 1978:1 to 1984:2, and these were used to construct a set of "efficient portfolios" for each real estate index. (An "efficient" portfolio contains the unique mix of assets that would have maximized expected returns over the sample period for a given level of risk exposure (standard deviation). The efficient set shows one such portfolio for each conceivable level of risk.

This exercise revealed that increases in real estate investment would have entailed major increases in portfolio risk for a wide range of portfolio compositions. For both measures of real estate returns, the standard deviation of portfolio earnings rose steadily as real estate's share of the asset composition was increased. Expected returns also rose with real estate's share of the portfolio, but modern portfolio theory suggests that this effect may have been due precisely to real estate's greater riskiness (as compared to that of displaced assets). Because each of the real estate indices has different deficiencies which could mask the true variability in returns, the broad agreement of these measures on the nature of real estate risk over the sample period suggests that volatility was clearly present in the rate-of-return data of 1978:1 to 1984:2.

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[14] G.S. Sirmans, Deriving a Thrift Institution's Efficient Frontiers in Constrained and Unconstrained Environments, Office of Policy and Economic Research, Federal Home Loan Bank Board (Nov. 29, 1984a) and Reestimation of a Thrift Institution's Efficient Frontiers, Office of Policy and Economic Research, Federal Home Loan Bank Board (Dec. 10, 1985b).

Crockett, Fry and Horvitz (1985) interviewed the top management of several large Texas S&L's in order to examine the nature of risk inherent in "typical" real estate ventures which have been conducted by these financial institutions.[15] While expanded powers granted to Texas S&L's have afforded them an opportunity to use direct real estate investment as a diversification tool, the authors did not draw the general conclusion that the risk-reducing benefits of diversification have been fully realized:

> For example, Texas S&L's are mainly interested in taking positions where projects will be sold and profits will be realized in a few years. Over a relatively short horizon, many of these projects, which produce little if any cash flow and lack liquidity, may be unfavorably affected by an increase in interest rates (pp. 17-18).

The inference is that, although recent opportunities for financial institutions to invest directly in real estate have permitted a reduction of risk through greater diversification, such powers also have been used imprudently to elevate risk exposure. This judgment is supported by several recent failures of thrift institutions which regulators have linked to real estate dealings. Even without benefit of these latest experiences, Crockett, Fry and Horvitz were able to detect from interviews that operative diversification strategies at some financial institutions were potentially inadequate to safely accommodate real estate investment:

> If thrifts are to become more involved in equity investment in real estate, an effort should be made to insure that projects are chosen not only on the basis of the riskiness of the individual investment, but on the basis of its contribution to the risk of the portfolio as a whole (p. 18).

On balance, past experience and current practice suggest that financial institutions frequently lack effective internal controls for limiting real estate exposure.

Current Real Estate-Related Problems. All of the above-mentioned studies suggest that real estate-related activities are riskier than a bank's traditional activities and could increase bank risk. It is worth noting that much of this evidence was for a period of time (i.e., the 1970s) that was characterized by generally high inflation. If anything inflation helps to improve the earnings prospects of real estate investments since land values increase with inflation. During the latter part of the 1970s it is almost certain that inflation was responsible for the profitability of many real estate ventures. What this suggests is that, since a noninflationary environment currently prevails, it may not be as easy to obtain profits from real estate ventures as it was in the past.

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[15] Crockett, Fry & Horvitz, supra note 3.

Indeed the FDIC is currently faced with a large number of banks with problems that are primarily due to real estate investments. While these are not equity investments, since the large majority of FDIC-insured institutions are not authorized to engage in direct real estate investments, they indicate the problems the real estate market is experiencing and the greater problems banks may incur should they be permitted to make equity investments in real estate without the protection afforded by a bona fide subsidiary and other restrictions put in place by the rule.

In addition to the problems banks are experiencing with their real estate portfolios, the Federal Home Loan Bank Board has indicated that many of the savings and loan institutions that it insures are experiencing asset-quality problems due to equity investments in real estate. The FHLBB noted in its final rule on regulation of direct investment by institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) that the recent failures of San Marino Savings and Loan and Empire Savings and Loan were caused primarily by real estate equity investments. 50 FR 6,912, 6,918. The FHLBB estimates that its losses as a result of these two failures may exceed $400 million.

In an internal memorandum circulated December 10, 1984 and released to the public in connection with its final rule on direct investments, the FHLBB provided examples of numerous other problem institutions that may fail due to their direct investments in real estate activities. The following example presents a typical case.

> Institution A
> Problem: Funds were used for speculative real estate development and construction loans and condo conversion loans. These loans were actually direct investments and many were made that exceeded net worth. Loans were often funded at 99% of value as based upon inflated appraisals and in fact far exceeded the actual value of the security property.
> Losses: Reappraisals indicate losses of over $30m, well in excess of net worth.
> Net Worth: At period of greatest growth, it declined from a positive to a substantially negative net worth because of poor asset quality.

There have been more recent examples of savings and loan institutions that are failing or near failing due primarily to poor real estate investments as reported in the press. To illustrate the events of a single week, on Monday, April 22, 1985 the American Banker highlighted the real estate-related problems of Shoreline Savings Bank in California; while on the same day another California S&L with problem real estate transactions, Beverly Hills Savings and Loan Association, was taken over by the FHLBB.. The April 23 issue of American Banker included an article on the real estate loan problems of Coronado Federal Savings and Loan Association in Kansas. On April 26th, the Wall Street Journal described the "high-risk real estate development loans" of Sunrise Savings and Loan Association of Florida, while on the same day the New York Times brought attention to the real estate losses of Bell

Savings and Loan Association in San Mateo, California. As many articles pointed out, real estate losses are expected to spread among other S&Ls because many of these troubled thrifts were active sellers of participations nationwide.

A further indication of the concern federal bank regulators have regarding equity investments in real estate by depository institutions, is that the Federal Reserve Board also has indicated its support for rules limiting direct investment in real estate by depository institutions. The Chairman of the Federal Reserve, Paul Volcker, indicated in a letter to Edwin Gray, Chairman of the Federal Home Loan Bank Board that:

> The Federal Reserve shares your concern about the risks the heavy investments in certain types of assets [including real estate] imply for depository institutions; our own experience supports your evaluation of such risks. In addition, our staff concurs with the assessment of your staff about the conclusions presented by consultants hired by opponents of the proposed rule: neither the facts nor the analysis presented by consultants are sufficient to justify the finding that real estate and equity investment does not increase the risk of loss to thrift institutions.
>
> The Federal Reserve Board shares your view that ultimately the cost of excessive risk taking by these institutions must be borne by the federal insurance agencies and the public. We are currently reviewing steps that might be taken to limit such activity within a bank holding company system, and we support your efforts to impose prudent restraints on investment activity by those state-chartered institutions insured by the FSLIC that have been granted increasingly broad asset powers.

Limits on Direct Investments in Real Estate. Despite these reasons for concern, the risks posed to insured banks from real estate investment can be controlled by ensuring adequate diversification. While geographic diversification can reduce a bank's overall exposure, real estate returns in different markets are subject to many of the same factors. Thus it is appropriate to set a limit on a bank's aggregate real estate investment. Moreover, the FDIC feels that it is more appropriate to determine this limit as a percentage of a bank's capital than as a percentage of total assets, as it is a bank's capital that provides a buffer against losses. The proposed regulation would thus allow banks to engage directly in real estate development provided that the bank's equity investment in any one real estate development does not exceed 10% of primary capital and its total equity investment in real estate does not exceed 50% of capital. While there is some arbitrariness in any specific percentage limit, a limit set at 50% of primary capital is justifiable, since under such a limit a bank's real estate exposure alone could not cause a bank to fail. (The FDIC specifically requests comments on whether these limits are too high or too low.) Under a worst-case scenario a bank may lose 50-60% of its real estate investment, in which case it would not lose more than 25-30% of its capital.

While the benefits of diversification are a well understood principle of financial theory, a study commissioned by the FHLBB gave additional support to this notion as well as to the FDIC's view that limits are more appropriately expressed as a percentage of capital than as a percentage of assets. An outside consulting firm contacted persons knowledgeable in the field of investment risk analysis who were also familiar with the U.S. thrift industry to see whether there was consensus on the effect of the FHLBB's proposed regulation on the risk to the FSLIC. The persons interviewed included representatives of insurance rating companies, investment banks/brokerage houses, lending institutions (banks), academia, accounting firms, and fund management companies. Of the 21 respondents, 19 stated that the proposed limit on aggregate direct investment would reduce risk to FSLIC as compared with no limitations. Moreover, the judgment predominating among the experts was that the aggregate direct investment limit should be tied to net worth rather than total thrift assets.[16]

If a bank wishes to engage in real estate development on a broader scale, the FDIC proposal indicates that (1) it must do so indirectly through a bona fide subsidiary, and (2) any investment in such a subsidiary will not be counted toward the bank's regulatory capital. The exclusion of a bank's investment as part of regulatory capital and the use of a bona fide subsidiary as defined in this proposal ensure that the bank is sufficiently isolated from risks posed by real estate development activities over and above the limit set for direct investment. While there is always room for abuse and thus some possibility of loss to the bank as a result of the actions of a subsidiary, corporate law makes it quite clear that in the absence of fraud or willful deceit banks and their bona fide subsidiaries would be separate legal entities, and one would not be held liable for the actions of the other.[17]

Insurance Underwriting

When looking at the riskiness of bank involvement in insurance activities it is essential to distinguish between different types of insurance (particularly between the life/health and property/casualty sectors) and between underwriting and brokerage activities. Historically banks have had a long involvement in insurance brokerage activities. As early as 1916 national banks were authorized to act as insurance brokers in order to ease the strain on profit margins for banks operating in small towns (with a population of 5,000 or less). Such activity is quite prevalent to this day, generally in Midwestern states, and it has not caused safety and soundness problems for banks. Insurance brokerage activities have been repeatedly authorized for

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[16]SRI International, Possible Regulations of the FHLBB to Limit Direct Investment of State Chartered, Federal Insurance Savings Associations, December 1984.

[17]Samuel Chase & Co., Corporate Separateness as a Tool of Bank Regulation (Washington, D.C. 1983).

banking organizations at the federal level under the National Banking Act, the Bank Holding Company Act, and reaffirmed most recently in the Garn-St Germain Depository Institutions Act of 1982.

Bank participation in insurance underwriting activities has largely been confined to life insurance. National banks generally are restricted to the underwriting and sale of credit life insurance. Savings banks in New York, Connecticut and Massachusetts have engaged in life insurance underwriting activities for the past 50 years (in Massachusetts, for the past 100 years) and there is no evidence that safety and soundness concerns have arisen for these banks due to their insurance activities. With respect to property/casualty insurance, however, banks historically have been largely prohibited from engaging in such activities. Thus, they have no particular expertise in this area.

The limited experience banks have in underwriting insurance (other than life insurance) is an important factor in the FDIC's belief that these other insurance underwriting activities be conducted in a separate bona fide subsidiary apart from the bank's non-insurance activities. It is generally recognized that new activities pose greater risks than activities in which the participants are more experienced. The FDIC has observed this with respect to banking as newly-chartered banks have higher failure rates than do more well-established and hence, more experienced, banks.[18]

Certainly, insurance underwriting must be viewed as an area where banks lack expertise, since the nature of the activity is very different from traditional bank activities. Bankers and insurers essentially have different attitudes toward risk. Insurance underwriting is risk taking and it is assumed that losses will materialize in a certain percentage of transactions. In banking, credit decisions are made with less of an expectation that losses will materialize. This difference between banking and insurance underwriting was noted by the Federal Reserve Board in 1974 when it denied applications submitted by BankAmerica Corporation and First National City Overseas Investment Corporation to engage in general insurance underwriting activities overseas through subsidiary investments. In denying the applications the board noted:

> General insurance underwriting involves the management of risk qualitatively different from those encountered in ordinary banking and familiar to bank management. It is an activity that requires a large amount of capital and specialized managerial resources.

Other factors partly responsible for the high risk banks will face as new entrants to the insurance underwriting business are the high startup costs and the limited opportunity, even for the largest banks, to leverage profitability upon their existing customer base. The latter factor is particularly relevant

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[18] J. Bovenzi & L. Nejezchleb, Bank Failures: Why Are There So Many?, FDIC Economic Outlook 21-22 (Aug. 1984).

in the property and casualty field because of the individualized nature of the insurance product and the differing needs of a diversified commercial bank clientele. Many banking organizations would find it difficult to achieve a prudent level of risk diversification if they chose to offer only selected insurance lines to an existing, localized customer base.Also, the FDIC's concern about the lack of experience banks have in most types of insurance underwriting activities is heightened given current market conditions in the insurance industry. Bank entry into property and casualty underwriting, for example, should logically enhance competition, and benefit insurance customers. In the current insurance environment, however, it would be difficult for a new entrant to build the market share necessary for prudent diversification without engaging in some price cutting. Bank entry would not, in and of itself, generate any significant volume of new property and casualty business and, by competing for an existing insurance customer base, could serve to lower margins for all underwriters. An additional danger is that the competition for high quality insurance clients could become quite intense with the new (bank) entrants attracting a relatively high proportion of marginal risks and subsequently experiencing relatively high underwriting losses.

Presently, the property and casualty sector of the insurance industry is suffering from a number of problems. Net income for property and casualty companies in the aggregate has been declining since 1980, and is likely to show a net loss for 1984. Underwriting losses have been incurred annually since 1979. Currently, there are a number of individual property/casualty companies facing financial difficulties. There are 124 firms on the National Association of Insurance Commissioners' "red flag" list of financially weak insurers and 15 firms failed during 1984. (There are about 3500 property and casualty insurers in the U.S.) Industry analysts project that as many as 200 additional property and casualty insurers may fail, merge with other institutions or drop the majority of their product lines during the waning stages of the present underwriting cycle.[19] The Insurance Information Institute has projected that when the figures are in for 1984, they will show that the property and casualty sector of the insurance industry posted a negative net income of about $3.6 billion.

The early 1984 figures from the giant firms of the industry reflect continuing difficulties in underwriting operations. For example, Cigna Corporation posted a $929 million underwriting loss on revenues of $11 billion through the first nine months of 1984. Aetna Life and Casualty reported a $45 million loss on commercial lines alone over the same period. In short, these figures suggest that underwriting performance continues to suffer from the same malaise that has persisted since 1978.

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[19] Insurers Are Scrambling to Break Their Losing Streak, Business Week 145 (Dec. 3, 1984).

One of the factors responsible for the industry's poor performance in recent years is the operation of a periodic "underwriting cycle" in property and casualty insurance. Historically, profitable periods of any significant length have led to periods of premium-cutting and relatively lax underwriting standards by property and casualty firms intent on enlarging their market shares. Prior to about 1978, the completion of an entire underwriting cycle took roughly 6 to 8 years: 3 to 4 years of price discounting and falling profitability followed by 3 to 4 years of firmer standards which ultimately would return profitability to underwriting. A.M. Best Co. identifies 6 such underwriting cycles between 1924 and 1976.

The presence of periodic downturns in the financial condition of the insurance industry has adverse implications for banks that wish to participate in the market and lends further support to the FDIC's contention that insurance underwriting activities should be conducted in a bona fide subsidiary rather than in the bank itself. While the current downturn may be nearly completed (although this is not certain), future downturns are inevitable and it is also likely that these downturns will be severe enough to force a number of firms, particularly newly-established insurers, into bankruptcy.

The downturn in the previous underwriting cycle, which ended in 1976, was not as prolonged as the current downturn, but it too was quite severe. For the five-year period between 1972-76, underwriting losses for property and casualty insurers amounted to $8.17 billion. The fifth largest automobile insurance firm in the country, Government Employees Insurance Co. (GEICO), was nearly forced into bankruptcy in 1976. Only a bail-out by the nation's other major property and casualty insurers and a transfusion of cash from stockholders saved the company from insolvency. At the time there was widespread concern that should GEICO fail, a domino effect could occur, resulting in failures throughout the industry. The domino effect would have been due to the fact that property and casualty insurers that operated in states where GEICO did business would have had to contribute to the state's insolvency fund, which is used to meet claims against an insolvent company. While the impact on individual companies was unclear, there were a number of other property and casualty insurers experiencing financial difficulties at that time and a number of additional failures may have resulted.[20]

There is no reason why similar problems may not occur in the future. GEICO's financial troubles were largely attributed to its aggressive efforts to increase its market share by cutting its prices. As pointed out, such premium cutting and the tendency to ease underwriting standards when profits are relatively high are the reasons why underwriting cycles exist, since these actions eventually lead to higher losses.

In addition to the existence of underwriting cycles, a second factor which may have contribued to the industry's current problems is the intense competition that has followed in the wake of recent financial deregulation. The potential threat of new entrants to the insurance industry may have prompted a more

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[20] Seeking Money for GEICO, Business Week 98 (Mar. 29, 1976).

aggressive attempt at market-share expansion than otherwise would have been undertaken, and this may account for much of the large underwriting losses of the 1980s.

A third factor impacting insurers, which is likely to persist in the years ahead, has been the recent increase in the incidence of litigated liability claims and the huge increase in the average size of awards handed down in such cases. A decidedly greater willingness to sue for damages emerged among liability claimants during the 1970s and has persisted to date. This has been accompanied by an apparently increased acceptance of the "compensatory justice" principle by juries and judges alike. While it is difficult to distinguish causes from effects among these developments, the result for insurers clearly has been an enlarged number and magnitude of liability payments. Highly publicized cases involving claimants' exposure to asbestos, toxic wastes and harmful drugs are representative of the huge claims becoming commonplace to property and casualty insurers, and even a single award can pose persisting financial difficulties for the insuring firm. For example, while Aetna Life and Casualty collected no premiums for liability on the Dalkon Shield after 1977, it has paid (along with the producer) more than $315 million since that time in settlements of liability claims. With respect to claims filed by workers exposed to asbestos, in 1982 alone, insurers paid an estimated $400 million in legal fees attempting to avoid payment on these claims.[21] Potential liability estimates vary between $5 billion and $38 billion over the next 30 years in compensation costs alone. Litigation costs may exceed total compensation by four times, placing the total cost estimate between $25 and $190 billion.[22] The widespread emergence of similar cases has increased the severity of the present underwriting downturn and extended its duration.[23]

These examples of the large losses an insurer may incur from a single event provide a further indication of the differences between banking and insurance underwriting. In banking, an institution's potential losses are generally limited to the amount it has lent or invested. This is not the case for insurance underwriters. Total insurance coverage is a more appropriate indicator of an insurer's maximum potential loss, and unlike banking, an insurer's risk exposure is far greater than its total assets. In this sense,

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[21]J. Kalcalik et al., Costs of Asbestos Litigation, (Santa Monica, California: The Rand Corporation, Institute for Civil Justice).

[22]A. Cornish, Asbestos Liability: A Problem of the Future Becomes a Current Reality, Industry Comments (New York: Lehman Brothers Kuhn Loeb Research).

[23]While these examples do not necessarily indicate problems inherent in the property and casualty sector of the insurance industry, they do point to the potential for large losses and the risks inherent for individual firms within the industry.

while a capital-to-assets ratio may provide an indication of a bank's risk exposure, the same measure would seriously understate an insurance underwriter's exposure. For these reasons the FDIC is concerned that, should property and casualty insurance underwriting activities be conducted within the bank itself, the potential losses to the deposit insurance fund would be much greater. In effect the FDIC potentially would be liable for losses from a failed bank's insurance activities, but it would not be collecting additional insurance premiums to offset its greater risk exposure.

Another factor that can partially explain the unprecedented persistence of reported underwriting losses in the present cycle is the extraordinarily large number of catastrophic occurrences. Catastrophe losses for 1979 and 1982 were the largest ever incurred (annually) in the property and casualty industry ($1.6 and $1.5 billion, respectively). These record losses largely were attributable to severe weather. Moreover, it appears that 1983's weather-related losses ultimately may prove to be even greater. Hurricane Alicia will generate payments exceeding $1 billion -- the largest single disaster settlement in history. The 1982-83 catastrophe claims also coincided with the depletion of deferred tax credits available to many property and casualty firms and, hence, the subsequent ability to cushion underwriting losses has been undermined.

Additional evidence supporting the proposition that most insurance underwriting activities would increase bank risk can be obtained by looking at failure rates and statistics on the variability of earnings. The average failure rate for property and casualty insurers has been approximately .22 percent per year since 1969. This compares to a .14 percent annual failure rate for commercial banks. Using failure rates as a measure of risk suggests that the underwriting of property and casualty insurance would add to the riskiness of banks. The same measure of risk would also suggest that underwriting life insurance would be a relatively safe activity for banks since, between 1976 and mid-1983 only four life insurers failed. (There are currently about 2100 life and health insurance firms operating in the United States.) Historically, failures of life insurance firms appear to be concentrated among small firms and often these firms appear to have been managed by persons of dubious integrity.

Using the standard deviation of the annual return-on-equity as a measure of relative riskiness it again seems clear that underwriting property and casualty insurance could increase bank risk, while life insurance underwriting could reduce it. From 1970 to 1980 the coefficient of variation for the annual return on assets for property and casualty insurers exceeded .40, compared to 0.17 for commercial banks and 0.10 for life and health insurers.[24] The relative safety of life insurance underwriting is not surprising given that, unlike most other types of insurance, losses can be actuarilly determined in advance with a very high level of precision, and premium rates can be set accordingly.

Aside from the additional risks insurance underwriting activities would present to banking operations, a general requirement that all insurance

[24] Wall and Eisenbeis, supra note 10.

underwriting activities be separated from an insured banks other activities is justifiable for accounting and regulatory reasons. Insurance companies, like banks, are highly regulated and overall regulatory costs will be lower if there is separate recordkeeping and accounting. Moreover, since accounting standards are different for the two industries it would be difficult to analyze the condition of the combined entity or each respective part if financial records for insurance and banking activities were not kept separate. For example, compared to banks, insurance firms are heavily capitalized. As of year-end 1983, FDIC-insured banks had an average capital to assets ratio of 6 percent. In the life/health sector capital was 7.1 percent of assets as of year-end 1983, and the analogous figure for property and casualty insurers was 26 percent. The larger capital ratio for property and casualty insurers mainly reflects the greater unpredictability of their earnings and the larger risk of catastrophic loss. The nearly self-funding nature of life insurance policies makes capital and reserves less important to these insurers.

Each provision of the revised regulation is discussed more fully below. Specific comments have been summarized where relevant to the explanation of the proposed regulation.

1. PROHIBITED ACTIVITIES

The regulation as originally proposed would have prohibited any insured bank from directly conducting the following activities: (1) underwriting casualty insurance, property insurance, life insurance (other than credit life), annuity contracts, mortgage guarantee insurance, or any other type of insurance, (2) reinsurance, (3) real estate development, real estate syndication, real estate equity participation, or any other form of real estate underwriting, (4) insuring, guaranteeing, or certifying title to real estate, (5) with certain limited exceptions, guaranteeing or becoming surety upon the obligations of others, and (6) conducting a surety business. These activities would not be prohibited, however, to a bona fide subsidiary of the bank. The prohibition did not apply in the case of any such activity if the activity was one that was authorized by statute, regulation, or interpretation to a national bank or an operations subsidiary of a national bank, (i.e., any insured bank could directly conduct that activity).

A significant portion of the total comments on the proposed regulation was directed to the prohibition on the above activities and the requirement that any subsidiary of an insured bank that engaged in the activities be a bona fide subsidiary. Many of those comments addressed these restrictions in terms of the definition of the term "bona fide subsidiary" as proposed by the FDIC. (These comments will be discussed in paragraph #2 below.) After reviewing the comments, the FDIC has determined to revise this portion of the proposal as more fully described below. In addition, the FDIC has deleted the national bank activity exclusion; in that regard several comments argued that it was inappropriate for the FDIC to fail to regulate an activity simply because the Comptroller of the Currency determined that national banks may, consistent with the National Bank Act, engage in a certain activity.

Real Estate Development

The FDIC received a large number of comments critical of the proposed requirement that real estate development, real estate syndication, real estate equity participation, and any other form of real estate underwriting be placed in a bona fide subsidiary of the bank. The major thrust of the objections was that real estate development requires many of the same skills necessary for real estate development financing and that the risk of loss in real estate development is no different than the risk of loss if the bank were to finance a real estate development. Therefore, the comments argued, the FDIC should not bar insured banks from directly conducting real estate development activities. Among the other objections were the following: (1) the bona fide subsidiary requirement will preclude many small, community banks from engaging in real estate development intermittently or on a small scale (this could deprive the communities in which they are located of development opportunities), (2) the proposal could be read to require real estate activities involving DPC property and other "traditional" real estate involvements on the part of banks to be placed in a bona fide subsidiary, (3) the FDIC has not presented any evidence that there is a need for the FDIC to regulate real estate activities on the part of insured banks, (4) the use of the term "underwriting" in connection with real estate is misplaced and confusing, (5) the proposal will override real estate investment powers recently granted to banks in New York, California and elsewhere, (6) the proposal deprives banks of added income sources in that it permits real estate lending but deprives banks of the opportunity to share in greater potential profits as equity participants, (7) forcing real estate activities into a subsidiary will deprive banks of certain tax benefits otherwise available to them, and (8) with proper management and safeguards, real estate development can be conducted safely in-house. Although the FDIC has retained the basic approach of the original proposal, i.e., requiring a bona fide subsidiary for real estate development activities, a number of revisions are being made to the proposal based upon the above comments. In addition, the prior discussion set forth the bases upon which the FDIC has determined that there is a need to regulate the conduct of real estate activities on the part of insured banks.

The major revision to the bona fide subsidiary requirement insofar as it applies to real estate activities is the inclusion in the proposal of a de minimis transaction exemption which permits an insured bank to conduct a certain amount of real estate development in the bank itself, provided of course that the bank's chartering authority authorizes such activities to the bank. The exemption is limited in the following manner: (1) the bank's aggregate investments in real estate developments, including any related extensions of credit, may not exceed 50 percent of the bank's primary capital, and (2) the bank's aggregate investment in any one real estate development may not exceed 10 percent of the bank's primary capital. Additionally, in order for an insured bank to take advantage of the exemption, the bank must meet the recently adopted minimum capital requirements set forth in section 325.3 of the FDIC's regulations (see 50 FR 11,128). If an insured bank wishes to participate in real estate development activities in excess of these ceilings, the activities must be conducted through a bona fide subsidiary of the bank. Only those activities falling within the definition of "real estate

development" as defined in the revised proposal are counted toward the ceiling. (See paragraph #5 below for a discussion of what constitutes real estate development.)

The de minimis transaction exemption addresses the concerns of comments which argued that real estate lending and real estate development require many of the same skills and that requiring all real estate development to take place in a bona fide subsidiary of a bank (1) precludes small, community banks from being involved in real estate projects on a limited or intermittent basis and (2) effectively preempts state law in those states which have granted bank real estate development powers. The de minimis transaction exemption should afford banks flexibility in structuring real estate transactions. The exemption also lessens, and may in some cases eliminate, any conflict with state or federal law granting real estate powers to banks. At the same time, the exemption is not inconsistent with the FDIC's safety and soundness concerns recounted above. The exemption should not expose banks to undue risks as a bank is subject to an aggregate limit on real estate development and is forced to diversify its real estate investments by virtue of the limit on investments in any one project.

The FDIC is specifically requesting comment on whether or not the ceilings contained in the de minimis transaction exemption should be set at some other level. For example, should the levels be greater than 50 percent of primary capital for the aggregate ceiling and 10 percent of primary capital for the individual project ceiling, or would some lower ceilings be more appropriate? Additionally, the FDIC specifically invites comment on whether or not this exemption exposes insured banks to any undue risks; whether any additional restriction(s) should be imposed in connection with the exemption if it is adopted by the FDIC; and whether any other conditions in lieu of the ones proposed should be utilized. With respect to each of the above, a full explanation of the basis for the comment should be provided.

Insurance Underwriting

The regulation as originally proposed prohibited insured banks from directly engaging in any insurance underwriting activity (other than credit life underwriting). Such activities could take place, however, in a bona fide subsidiary of the insured bank. Most of the comments concerning insurance activities on the part of insured banks addressed insurance agency activities rather than insurance underwriting. Among the comments which did address the latter were several that described life insurance as not inherently unsafe or unsound and further characterized insurance underwriting as compatible with traditional banking. One comment described a life insurer as, in essence, a company that in a manner similar to banks takes deposits (premiums), invests those deposits, and agrees to repay the deposits at a future date with a stated interest. Other comments pointed out that life insurance is not a risky activity as the insurer can predict losses based upon actuarial tables. These comments contrasted life insurance with property and casualty insurance in which the risk of loss is not as capable of prediction. Other comments were opposed to distinguishing between types of insurance underwriting (i.e., all insurance activities should be in a subsidiary of the bank as opposed to in-house), or were opposed to banks entering into insurance underwriting

whatsoever. The latter generally objected to bank entry on competitive grounds (banks would have an unfair competitive advantage), argued that such entry would result in express and implicit tying arrangements to the detriment of consumers, and argued that insurance activities would expose banks to increased risks.

Several comments were received from savings banks in New England that underwrite savings bank life insurance ("SBLI"). Comments regarding SBLI were also received from the Commissioner of the Connecticut Department of Banking, the Commissioner for the Massachusetts Department of Banking and Insurance, and the Superintendent of Banking for the State of New York. All three urged the FDIC to exempt SBLI from the prohibition on direct insurance underwriting. These comments requested the exemption for the following reasons: (1) the savings banks in their respective states have underwritten and/or sold life insurance policies and annuities through a separate department of the bank for many years, (2) the life insurance departments of these banks have been profitable, (3) there has been no demonstrated adverse effect on the condition of these banks due to their life insurance underwriting activities, and (4) the state statutory schemes which authorize savings banks to operate life insurance departments effectively separate the insurance department from the bank. These statutes require that: (1) the assets and liabilities of the insurance department be separate from those of the other departments of the bank, (2) the assets of the bank cannot be used to satisfy the obligations, liabilities, or expenses of the insurance department, (3) the insurance department keep separate records and accounts, (4) the insurance department may not make investments of a type not authorized to the bank, and (5) the insurance department is liquidated separately and does not form part of the receivership if the bank fails (usually the policies are transferred to an insurance department of another bank).

The FDIC also received several comments urging that the agency prohibit insured banks from entering the mortgage guarantee insurance industry for the following reasons: (1) banks will have an unfair competitive advantage, (2) mortgage guarantee insurance requires significant amounts of capital, (3) bank entry into mortgage guarantee insurance is fraught with conflicts of interests that could result in lowered underwriting standards and impact the safety and soundness of banks, and (4) the financial stability of the "captive" mortgage insurer may be jeopardized as its portfolio is more likely to be geographically concentrated. These comments urged the FDIC, at a minimum, to prohibit any insured bank from insuring its mortgage portfolio through its mortgage insurance subsidiary or affiliate. Similar concerns and objections were raised by other comments directed toward bank entry into title insurance.

After reviewing the comments, the FDIC has determined to revise the insurance underwriting provisions of the proposed regulation in one major respect. The revised proposal permits an insured bank to conduct life insurance underwriting through a department of the bank provided that the state or federal statute or regulation which authorizes the bank to operate a life insurance underwriting department establishes certain safeguards as to that department. Those safeguards are: (1) the assets, liabilities, obligations,

and expenses of the insurance department are separate and distinct from those of the other departments of the bank, (2) the assets of the other departments of the bank cannot be used to satisfy the obligations, liabilities, or expenses of the insurance department, (3) the insurance department keeps separate accounting and other records, (4) the insurance department may not make investments not permitted to the bank, and (5) the insurance department is liquidated separately from the other departments of the bank and does not form part of the receivership of the bank in the event of the bank's insolvency.

The remainder of the insurance underwriting provision is unchanged from the original proposal with the exception that the credit life exclusion has been broadened to encompass insurance designed to repay the outstanding balance on an extension of credit in the event of disability or involuntary unemployment. The regulation does not affirmatively prohibit insured banks from becoming affiliated with a mortgage or title insurer or from establishing or acquiring a mortgage or title insurance subsidiary. In the FDIC's opinion the bona fide subsidiary requirement as well as the other restrictions of the proposed regulation adequately address the risks, if any, presented to an insured bank due to the operation of any subsidiary or affiliate that engages in a prohibited activity. It is the FDIC's intent, insofar as any conflicts of interest may arise due to an insured bank indirectly acting as its own mortgage or title insurer through its own subsidiary or affiliate, to address those concerns in a subsequent policy statement.

Even though the separation achieved by the restrictions described above in the case of a life insurance department is not as complete as in the case of a bona fide subsidiary, the restrictions do statutorily separate the insurance department from the remainder of the bank in much the same way. As the bank's assets cannot be used to satisfy the obligations, liabilities or expenses of the insurance department, that department stands as a separate economic entity. If the department suffers extreme losses, the losses should not affect the bank's financial viability. The bank is further protected in that the insurance department may not make investments of a type not otherwise permitted to the bank itself. The FDIC is persuaded by the historical record of the New England savings banks that have underwritten SBLI under the type of statutory schemes exempted by the revised proposal for as long as 50 years (and in the case of Massachusetts for nearly 100 years) that its safety and soundness concerns are adequately addressed to the extent that an insurance department operates under such a statutory scheme. (The FDIC has been informed that no savings bank in New England has ever failed due to, or been adversely affected by, its operation of an SBLI department.) The revised proposal does not contain a similar exemption for other types of insurance underwriting as there is no historical record with respect to property and casualty insurance, etc. In the absence of such a record, the FDIC does not feel that it is appropriate at this time to propose a similar exemption for insurance underwriting in general.

It must be stressed that the FDIC cannot, and has not, authorized any insured bank to engage in mortgage guarantee insurance or any other insurance activity by virtue of this proposal. That authority must come from another source.

The FDIC can, however, as it has done here, evaluate the risks posed to an insured bank by the conduct of insurance activities. The FDIC believes that the insurance activities dealt with by this proposal, if conducted in accordance herewith, will not pose a safety and soundness problem for insured banks. The FDIC has not made any policy decisions on the propriety of a bank's chartering authority authorizing insurance activities. The FDIC has merely proposed certain prudential restrictions in order to protect bank safety and soundness, and the insurance fund.

Guarantor or Surety

The proposed regulation would have, with certain exceptions, prohibited an insured bank from acting as guarantor or surety upon the obligations of others, insuring the fidelity of others, or conducting a surety business. This provision of the regulation has been retained as originally proposed with two exceptions. The revised proposal expressly indicates that the prohibition does not apply to the issuance of standby letters of credit or other similar arrangements, and the exceptions have been expressly set out in the text of the regulation.

The FDIC received several comments from insured banks objecting to the apparent prohibition under the proposal on a bank entering into standby letter of credit arrangements. Inasmuch as it was not FDIC's intent to prohibit such arrangements to insured banks (insured nonmember banks are not now prohibited from entering such arrangements directly, see section 337.2 of the FDIC's regulations) the proposal has been clarified in this regard.

2. BONA FIDE SUBSIDIARY

The basic structure adopted by the proposed regulation prohibited insured banks from conducting certain activities found to present risks. The proposal in turn allowed such activities to be conducted in a bona fide subsidiary of the bank. The FDIC's goal in proposing this regulatory scheme was, and continues to be, to: (1) insulate insured banks from potential risks, (2) avoid regulatory overlap, and (3) make examination of these activities easier. (The FDIC has the authority under section 10 of the Federal Deposit Insurance Act (12 U.S.C. 1820(b)) to examine the affairs of any subsidiary or affiliate of an insured bank to disclose fully the relations between the bank and its affiliate and subsidiary and the effect of such relations upon the insured bank.) The proposed definition of the term "bona fide subsidiary" was designed to assure that any subsidiary of an insured bank that engages in activities prohibited to the bank is an independent, well managed, financially viable corporate entity whose operation will not pose a threat to the bank and whose obligations and liabilities, as well as whose products or services offered to the public, will be perceived by the public to be its own and not those of the bank.

The proposed regulation defined the term "bona fide subsidiary" to mean a subsidiary of an insured bank that at a minimum meets the following criteria: (1) the subsidiary is adequately capitalized, (2) the subsidiary is physically separate and distinct in its operation from the operation of the bank, such physical separation being achieved at a minimum by separate offices clearly

demarcated as belonging to the subsidiary, access to which is through a separate entrance from that used for the insured bank except that the bank's and subsidiary's offices may be accessed through a common outer lobby or common corridor, (3) the subsidiary does not share a common name or logo with the bank, (4) the subsidiary maintains separate accounting and other corporate records, (5) the subsidiary observes separate formalities such as separate board of directors meetings, (6) the subsidiary maintains separate employees who are compensated by the subsidiary, (7) the subsidiary shares no common officers with the bank, (8) a majority of the subsidiary's board of directors is composed of persons who are neither directors nor officers of the bank, and (9) the subsidiary conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are any undertakings on the part of the subsidiary otherwise undertakings or obligations of the bank.

A substantial number of the comments received on the proposed regulation objected to one or another of the criteria used to define bona fide subsidiary. In addition, several comments objected to the bona fide subsidiary approach in and of itself arguing that: (1) placing so called "risky" activities in a subsidiary will not necessarily insulate a bank from risk, (2) none of the activities required by the proposal to be placed in a subsidiary need be relegated to a subsidiary as they do not present any more risks to a bank than many "traditional" bank activities, (3) proper management of any activity is the key as opposed to whether the activity takes place in-house or not, (4) the FDIC would have better oversight of the activities if they were conducted by banks in-house, (5) the costs associated with forming a subsidiary outweigh any perceived benefits, (6) because of a Federal Reserve Board interpretation of the Bank Holding Company Act, the subsidiary requirement will preclude most banks in holding company structures from engaging indirectly as well as directly in real estate development, etc., (7) the subsidiary requirement will have a disproportionate adverse impact on small banks due to the costs involved in forming a subsidiary, and (8) the question of what activities are appropriate for insured banks and whether those activities should be conducted in-house or not should be left to the bank's chartering authority.

After considering these comments, the FDIC has retained the bona fide subsidiary approach. The FDIC has determined that real estate development and insurance underwriting activities can present risks to the viability of insured banks and the insurance fund and further that the subsidiary structure is an appropriate regulatory tool to insulate insured banks from those risks. (See "Bases for Concern" above.) Even though the FDIC has not found the risks to be so great as to warrant prohibiting the indirect conduct of those activities, the risks are such that it is still appropriate to limit a bank's risk exposure by requiring the activities to be in a separate subsidiary or affiliate of the insured bank. Any costs entailed by such an approach are thus, in the FDIC's opinion, justified. (The de minimis transaction exemption

for real estate development activities discussed in paragraph #1 should substantially reduce the number of insured banks that would in fact, in any event, incur such costs.)

One of the criticisms leveled at bank expansion into nonbanking activities has been that a bank will "come to the aid" of its nonbanking subsidiaries or affiliates that are encountering financial difficulties whether or not the bank is legally obligated to do so. There is in fact a basis for concern that this will happen. For example, in 1963 the American Express Company assumed liability for approximately $60 million in claims against its subsidiary American Express Warehousing, Ltd., and, in 1969, United California Bank assumed responsibility for the debts of its Swiss subsidiary United California Bank of Basel, after the Swiss bank suffered large losses. Although this is not always the case (in 1968 Raytheon walked away from its Italian subsidiary which declared bankruptcy), whether or not a bank comes to the aid of its subsidiary or affiliate seems to involve a management decision on the part of the bank. One goal of the FDIC in formulating the proposed definition of bona fide subsidiary is to put insured banks in a position from which they are free to make the decision to walk away. Additionally, the proposed regulation establishes lending and other restrictions (see paragraph #7, 8, and 9) in order to counteract the temptation (to the extent that it exists) on the part of the bank to divert resources to the aid of troubled subsidiaries and affiliates.

The proposed definition of bona fide subsidiary has been retained in the revised proposal without amendment. The criteria necessary in order for a subsidiary to be bona fide and the comments received in response thereto are discussed more fully below.

Adequate Capital

The presence of adequate capital is typically viewed as a central issue by a court when assessing whether or not a parent will be held liable for the obligations and acts of its subsidiary. Adequate capital is also very important from a safety and soundness point of view as a parent bank is less likely to be harmed if the subsidiary has adequate capital. Adequate capital will enable the subsidiary to absorb its losses as well as any liabilities arising from its operation without having to look to its parent.

The FDIC has not proposed a definition of adequate capital but will look rather to industry standards. The insurance industry, for example, is highly regulated and has established capital requirements usually set by state statute. Although the real estate industry is for the most part unregulated in comparison with the insurance industry, industry standards should be identifiable. The FDIC still intends, however, to reserve the option of requiring that the subsidiary have capital over and above any such industry standard if the FDIC at any time finds such requirement to be warranted. It is the FDIC's intention to make this determination during the notice period (see section 332.5 of the proposal) and to inform the bank whether, in the FDIC's opinion, the capital position of the subsidiary is adequate. It is the FDIC's belief that such a flexible approach will better serve the FDIC's

supervisory interest of insuring the safety and soundness of insured banks and that it will also avoid conflict with existing regulatory and supervisory systems governing the insurance and real estate industries. The adequacy of a subsidiary's capital will thereafter be reviewed on an ongoing basis as a part of the regulatory process.

This aspect of the bona fide subsidiary definition received favorable comment.

Physical Separation

The proposed regulation would permit an insurance underwriting subsidiary or real estate development subsidiary of an insured bank to operate out of an office within a branch of an insured bank so long as the office is clearly demarcated as belonging to the subsidiary and the subsidiary's office has a separate entrance from that used by the insured bank. The bank's and subsidiary's offices may be accessed, however, through a common outer lobby or common corridor. The FDIC will require that insured banks, when formulating plans to establish or acquire a subsidiary that will engage in prohibited activities, to plan to locate the subsidiary's offices so as to allow for separate entrances. Any insured bank that presently has such a subsidiary whose operation is located within a branch of the bank will be required to establish a separate, clearly identified office for the subsidiary and make whatever changes are necessary to allow for a separate entrance from the bank except for a common outer lobby or common corridor. This aspect of the bona fide subsidiary definition received some critical comment on the basis that the requirement for a separate facility would create an added, unnecessary cost. The FDIC is retaining this requirement in the definition, however, as a shared facility is a factor considered by the courts in determining whether or not to pierce the corporate veil between a subsidiary and its parent. Additionally, the FDIC strongly feels that any added costs associated with a separate facility are justified by the reduction in potential confusion on the part of the subsidiary's customers as to with whom they are dealing.

Common Name or Logo

The regulation as proposed would prohibit an insured bank and its subsidiary from using a common name or logo. The proposed regulation specifically indicates, however, that the ban on the use of a common name or logo does not preclude a bank from advertising and/or otherwise disclosing the relationship between its subsidiary and itself. For example, bank X may advertise the real estate services of its real estate development subsidiary, Y company, and denote Y company as a subsidiary of bank X. In this way, a bank may still obtain some benefits of name recognition but the public confusion that may arise if the subsidiary uses a common name (especially if that subsidiary operates out of the bank's branch) is lessened.

The FDIC is proposing this restriction as name identification is a factor used by the courts in deciding whether to pierce the corporate veil, is a factor in public identification of the subsidiary's operation with the parent bank, plays a role in public misconception as to the insured status of investments made through the subsidiary, and plays a role in engendering an expectation

that the bank is liable for the obligations of the subsidiary. Additionally, an insured bank may be reluctant to allow its subsidiary to fail if that subsidiary carries the bank's name. (See for example the experience in the 1970's with REITs when banks whose only connection with a REIT was a common name and an investment advisory relationship dramatically increased lending to those REITs when the REIT industry took a downturn.)

Although this portion of the bona fide subsidiary requirement did not receive as many comments as the other factors set forth in the proposed definition, several comments criticized including a ban on common name or logo in the definition. These comments objected to this factor as: (1) a company's name is an asset upon which it should be permitted to trade, (2) the FDIC has not demonstrated that the presence of a common name or logo can adversely affect the safety and soundness of banks, (3) public confusion arises from misleading sales practices and not from the existence of a common name or logo, and (4) the ban on common name or logo serves no purpose not already addressed by other criteria in the bona fide subsidiary definition.

After reviewing the criticism, the FDIC has retained the prohibition on the use of a common name or logo. The FDIC recognizes that the link between a parent and its subsidiary cannot be totally obliterated. It is for this reason that the regulation contains the exception that permits a bank to advertise or disclose its relationship with its subsidiary. Furthermore, although the FDIC agrees that public confusion can and does arise from misleading sales practices (the last item in the bona fide subsidiary definition is designed to meet that concern), public confusion can arise from other sources such as the presence of a common name or logo. For all of these reasons, and the reasons set forth in connection with the prior proposal, the FDIC is convinced that it is necessary to propose a ban on the use of a common name or logo between a bank and its subsidiary that engages in prohibited activities.

Separate Employee Requirement

The proposed regulation requires that the subsidiary maintain separate employees who are compensated by the subsidiary. The restriction does not, however, extend to the use by the subsidiary of bank employees to perform functions which do not directly involve customer contact, e.g., such as accounting, data processing, and recordkeeping, so long as the bank and the subsidiary contract for such services on an arms-length basis.

The FDIC is continuing to propose the separate employee requirement as it is felt that the use of separate employees in customer contact positions is an extremely important factor in maintaining the separate corporate identity of the subsidiary and the bank and will help avoid public confusion. The requirement is also expected to have the added benefit of encouraging banks to hire experienced personnel to operate the subsidiary. Although the FDIC acknowledges that a separate employee requirement can produce additional costs for insured banks, the FDIC anticipates that the exception contained in the proposed regulation allowing bank employees to perform administrative,

non-customer contact activities will reduce any inefficiency and added cost that might otherwise arise. Furthermore, the addition of the de minimis transaction exemption for real estate development in the revised proposal should accommodate many of the banks that objected to the bona fide subsidiary requirement due to the additional costs that such a structure can entail. These banks will be permitted under the exception to conduct a certain amount of real estate development activities in-house and thus need not incur the expenses associated with a bona fide subsidiary (including the expense of separate personnel) unless it is the bank's intention to enter into the real estate development area to a significant degree. Likewise, the exception for a life insurance department provided for by the revised proposed regulation provides insured banks the same option with respect to underwriting life insurance.

Common Officer/Director Restriction

The revised proposed regulation continues to prohibit the bank and subsidiary from sharing common officers and likewise continues to require that a majority of the board of directors of the subsidiary be composed of persons who are neither directors nor officers of the bank. Under the proposal, the CEO, president, or some other officer of an insured bank may not at the same time serve as an officer of the bank's subsidiary. That officer, however, as well as other officers and/or directors of the bank, may form all but a majority of the board of directors of the subsidiary.

This aspect of the bona fide subsidiary definition received by far the greatest amount of criticism. The comments objecting to the prohibition on shared management did so for the following reasons: (1) having to duplicate management is costly, (2) the bank runs the risk of losing control over its subsidiary due to the management prohibition (this could lead to the subsidiary adopting policies incompatible with those of the bank), (3) the subsidiary will not be able to use the existing real estate expertise of bank personnel, (4) the subsidiary's officers and directors will be forced to adopt aggressive policies in order to produce enough business to justify their salary costs, and (5) the presence of shared management in and of itself will not result in a court piercing the corporate veil between the bank and its subsidiary. Most if not all of these comments were raised in the context of a real estate development subsidiary. (Several banks pointed out that they currently operate real estate development subsidiaries that share a total identity of management with the bank.)

The FDIC concedes that the proposed management restriction can produce some additional costs but at the same time the FDIC does not feel that the costs will be inordinate nor that the costs are unjustified. In the case of a real estate development subsidiary, the costs only need be incurred if the bank enters into real estate development in excess of the de minimis transaction exemption. Even then the subsidiary is not precluded from taking advantage of the bank's existing real estate expertise as any bank officer responsible for real estate lending can serve as a director of the subsidiary. Thus the FDIC is not persuaded by the comments that the restriction as proposed will cause

the bank to lose oversight of the operation of its subsidiary to the detriment of the bank. Lastly, while the FDIC agrees that shared management in and of itself will probably not cause a court to pierce the corporate veil between a bank and its subsidiary, shared management is an important factor in a court deciding to do so. The FDIC has not proposed, as it could, that the subsidiary share no management with the bank. Instead the agency has attempted to strike a fair balance between two competing concerns: the interest, as expressed by insured banks, to expand into additional activities and the interest of the FDIC to protect insured banks and the deposit insurance fund.

Separate Records, Board of Directors' Meetings, and Independent Policies

The revised proposal continues to require that the subsidiary maintain separate accounting and other corporate records, that the subsidiary observe separate corporate formalities, and that the subsidiary conduct business pursuant to independent policies and procedures designed to adequately apprise customers that (1) the subsidiary is a separate organization from the bank, (2) any insurance policy or annuity underwritten by the subsidiary, as well as any real estate investment recommended, offered, or sold by the subsidiary, are not insured deposits, and (3) any undertakings or obligations of the subsidiary are not undertakings or obligations of the bank. These requirements received favorable comment.

3. INVESTMENT IN SUBSIDIARY

The revised proposed regulation provides that no insured bank may establish or acquire a subsidiary that underwrites insurance (excluding credit life insurance), engages in real estate development, or acts as guarantor or surety unless the bank's capital (exclusive of its direct investment in such subsidiary or subsidiaries) meets the minimum level set forth in section 325.3 of the FDIC's regulations. Furthermore, any such subsidiary will not be consolidated with its insured bank parent and any direct investment therein will be deducted from the parent bank's primary capital (as defined in 12 CFR 325.2) and total assets.

This provision provides the FDIC with an enforcement tool to help safeguard the safety and soundness of insured banks that enter into these activities through their subsidiaries. If, for example, the FDIC should determine after receiving notice under proposed section 332.5 that an insured bank's capital is not adequate after making the necessary adjustments previously described, the bank could be subject to enforcement action if it were to proceed with the acquisition. This restriction will serve to prevent institutions with inadequate capital from entering into these activities and possibly incurring unwarranted additional risks. Further, it is the FDIC's opinion that the exclusion of a bank's investment in any such subsidiary will provide greater assurance that the bank and the subsidiary are independent, financially viable entities.

4. FILING OF NOTICE

The original proposed regulation required that an insured bank that intended to acquire or establish a subsidiary that engages in insurance underwriting or real estate development must file notice of intent with the appropriate FDIC Regional Office at least sixty days prior to the consummation of the acquisition or commencement of the operation of the subsidiary, whichever is earlier. The bank was also required to notify the FDIC Regional Office in writing within ten days after the consummation of the acquisition or commencement of the operation of the subsidiary, whichever is earlier. These notice requirements were waivable under the original proposal by the FDIC, in its discretion, where such notice was found to be impracticable.

The notice requirements as proposed received favorable comment and therefore are being retained in the revised proposal subject only to the following modifications. As originally proposed, the notice requirements did not apply when an insured bank was to become affiliated with a company that engages in prohibited activities. The revised proposal extends the notice requirement to such situations as the FDIC, upon further reflection, has determined that it will not always have the benefit of prior notice of affiliation of an insured bank with such a company from some other application such as a change in bank control or deposit insurance application. Inasmuch as it is still the FDIC's intent to not duplicate an existing prior notice mechanism, the revised proposed regulation indicates that the notice requirements do not apply in the case of an affiliation that will arise out of a change in bank control or bank merger provided that the bank has filed a change in bank control notice with the FDIC or has filed an application with the FDIC for the agency's prior consent to a merger, consolidation, or purchase and assumption transaction or has filed such a notice or application with another federal or state agency required by statute or regulation to consult withthe FDIC with respect to the notice or application. Lastly, the notice requirements have been made to apply to a subsidiary or affiliate that engages in guarantor or surety activities. The original proposal had neglected to extend the notice requirements to such subsidiaries, and the revised proposal corrects this omission. (This omission has been corrected throughout the other provisions of the revised proposed regulation as well.)

Again, the revised proposal does not specify the content of the written notice of intent. By not specifying the content of the notice, the FDIC is permitting a bank to satisfy the notice requirements in any way it finds most convenient. It is the FDIC's intent to use the notice as a point of reference and for the regional office to contact the insured bank seeking further information if the bank's condition or other facts warrant a closer review. The proposal thus requires that the notice be received in the regional office at least sixty days prior to the consummation of the transaction. (Contrary to the reading of the proposal by several comments, an insured bank would not be required to give sixty days prior notice to the FDIC each time it enters into a real estate development project.)

Although the notice requirement is not an approval process, the FDIC would not be precluded from intervening in the intended acquisition or establishment of the subsidiary or the intended affiliation if such intervention was

warranted. For example, if the subsidiary would not appear to meet the requirements for a bona fide subsidiary or any details of the planned transaction (such as the source of funding for the establishment or acquisition of the subsidiary) present any supervisory concerns, the FDIC could intercede.

5. DEFINITION OF REAL ESTATE DEVELOPMENT

Unlike the original proposal, the revised proposed regulation contains a definition of the term "real estate development". As defined therein, real estate development means any form of direct or indirect equity interest in real property. The definition specifically excludes the following: (1) an interest in real property that is primarily used by the bank, its subsidiaries, or affiliates as offices or related facilities for the conduct of its business, (2) an interest in real property that is acquired in satisfaction of debts previously contracted in good faith provided that the property is not held longer than permitted by any applicable law or regulation, (3) an interest in real property that is acquired at sales under judgments, decrees or mortgages held by the bank provided that the property is not held longer than permitted by any applicable law or regulation, (4) the right to receive a portion of a borrower's gross or net income earned from the operation of real property or upon the sale or refinancing of the real property when that right is acquired as an addition to, or in lieu of, interest on a loan to the borrower secured by such real property, and (5) interests in real property that are primarily in the nature of charitable contributions to community development.

The exclusion for interests in real property acquired in satisfaction of debts previously contracted for in good faith and interests in real property acquired at sales under judgments, decrees or mortgages held by the bank apply only to the amounts booked at the time of acquisition plus any additional funds necessary to substantially complete the projects. If the real property is not substantially complete, and funds are expended toward the completion of the project, the interest in the real property will be considered real estate development.

Real estate lending activities will not normally be considered to constitute real estate development unless the lending is structured in such a manner that the lending bank has virtually the same risks and potential rewards as an investor in real estate. The following considerations, viewed individually or collectively, will be considered by the FDIC to provide evidence that a transaction is in substance real estate development and thus subject to the restrictions of the proposed regulation: (1) the bank provides all or substantially all of the funds for the real estate venture while the borrower, although legally holding title to the property, has little or no equity in the property, (2) the bank funds the loan commitment or origination fees for the borrower by including them in the amount of the loan, (3) the bank funds accrued interest during the term of the loan by adding interest to the borrower's loan balance, or by debiting an interest reserve account established from a portion of the loan proceeds, (4) the loan is secured only by the real estate and the lender has no recourse to other substantive assets of the borrower and the borrower has not guaranteed the debt, (5) the bank, in

addition to receiving interest rates at a fair market rate, participates in over fifty percent of the expected residual profits during the life of the real estate project or upon the sale of the real property, (6) the bank in order to recover its investment must rely on the ability of the borrower to sell the real property or obtain refinancing from another source, and (7) the bank structures the lending arrangement so that foreclosure during the project's development is unlikely as the borrower is not required to fund any payments until the project is completed. If it is determined based upon the presence of one or more of the above considerations that the real estate loan is in fact a real estate development venture on the part of the bank, that portion of the loan which represents the real estate development interest as accounted for in accordance with FASB accounting procedures for acquisition, development, and construction loans shall be included towards the bank's de minimis transaction exclusion ceiling.

The FDIC specifically invites comments on the proposed definition and is particularly interested in receiving comments on whether or not the proposed definition is too restrictive or overly broad, or whether some other definition would better serve the interests of insured banks as well as the FDIC's regulatory interests.

6. AFFILIATION WITH A COMPANY THAT ENGAGES IN ANY ACTIVITY PROHIBITED TO AN INSURED BANK

The current proposal preserves virtually intact from the original proposal the prohibition against an insured bank becoming affiliated with any company that engages in any activity prohibited under section 332.3 (including, in order to correct an oversight in the original proposal, an affiliate engaging in guarantee or surety activities) unless certain conditions are met. Those conditions, as set out in section 332.6 are: (1) the affiliate is physically separate and distinct in its operation from the operation of the bank, such physical separation being achieved at a minimum by separate offices clearly demarcated as belonging to the affiliate, access to which is through a separate entrance from that used for the bank, except that the bank's and affiliate's offices may be accessed through a common outer lobby or a common corridor; (2) the bank and affiliate share no common officers; (3) a majority of the board of directors of the bank is composed of persons who are neither officers nor directors of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct activities on behalf of the affiliate that involve customer contact; (5) the bank and affiliate do not share a common name or logo, and (6) the affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and that any insurance policies or annuities underwritten by the affiliate, as well as any real estate investments recommended, offered, or sold by the affiliate, are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are any undertakings on the part of the affiliate otherwise undertakings or

obligations of the bank. A footnote specifically provides that an insured bank is not prohibited from advertising or otherwise disclosing its relationship to the affiliate.

The only differences between the currently proposed section 332.6 and the provision as it originally appeared are: (1) the phrase "investments recommended" has been expanded to include "any insurance policies or annuities underwritten by the affiliate" and (2) a footnote has been added which indicates that the proposed prohibition does not apply in the case of any affiliate that is principally engaged in business outside the United States. This last change is made in order to avoid the regulation having any extraterritorial effect. (See paragraph #14 below.)

The restrictions of this provision are substantially the same as those that pertain to the qualifications for a bona fide subsidiary. Just as an insured bank may be held liable for the acts of a subsidiary (see paragraph #2 above), the law provides that a corporation can be held liable for the obligations and acts of its affiliate (either a parent or a sister corporation) when that corporation completely dominates the affairs of the affiliate as well as when other factors relevant to piercing the corporate veil are present. To have an insured bank held liable for the acts and obligations of its affiliates presents an obvious safety and soundness problem. Nonetheless, the FDIC's chief goal with regard to affiliate relationships is, as stated in the original proposal: (1) to protect the safety and soundness of insured banks by requiring that the bank be operated independently and in a manner consistent with safe and sound banking practice, and (2) to protect the deposit insurance fund by avoiding claims against the bank arising from the public's misconception about the entity with which it is dealing.

The FDIC only received three comments addressing the affiliate provision. Those comments were exclusively concerned with the common name or logo prohibition and will be discussed below. Despite the dearth of comments on the affiliation issue, in assessing that provision the FDIC has treated the comments objecting to the criteria used to define "bona fide subsidiary" as equally applicable to the affiliation criteria due to the substantial similarity of the two provisions. The reasons for retaining the criteria for affiliation in this revised proposal are concomitantly similar to the reasons for retaining the bona fide subsidiary criteria as proposed (see paragraph #2 above). The restriction on common officers, directors, and employees is designed to ensure that the bank is run in an independent safe and sound manner as management's concerns will be focused on the bank and not on the affiliate. The remaining restrictions in section 332.6, including paragraph (4) which prohibits an employee of the affiliate who is also an employee of the bank from conducting activities on behalf of the affiliate that involve customer contact, are aimed at preventing the public from perceiving the insured bank and its affiliate to be one and the same entity. The avoidance of this perception will help to protect the deposit insurance fund by preserving confidence in a bank even when its affiliate encounters difficulties.

When a bank has failed due, at least in part, to the activities of its affiliate, compliance with section 332.6 (particularly those provisions aimed at avoiding customer confusion) will help immunize the deposit insurance fund from claims that either the bank or the affiliate, as authorized by the bank, misrepresented the nature of the obligations of the affiliate. In the case of a deposit payoff, compliance with the above provisions should be a defense against claims that the obligations of the affiliate are deposits of the failed bank. In the case of an assumption by a healthy bank of the deposits and other liabilities of a failed bank, in which case the FDIC advances an amount from the insurance fund to the assuming bank equal to the difference between the amount of all liabilities assumed and the amount of assets assumed, compliance with section 332.6 protects the fund by ensuring that the liabilities of the affiliate are not those of the failed bank subject to assumption by the healthy bank. For example, after the failure of the American Bank & Trust Co., New York, N.Y. ("AB&T") in 1976, individuals who thought they had purchased certificates of deposit from the bank but in fact had purchased commercial paper of the similarly named American B & T Corp. (the bank's holding company), were given standing to proceed under the securities laws to state a case that they were in reality holding obligations of American Bank & Trust. Adato v. Ragan, 599 F.2d 1111 (2d Cir. 1979). Another example of harm to the deposit insurance fund that can result from public confusion over affiliate relationships is the nearly devastating run on a large mid-western bank in the mid-1970s because of the losses incurred by a real estate investment trust owned by the bank's holding company. The REIT and the bank were not even similarly named, yet the losses incurred by the REIT were enough to set off a run on the bank by sophisticated, large-denomination depositors. A common name or logo clearly would have exacerbated the problem. (See paragraph #2 above for an explanation of the exception in the regulation permiting a bank to disclose its relationship to its affiliates.) Other problems created for banks by virtue of similarly named affiliated REIT in the 1970s are well-known.

As mentioned, FDIC received three comments exclusively devoted to the prohibition against a common name or logo. All three strongly opposed this restriction. One of these comments was from an insured bank owned by a well-known national insurance company, while another was from a national bank owned by a well-known national retailer. The FDIC believes that the Adato case cited above, the REIT experience, and the other analyses set forth in connection with this proposal and the prior proposal support retention of the prohibition on a common name or logo. The FDIC rejected the idea of grandfathering existing common names because of the continued possibility of public confusion.

7. RESTRICTIONS ON LENDING

Section 332.7 of the original proposal contained several restrictions on the extent to which, and the manner in which, an insured bank may deal with its subsidiary or affiliate that engages in insurance underwriting (excluding credit life insurance), real estate development, reinsurance, or insures, guarantees, or certifies title to real estate. With several modifications and

additions, the restrictions in the current proposal remain the same as the ones set forth in the original proposal. The currently proposed restrictions apply to any insured bank that has a subsidiary that engages in activities prohibited to the bank under section 332.3 and to any insured bank that has an affiliate which is subject to the restrictions of section 332.6. (The restrictions of section 332.7 are applicable to banks with subsidiaries or affiliates that engage in insurance underwriting, real estate development, or guarantee or surety activities, thereby correcting an oversight in the first proposal which had only covered insurance underwriting and real estate development.)

As revised, section 332.7 provides that: (1) any extension of credit by an insured bank to a subsidiary that engages in prohibited activities may not be in excess of 10% of the bank's primary capital, (2) the bank's aggregate extensions of credit to all such subsidiaries may not exceed 20% of the bank's primary capital, (3) any extension of credit by an insured bank where the purpose of the extension of credit is to acquire an interest in any real estate developed by the bank's subsidiary or affiliate must be consistent with safe and sound banking practices and the aggregate of such purpose loans may not exceed 10% of the bank's primary capital, and (4) any extension of credit by an insured bank to any real estate development in which the bank's subsidiary or affiliate has an equity interest may not exceed 15% of the bank's primary capital.

The currently proposed restrictions on extensions of credit by an insured bank deletes the reference to section 23A of the Federal Reserve Act contained in the original proposal and removes affiliates from the reach of the prohibition. As section 23A already covers extensions of credit to affiliates, covering affiliates under this provision would merely be superfluous. The current proposal has dropped the reference to section 23A in order to avoid the inadvertent impression that the FDIC was trying to extend section 23A to bank subsidiaries. It had been the FDIC's intent merely to borrow from that regulatory structure in formulating prudential restrictions. The prudential limitations set on extensions of credit by the proposal for safety and soundness reasons track the percentages used in section 23A, but do not contain any collateral requirements such as those used in section 23A. (Several comments objected to imposing collateral requirements.) Several comments suggested imposing restrictions on transactions between subsidiaries of an insured bank to avoid circumvention of the limits on loans to any one subsidiary. These comments, however, overlook the aggregate limit on loans to all subsidiaries. The FDIC believes that the aggregate limit is sufficient to safeguard against such circumvention.

The current proposal continues virtually unchanged from the former proposal the restriction against an insured bank making loans for the purpose of acquiring any interest in real estate developed by the bank's subsidiary or affiliate unless the terms and conditions of the extension of credit are consistent with safe and sound bank practice. The aggregate of such "purpose loans" may not exceed 10% of the bank's primary capital. This restriction is designed to prevent an insured bank from making excessive and/or imprudent

loans in order to "move" the subsidiary's or affiliate's real estate. Likewise, the requirement that extensions of credit by the bank to any real estate development in which the bank's subsidiary or affiliate has an equity interest may not exceed 15% of the bank's primary capital is designed to prevent a bank from making excessive and/or imprudent loans to a real estate venture in which its subsidiary or affiliate has an equity interest in an effort to protect the subsidiary's or affiliate's investment position. (The original proposal had contained a cross reference to 12 U.S.C. 84 which places a limit on loans to one borrower. That cross reference has been dropped for the same reasons the reference to section 23A of the Federal Reserve Act has been dropped.)

Despite several comments arguing that the restrictions overly limit an insured bank's ability to lend to projects of an affiliate or subsidiary, the FDIC reaffirms its statement made in the original proposal that, "taken together, these restrictions are designed to prevent abuses while at the same time allowing purpose lending and other direct and indirect financing of real estate." Additionally, the FDIC has determined that this proposal's allowance of certain in-house real estate activities significantly diminishes the concerns expressed in the comments by permitting increased direct involvement in real estate development.

8. TRUST DEPARTMENT RESTRICTIONS

Proposed section 332.7(a)(5) prohibits any insured bank that has a subsidiary that engages in activities prohibited to the bank under section 332.3, and any insured bank that has an affiliate that is subject to the restrictions of section 332.6, from purchasing as fiduciary, co-fiduciary or managing agent on behalf of any account for which the bank has sole investment discretion any interest in real estate developed by such subsidiary or affiliate or any insurance policy or annuity underwritten by such subsidiary or affiliate unless (1) the purchase is expressly authorized by the managing agency agreement, the trust instrument, court order or local law, or specific authority for the purchase is obtained from all interested parties after full disclosure; (2) the purchase, although not expressly authorized under item (1), is otherwise consistent with the bank's common law fiduciary obligation; or (3) the purchase is permissible under applicable state and federal law or regulation. Except for minor wording changes, this provision is as originally proposed.

The FDIC intends by this provision to ensure against abuses that can arise in the administration of trust and other accounts over which the bank has investment discretion. The provision is, for the most part, simply a restatement of a bank's common law fiduciary obligation to refrain from dealing with itself in the administration of a trust. The provision has been styled as proposed (in the alternative) in order to take into account, for example, federal law governing employee benefit and pension plans that would permit, in certain instances, transactions involving such funds and affiliates of their trustees. An insured bank would still be subject to any applicable stricter federal or state statutory or regulatory requirement. For example, if a particular transaction is specifically prohibited under state law, a bank could not rely on section 332.7(a)(5) as authority to enter into the transaction.

9. TYING

The revised proposal continues, with slight modifications, to prohibit directly or indirectly conditioning any extension of credit on the requirement that a borrower purchase any real estate developed by the bank's subsidiary or affiliate or purchase any insurance policy or annuity underwritten by the bank's subsidiary or affiliate. While some comments argued that this prohibition was unnecessary due to similar restrictions found in section 106(b) of the Bank Holding Company Act, many other comments evidenced extreme concern about tying arrangements and urged the FDIC to bar bank entry into nonbanking areas in order to avoid tie-ins. The FDIC has retained this provision, however, inasmuch as not all insured banks are encompassed by the restrictions of section 106(b) of the Bank Holding Company Act (e.g., nonbank banks) and because tying arrangements involving subsidiaries of banks not in a holding company system may not be covered thereby. The provision is not duplicative as to banks that are covered by section 106(b) as section 332.7(a)(4) contains a footnote which provides that compliance with section 106(b) shall be deemed to be compliance with the proposal's anti-tying provision.

10. RESTRICTIONS ON OPERATIONS OF BANK INSURANCE DEPARTMENTS AND PERMISSIBLE REAL ESTATE ACTIVITIES

Because the current proposal permits insured banks to (1) engage directly in real estate development up to certain limits pursuant to section 332.3(b)(2)(i) and (2) underwrite life insurance and annuities through a department of the bank pursuant to section 332.3(c)(2)(i), certain restrictions are necessary to prevent abuses that might arise. Paragraphs (3) and (4) of section 332.7(b) have therefore been added to the proposal. These paragraphs parallel the trust department restrictions and anti-tying provisions explained above that are applicable to insured banks that have subsidiaries or affiliates that engage in real estate or insurance activities.

Paragraphs (1) and (2) of new section 332.7(b) are designed to prevent customer confusion when an insured bank operates a life insurance department. Paragraph (1) prohibits an insured bank from referring to federal deposit insurance in any life insurance department advertisement, solicitation, or promotional material, and paragraph (2) requires any life insurance policy or annuity underwritten by the insurance department of an insured bank to be accompanied by a written disclosure stressing that only the assets of the insurance department are available to pay the liabilities of the insurance department. The FDIC hopes, by adopting these requirements, to avoid situations in which customers of the life insurance department mistakenly believe that they have an insured deposit when, in fact, the customer has purchased an annuity.

The FDIC specifically requests comments on whether any other conditions in lieu of, or in addition to, the ones proposed should be imposed when an insured bank directly engages in real estate development and/or operates a

life insurance department. For example, should the FDIC require that the life insurance department be physically separate and distinct within the bank from the other departments? Should the same bank employee be prohibited from selling annuities and setting up money market deposit accounts?

11. WAIVER

In response to several comments, a provision has been added to the revised proposal that provides for a waiver by the FDIC's Board of Directors. The standard for the waiver as set forth in the proposal is that the Board of Directors may, by resolution, waive all or any portion of the regulation when the Board of Directors deems it necessary and in the public interest to do so. In addition to waiving the regulation, the Board of Directors may impose such other conditions as it determines to be appropriate. This provision will allow the FDIC at the request of an insured bank or upon the agency's own initiative to waive any particular portion of the regulation and tailor make such conditions or restrictions that the Board of Directors feels are appropriate under the individual circumstances.

12. INSURANCE SALES, REAL ESTATE BROKERAGE, TRAVEL SERVICES, EDP SERVICES

The regulation as originally proposed contained several restrictions applicable to instances in which an insured bank, its subsidiary, or affiliate were providing certain brokerage services, EDP services and/or travel agency services. The restrictions were primarily designed to address conflicts of interest and anti-tying concerns. Comments received in response to the proposed restrictions were overwhelmingly critical. Banks presently involved in these activities objected to the restrictions as unnecessary and duplicative. Nonbanking trade groups objected to the "attempt" on the part of the FDIC to "authorize" insured banks to conduct such activities.

Upon reconsideration of the issue, the FDIC has determined to withdraw these proposed requirements. The effect of doing so is not, however, to preclude insured banks from conducting brokerage, EDP, and travel activities nor does it mean that the FDIC will not address any problems that may arise due to the involvement of an insured bank in such activities. It is the FDIC's opinion that these activities pose only minimal safety and soundness concerns and that these concerns may be adequately addressed during the examination process or otherwise where the need arises. If further experience in this area demonstrates the need for a regulation to address conflicts of interest and tying, the FDIC will initiate rulemaking or take other appropriate action.

13. DEFINITION OF "AFFILIATE", "SUBSIDIARY", "EXTENSION OF CREDIT" AND "COMPANY"

The original proposed regulation defined the term "affiliate" to mean a company that directly or indirectly controls an insured bank or is under common control with an insured bank. "Control" was defined as the power to directly or indirectly vote twenty-five percent of a bank's or company's stock, the ability to control the election of a majority of a bank's or company's directors or trustees, or the ability to exercise a controlling

influence over the management and policies of a bank or company. At a minimum, the original proposed regulation treated as affiliates of an insured bank the bank's parent company, a company that controls twenty-five percent or more of the bank's stock, and any companies controlled by either of the above.

The term "subsidiary" was defined in the original proposal to mean a company directly or indirectly controlled by a bank. As "company" was defined in the proposed regulation to include corporations (other than banks), partnerships, businesses trusts, associations, joint ventures, pools, syndicates or other similar business organizations, the term subsidiary as originally proposed encompassed a business entity operated by several insured banks in a cooperative effort.

The term "extension of credit" as defined in the original proposed regulation had generally the same meaning as found in Federal Reserve Board Regulation O (12 C.F.R. 215.3) which concerns insider transactions. As defined in the original proposal, however, the term covered purchases "whether or not under repurchase agreement" of securities, other assets, or obligations. The "whether or not" language was included in the proposed regulation in an attempt to control the extent to which a bank may indirectly divert funds into a subsidiary by means of puchasing securities and other assets from the subsidiary. The term also differed from that used in Regulation O in that a "draw" upon a line of credit was an extension of credit whereas a "grant" of a line of credit was not.

The revised proposed regulation retains the above definitions as originally proposed without any modifications. (The agency did not receive any comments directed to the definitions.) A footnote has been added to proposed section 332.7 ("Restrictions") in response to comments that including a purchase of securities in the definition of extension of credit raised the question of whether or not a bank's direct investment in its subsidiary through a purchase of securities issued by that subsidiary was subject to the lending restrictions established by section 332.7. That footnote indicates that the lending restriction does not limit such purchases.

14. SCOPE OF REGULATION

The revised proposed regulation continues to apply to all FDIC-insured banks, i.e., nonmember banks, state banks that are members of the Federal Reserve System, national banks, federal savings banks insured by the FDIC, and insured branches of foreign banks. Numerous comments challenged the FDIC's authority to adopt a regulation that would apply to insured banks other than insured state nonmember banks. For the reasons set forth at length in the statutory authority discussion above, the FDIC has determined not only that it has the authority to adopt a regulation applicable to all insured banks but also that the adoption of this particular proposed regulation is necessary to the protection of the insurance fund and the safety and soundness of insured banks. As a practical matter, national banks and state banks that are members of the Federal Reserve System, as well as affiliates of insured banks that are nonbank subsidiaries of a bank holding company, are not impacted by the proposed regulation. Such entities are either not presently authorized to

engage in insurance underwriting or real estate development or are precluded by some other federal law and/or regulation from engaging in such activities. To the extent that state nonmember banks and federal savings banks insured by the FDIC may be affected by the regulation (those entities may be authorized by state or federal law or regulation to engage in insurance underwriting or real estate development), the FDIC has determined that such impact is both advisable and within the agency's authority. Again, the FDIC feels that the revisions made to the proposed regulation will minimize, if not eliminate, any conflict with state or other federal law. Lastly, insofar as the proscription on acting as guarantor or surety is concerned, it would appear that this prohibition is no broader than similar prohibitions already applicable to national banks, member banks, and federal savings banks insured by the FDIC.

Foreign banks and insured branches of foreign banks - The FDIC received a comment on behalf of the Institute of Foreign Bankers urging the FDIC to clarify that a foreign bank with an insured branch is not an insured bank for the purposes of the regulation. The comment also urged the FDIC to exclude from the reach of the regulation: (1) the non-U.S. affiliates of insured branches of foreign banks, (2) the non-U.S. affiliates of domestic bank subsidiaries of foreign banks, and (3) the affiliates of domestic bank subsidiaries and insured branches of foreign banks where their U.S. nonbanking activities are either (a) grandfathered under section 8 of the International Banking Act (12 U.S.C. 3106) or (b) are permissible under the Bank Holding Company Act.

Section 332.1 of the revised proposed regulation ("Purpose and Scope") has been amended to indicate that the foreign bank parent of an insured branch is not within the scope of the regulation. It is clear, even without this indication, however, that the foreign bank parent of an insured branch or of a domestic bank subsidiary is not an affiliate subject to the restrictions of the regulation. This is so as an affiliated company does not include a bank. (See section 332.2(a)). Non-U.S. companies that are affiliated with an insured bank (including an insured branch of a foreign bank or a domestic bank subsidiary of a foreign bank) have also been excluded from coverage under section 332.6 of the regulation. These affiliates are also therefore not subject to the restrictions of section 332.7(a) as the preface of that paragraph recites that the restrictions therein apply to any insured bank that has an affiliate that is subject to the restrictions of section 332.6.

The above exclusions are designed to prevent the regulation from having an extraterritorial effect. There is no need to exclude from the regulation the affiliates of insured branches or of domestic bank subsidiaries of foreign banks that engage in activities permissible under the Bank Holding Company Act. The activities covered by the regulation have not been found to be closely related to banking and therefore are not permissible under that statute. U.S. nonbanking activities grandfathered by the International Banking Act on the part of affiliates of insured branches of foreign banks and affiliates of domestic bank subsidiaries of foreign banks have also not been excluded from coverage under the regulation. Although the Federal Reserve Board has the authority to terminate the grandfather status conferred by the International Banking Act, the FDIC is of the opinion that that authority does not preclude the FDIC from regulating insured banks and their relationship to such affiliates nor does it remove the need for the FDIC to do so.

Exemption for certain subsidiaries - the original proposed regulation contained a provision which indicated that the restrictions of sections 332.4, 332.5, and 332.7 did not apply in the case of a subsidiary of an insured bank that exclusively conducted any activity that is specifically authorized by statute, regulation, or interpretation to national banks or their operating subsidiaries. (A companion exclusion in section 332.3(b) provided that no insured bank was required to establish or acquire a bona fide subsidiary in order to conduct any such activity.) Upon reconsideration, the FDIC has determined to delete these exclusions from the revised proposed regulation.

15. COMPLIANCE

The revised proposed regulation requires that any insured bank that, prior to the date of publication of the proposal in the Federal Register, engaged in any activity prohibited to the bank shall have one year from the effective date of the regulation to move the operation into a bona fide subsidiary. Thus, for example, an insured bank that underwrites property and casualty insurance will have one year to establish a bona fide subsidiary to take over that operation. In the case of real estate development, the bank will be permitted to complete any real estate development project that is ongoing as of the date of publication of the proposal in the Federal Register as well as any real estate development project for which it has, as of such date, entered into a binding contractual obligation. The bank will not be permitted, however, to enter into any new real estate development projects after the effective date of the regulation other than in compliance with the regulation. Thus, if an insured bank is involved in one or more real estate development projects that exceed the de minimis real estate transaction exclusion, the bank will be permitted to complete the projects but any additional real estate developments must be entered into through a bona fide subsidiary of the bank until the bank can again comply (for example, because of sales of development interests or growth of primary capital) with the de minimis requirement.

This limited grandfather aspect of the compliance provision is designed to prevent undue disruption to existing real estate operations to the detriment of the bank, i.e., avoid forcing a bank to precipitously divest its interests in ongoing real estate developments. The revised compliance provision should provide more flexibility than the provision as originally proposed which would have given a bank two years to move an existing operation but did not establish a limited grandfather for ongoing real estate development. The provision as revised is thus responsive to comments which urged the FDIC to grandfather existing levels of real estate investment so as to not force a bank to divest assets at a liquidation price. The proposal does not simply grandfather insured banks that are conducting directly or indirectly activities authorized by their state or federal chartering authority as requested by some comments. This approach has not been adopted for all the reasons more fully discussed in the "Bases of Concern" discussion above.

The FDIC is specifically requesting comment on whether the regulation should identify when a real estate project is "completed" and invites comment on how

to determine when that has occured. Additionally, the FDIC invites comment on whether the regulation should establish a specific time period on the limited grandfather and whether the one year compliance period for all other prohibited activities is sufficient.

If an insured bank, prior to the date of publication of the proposal in the Federal Register, acquired or established a subsidiary that engages in prohibited activities or, prior to such date, became affiliated with a company that engages in such activities, the bank has one year from the effective date of the regulation to comply therewith with the following exceptions. The subsidiary must meet the definition of a bona fide subsidiary within 180 days and the affiliate provision of the regulation must be in compliance with within 180 days. The lending and other restrictions of section 332.7 must be met within 90 days.

16. PAPERWORK REDUCTION ACT

The notice requirements contained in the proposed regulation do not constitute "collections of information" for purposes of the Paperwork Reduction Act (44 U.S.C. 3501 et seq.) and therefore are not subject to the Office of Management and Budget ("OMB") clearance provisions of that Act. This is because the notice requirements fall within the exception to the definition of "information" set out in subsection 1320.7(k)(1) of the OMB regulations implementing the "collection of information clearance" provisions of the Act (5 C.F.R. 1320). It is recognized, however, that the notice requirements do place an affirmative obligation on an insured bank to notify the FDIC of its intended action, to confirm whether or not the transaction has been consummated, and to notify the FDIC if the bank has a subsidiary that engages in restricted activities or is affiliated with a company that engages in restricted activities. Any costs associated with these notices would appear, however, to be minimal. The proposed regulation does not specify the content of the written notices nor does it require insured banks to provide the FDIC with any specific information.

17. REGULATORY FLEXIBILITY ACT ANALYSIS

In accordance with the FDIC's policy statement entitled "Development and Review of FDIC Rules and Regulations" and the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FDIC conducted an analysis of the proposed regulation. The results of that analysis follow.

The proposed regulation would prohibit, with certain exceptions, an insured bank from conducting insurance or real estate underwriting activities unless such activities were conducted in a bona fide subsidiary of the bank. There are several benefits to such a restriction. By separating these activities from the bank, there will be less regulatory overlap and it will be easier for the various regulatory agencies to monitor the conditions of the institutions for which they are responsible. Moreover, by providing some insulation between the bank and its real estate and insurance underwriting activities, the safety of the bank is less likely to be threatened should its real estate or insurance subsidiaries encounter financial difficulty.

The provisions which would require independent capitalization, limit intercompany dealing, and prohibit insured banks from becoming affiliated with companies engaging in insurance or real estate underwriting activities unless the affiliate is physically separate from the bank and has a separate name and logo are consistent with the desire to limit the oveall exposure of the banking organization by maintaining some separation between an insured institution's banking and nonbanking activities. These restrictions should not impose substantial costs on insured banks and will make it less likely that financial problems encountered by an affiliate will result in problems for the bank itself. The absence of an investment cap in the insured bank's subsidiaries will enable even relatively small insured banks to compete in these markets. The exclusion of the bank's investment in its subsidiary does not eliminate any of the potential benefits that will result from increased competition in these markets. It does, however, encourage asset diversification by ensuring that insured banks do not become overexposed to cyclical declines in any of these activities.

As already stated, the FDIC does not believe that this regulation will result in excessive costs for insured banks in general or for small banks in particular. The primary concern, with respect to real estate development (particularly for small banks), would be if banks did not plan to engage in real estate development activities on a large enough scale to warrant the costs associated with forming a bona fide subsidiary. In such cases the regulation might discourage the bank from participating in real estate development activities and some public benefit might be lost. However, this potential concern is alleviated under the revised proposed regulation. Any bank that wished to engage in real estate activities on a limited basis would not have to incur any additional costs as a result of the proposed regulation since real estate investments that did not exceed 50% of primary capital could be conducted in the bank itself. Only those institutions that wish to participate in this market on a large scale would be required to set up a bona fide subsidiary, and in those instances the bank's real estate activities would be on a large scale to justify the costs associated with the formation of a bona fide subsidiary.

With respect to insurance activities by insured banks, it is unlikely that the proposed regulation will create unjustifiable costs or deter market entry. Banks that want to service their customer's insurance needs on a limited basis would be more interested in insurance brokerage than insurance underwriting, and the proposed regulation does not prohibit insurance brokerage activities. There are economies of scale associated with insurance underwriting which suggest that banks should not participate in this market unless they are willing to enter on a large enough scale to make the costs associated with forming a bona fide subsidiary a relatively minor part of their total costs. These economies of scale result from the need to sufficiently diversify underwriting risks.

Based on the above, the Board of Directors hereby certifies that the proposed rule, if promulgated, will not have a significant economic impact on a substantial number of small entities.

List of subjects in 12 C.F.R. Part 332:

Banks, banking; Federal Deposit Insurance Corporation; Foreign banks, banking; State nonmember banks.

In consideration of the foregoing, the FDIC is proposing to revise Part 332 of title 12 Code of Federal Regulations as follows:

Part 332 - Powers Inconsistent with Purposes of Federal Deposit Insurance Law

Sec.

Authority: Sec. 6, 64 Stat. 876, 12 U.S.C. 1816; sec. 8(a), sec. 2[8(a)] of the Act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 879), effective September 21, 1950, as amended by sec. 204 of title II of the Act of October 16, 1966 (Pub. L. No. 89-695; 80 Stat. 1054), effective October 16, 1966; sec. 6(c)(14) of the Act of September 17, 1978 (Pub. L. No. 95-369; 92 Stat. 618), effective September 17, 1978; and sec. 113(g) of title I of the Act of October 15, 1982 (Pub. L. No. 97-320; 96 Stat. 1473 and 1474), effective October 15, 1982; 12 U.S.C. 1818(a); sec. 8(b), sec. 2[8(b)] of the Act of September 21, 1950 (Pub. L. No. 797), as added by sec. 202 of title II of the Act of October 16, 1966 (Pub. L. No. 89-695; 80 Stat. 1046), as amended by sec. 110 of title I of the Act of October 28, 1974 (Pub. L. No. 93-495; 88 Stat. 1506); sec. 11 of the Act of September 17, 1978 (Pub. L. No. 95-369; 92 Stat. 624); secs. 107(a)(1) and 107(b) of title I of the Act of November 10, 1978 (Pub. L. No. 95-630; 92 Stat. 3649 and 3653); and secs. 404(c), 425(b), and 425(c) of title IV of the Act of October 15, 1982 (Pub. L. No. 97-320; 96 Stat. 1512 and 1524); 12 U.S.C. 1818(b); sec. 9, 64 Stat. 881-882, 12 U.S.C. 1819; sec. 11(a), sec. 2[11(a)] of the Act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 884), effective September 21, 1950, as amended by sec. 301(c) of title III of the Act of October 16, 1966 (Pub. L. No. 89-695; 80 Stat. 1055), effective October 16, 1966; section 7(a)(3) of title I of the Act of December 23, 1969 (Pub. L. No. 91-151; 83 Stat. 375), effective December 23, 1969; secs. 101(a)(3) and 102(a)(3) of title I of the Act of October 28, 1974 (Pub. L. No. 93-495; 88 Stat. 1500 and 1502), effective November 27, 1974; sec. 1401(a) of title XIV of the Act of November 10, 1978 (Pub. L. No. 95-630; 92 Stat. 3712), effective March 10, 1979; sec. 323 of title III of the Act of December 21, 1979 (Pub. L. No. 96-153; 93 Stat. 1120); sec. 308 of title III of the Act of March 31, 1980 (Pub. L. No. 96-221; 94

Stat. 147), effective March 31, 1980; and sec. 103 of title I of the Act of December 26, 1981 (Pub. L. No. 97-110; 95 Stat. 1514), effective December 26, 1981; sec. 11(f), section 2[11(f)] of the Act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 885), effective September 21, 1950, as amended by sec. 6(c)(20) of the Act of September 17, 1978 (Pub. L. No. 95-369; 92 Stat. 619), effective September 17, 1978, 12 U.S.C. 1821(f).

332.1 Purpose and scope.

The provisions of this part apply to all insured banks including state chartered banks that are members of the Federal Reserve System, insured nonmember banks, national banks, insured branches of foreign banks (but not the foreign bank itself), and federal savings banks that are insured by the FDIC. The purpose of this part is to assure the safe and sound operation of insured banks by prohibiting activities that are inconsistent with the purposes of federal deposit insurance.

332.2 Definitions.

For the purposes of this part, the following definitions apply.

(a) "Affiliate" shall mean any company that directly or indirectly controls or is under common control with an insured bank.

(b) "Bona fide subsidiary" shall mean a subsidiary of an insured bank that at a minimum:

(1) is adequately capitalized;

(2) is physically separate and distinct in its operations from the operation of the bank, such physical separation being achieved at a minimum by separate offices clearly demarcated as belonging to the subsidiary, access to which is through a separate entrance from that used for the insured bank, except that the bank's and subsidiary's offices may be accessed through a common outer lobby or common corridor;

(3) does not share a common name or logo with the bank;[1]

(4) maintains separate accounting and other corporate records;

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[1]This requirement shall not prohibit the subsidiary from advertising or otherwise disclosing its relationship to the insured bank.

(5) observes separate formalities such as separate board of directors' meetings;

(6) maintains separate employees who are compensated by the subsidiary;[2]

(7) shares no common officers with the bank;

(8) a majority of its board of directors is composed of persons who are neither directors nor officers of the bank; and

(9) conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the bank, that any insurance policies or annuities underwritten by the subsidiary, as well as any real estate investments recommended, offered or sold by the subsidiary, are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank and that any undertakings or obligations of the subsidiary are not undertakings or obligations of the bank.

(c) "Company" shall mean any corporation (other than a bank), partnership, business trust, association, joint venture, pool, syndicate, or other similar business organization.

(d) "Control" shall mean the power to directly or indirectly vote 25 per centum or more of the voting stock of a bank or company, the ability to control in any manner the election of a majority of a bank's or company's directors or trustees, or the ability to exercise a controlling influence over the management and policies of a bank or company.

(e) "Extension of credit" shall mean the making or renewal of any loan, a draw upon a line of credit, or an extension of credit in any manner whatsoever and includes, but is not limited to:

(1) a purchase, whether or not under repurchase agreement, of securities, other assets, or obligations;

(2) an advance by means of an overdraft, cash item or otherwise;

(3) issuance of a standby letter of credit (or other similar arrangement regardless of name or description);

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[2]This requirement shall not be construed to prohibit the use by the subsidiary of bank employees to perform functions which do not directly involve customer contact such as accounting, data processing and recordkeeping, so long as the bank and the subsidiary contract for such services on terms and conditions comparable to those agreed to by independent entities.

(4) an acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which a natural person or company may be liable as maker, drawer, endorser, guarantor, or surety;

(5) a discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, whether with or without recourse;

(6) an increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (A) accrued interest or (B) taxes, insurance, or other expenses incidental to the existing indebtedness; or

(7) any other transaction as a result of which a natural person or company becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

(f) "Primary capital" shall have the meaning set forth in section 325.2(h) of the FDIC's regulations.

(g) "Real estate development" shall mean any form of direct or indirect equity interest in real property other than the following:

(1) an interest in real property that is primarily used by the bank, its subsidiaries, or affiliates as offices or related facilities for the conduct of its business;

(2) an interest in real property that is acquired in satisfaction of debts previously contracted in good faith provided that the property is not held longer than permitted by any applicable law or regulation;

(3) an interest in real property that is acquired at sales under judgments, decrees or mortgages held by the bank provided that the property is not held longer than permitted by any applicable law or regulation;

(4) the right to receive a portion of a borrower's gross or net income earned from the operation of real property or upon sale or refinancing of the real property when that right is acquired as an addition to, or in lieu of, interest on a loan to the borrower secured by such real property; and

(5) interests in real property that are primarily in the nature of charitable contributions to community development.

(h) "Subsidiary" shall mean any company directly or indirectly controlled by an insured bank.

332.3 Prohibited Activities.

(a) Acting as surety or guarantor.

(1) Except as otherwise provided in paragraph (a)(2), no insured bank may directly or indirectly conduct a surety business, insure the fidelity of others, or guarantee the obligations of others.

(2)(i) An insured bank may directly: (A) in the case of an insured branch of a foreign bank, guarantee or become surety upon the obligations of others as provided in section 347.3(c)(1) of the FDIC's regulations, (B) guarantee or become surety upon the obligations of others through an acceptance, endorsement, or letter of credit made or issued in the usual course of the banking business, (C) issue standby letters of credit as that term is defined in section 337.2 of the FDIC's regulations or enter into other similar arrangements, (D) guarantee or become surety upon the obligations of others if the bank has a substantial interest in the performance of the transaction or has a segregated deposit sufficient in amount to cover the bank's total liability, (E) enter into check guaranty card programs, customer-sponsored credit card programs, and similar arrangements on behalf of its retail banking deposit customers provided that the bank establishes the credit-worthiness of the individual before undertaking to guarantee his/her obligations, and (F) endorse or otherwise guarantee notes or other obligations sold by the bank for its own account.

(ii) An insured bank may, through a bona fide subsidiary of the bank, indirectly engage in activities otherwise prohibited to the bank under paragraph (a)(1) of this section.

(b) Real estate development.

(1) Except as otherwise provided in paragraph (b)(2), no insured bank may directly or indirectly engage in real estate development.

(2)(i) An insured bank may directly engage in real estate development provided that: (A) the bank meets at least the minimum capital requirements set forth in section 325.3 of the FDIC's regulations, (B) the bank's aggregate investments in such real estate development, including any related extensions of credit, do not exceed 50% of the bank's primary capital, and (C) the bank's aggregate investment in any one real estate development (including any related extensions of credit) does not exceed 10% of the bank's primary capital;

(ii) An insured bank may, through a bona fide subsidiary of the bank, indirectly engage in real estate development activities otherwise prohibited to the bank under paragraph (b)(1) of this section.

(c) Insurance underwriting.

(1) Except as otherwise provided in this paragraph and paragraph (c)(2), no insured bank may directly or indirectly underwrite insurance or engage in reinsurance. This prohibition extends, but is not limited to, casualty insurance, property insurance, life insurance (exclusive of insurance limited to assuring repayment of the outstanding balance due on an extension of credit in the event of death, disability, or involuntary unemployment), annuities, mortgage guarantee insurance, and title insurance.

(2)(i) An insured bank may underwrite life insurance and annuities through a department of the bank provided that the state or federal statute or regulation which authorizes the bank to do so requires that: (A) the assets, liabilities, obligations, and expenses of the insurance department are separate and distinct from those of the other departments of the bank, (B) the assets of the other departments of the bank cannot be used to satisfy the obligations, liabilities, or expenses of the insurance department, (C) the insurance department keeps separate accounting and other records, (D) the insurance department may not make investments not permitted to the bank, and (E) the insurance department is liquidated separately from the other departments of the bank and does not form part of the receivership in the event of the insolvency of the bank;

(ii) An insured bank may, through a bona fide subsidiary of the bank, indirectly engage in insurance underwriting activities otherwise prohibited to the bank under paragraph (c)(1) of this section.

332.4 Investment in subsidiary.

(a) No insured bank may establish or acquire a subsidiary that engages in any activity prohibited to an insured bank under section 332.3 unless the bank meets at least the minimum capital requirements set forth in section 325.3 of the FDIC's regulations.

(b) An insured bank's direct investment in a subsidiary that engages in any activitiy prohibited to an insured bank under section 332.3 will not be counted toward the bank's consolidated capital.

332.5 Notice.

(a) Notice of intent.

(1) Any insured bank that intends to (i) establish or acquire a subsidiary that engages in activities prohibited to the bank under section 332.3, or (ii) become affiliated with a company that engages in any such activity, shall file a written notice of intent with the regional director of the FDIC region in which the bank is located. This notice must be received in the regional office at least 60 days prior to consummation of the transaction. Any insured bank that files a notice pursuant to this paragraph must also notify the

regional director in writing within 10 days after the consummation of the transaction.[3]

(2) The notices required by paragraph (a)(1) may be waived in the FDIC's discretion where such notices are impracticable or where waiver would be in the public interest.

(b) Notice of existing relationship.

Any insured bank that as of (insert effective date of the regulation) has a subsidiary that engages in activities prohibited to an insured bank under section 332.3 or, is as of that date affiliated with a company encompassed by section 332.6, must notify in writing the regional director of the FDIC region in which the bank is located of the existence of that relationship. This notice must be received in the regional office no later than (insert a date 30 days from the effective date of the regulation).

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[3]In the case of an affiliation that will arise out of a change in bank control or bank merger, the notice requirements of section 332.5(a) shall not apply provided that (1) the bank has filed a change in bank control notice with the FDIC pursuant to section 303.15 of the FDIC's regulations, (2) has filed an application with the FDIC for prior written consent to merge, consolidate, acquire assets, or enter into a purchase and assumption transaction, or (3) has filed such a notice or application with another federal or state agency that is required by statute or regulation to consult with the FDIC with respect to the notice or application.

332.6 Affiliation.[4]

No insured bank may become affiliated with any company that engages in any activity prohibited to an insured bank under section 332.3 unless:

(a) The affiliate is physically separate and distinct in its operation from the operation of the bank, such physical separation being achieved at a minimum by separate offices clearly demarcated as belonging to the affiliate, access to which is through a separate entrance from that used for the bank, except that the bank's and affiliate's offices may be accessed through a common outer lobby or a common corridor;

(b) the bank and affiliate share no common officers;

(c) a majority of the board of directors of the bank is composed of persons who are neither officers nor directors of the affiliate;

(d) any employee of the affiliate who is also an employee of the bank does not conduct activities on behalf of the affiliate that involve customer contact;

(e) the bank and affiliate do not share a common name or logo;[5] and

(f) the affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and that any insurance policies or annuities underwritten by the affiliate, as well as any real estate investments recommended, offered, or sold by the affiliate, are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are any undertakings on the part of the affiliate otherwise undertakings or obligations of the bank.

332.7 Restrictions.

(a) Transactions with subsidiary or affiliate.

Any insured bank that has a subsidiary that engages in activities prohibited to the bank under section 332.3 and any insured bank that has an affiliate that is subject to the restrictions of section 332.6 shall not:

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[4]The restrictions of section 332.6 shall not apply in the case of any affiliate that is principally engaged in business outside the United States.

[5]This requirement shall not be construed to prohibit the bank from advertising or otherwise disclosing its relationship to the affiliate.

(1) directly or indirectly make any extension of credit to any such subsidiary in excess of 10% of the bank's primary capital;

(2) directly or indirectly make extensions of credit in the aggregate to all such subsidiaries in excess of 20% of the bank's primary capital;[6]

(3) make any extension of credit where the proceeds are to be used by the borrower to acquire any interest in real estate developed by such subsidiary or affiliate unless the terms and conditions of the extension of credit are consistent with safe and sound banking practice. The aggregate of such extensions of credit shall not exceed 10% of the bank's primary capital.

(4) directly or indirectly condition any extension of credit on the requirement that the borrower purchase any real estate developed by such subsidiary or affiliate or purchase any insurance policy or annuity underwritten by such subsidiary or affiliate.[7]

(5) purchase as fiduciary, co-fiduciary, or managing agent on behalf of any account for which the bank has sole investment discretion any interest in real estate developed by such subsidiary or affiliate or any insurance policy or annuity underwritten by such subsidiary or affiliate unless: (i) the purchase is expressly authorized by the managing agency agreement, trust instrument, court order, or local law, or specific authority for the purchase is obtained from all interested parties after full disclosure, (ii) the purchase, although not expressly authorized under (i), is otherwise consistent with the bank's common law fiduciary obligation, or (iii) the purchase is permissible under applicable state and federal law or regulation.

(6) make any extension of credit in excess of 15% of the bank's primary capital to any real estate development in which the bank's subsidiary or affiliate has an equity interest.

(b) Operation of insurance department/permissible real estate development.

Any insured bank that operates a life insurance department as permitted by section 332.3(c)(2), and any insured bank that directly engages in real estate development pursuant to section 332.3(b)(2), shall comply with the following:

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[6]Section 332.2 (e)(1) notwithstanding, a bank's investment in stock issued by its subsidiary shall not be considered an extension of credit subject to the restrictions of paragraphs (a)(1) or (a)(2) of section 332.7(a).

[7]Compliance with section 106(b)(1) of the Bank Holding Company Act (12 U.S.C. 1972) shall be deemed to be compliance herewith.

(1) the bank is prohibited from referring to federal deposit insurance in any life insurance department advertisement, solicitation, or promotional material.

(2) any life insurance policy or annuity underwritten by the insurance department of the bank must be accompanied by the following, or a similar statement, either on the face of the policy or annuity or in a written disclosure given to the customer: "The only assets of this bank which are liable for and applicable to the payment and satisfaction of the liabilities, obligations, and expenses of the insurance department of this bank are the assets of the insurance department of this bank."

(3) the bank shall not directly or indirectly condition any extension of credit on the requirement that the borrower purchase any interest in real estate developed by the bank, or purchase any life insurance policy or annuity underwritten by the bank.[32]

(4) the bank shall not purchase as fiduciary, co-fiduciary, or managing agent on behalf of any account for which the bank has investment discretion any interest in any real estate developed by the bank, or any annuity underwritten by the bank, unless the requirements of section 332.7(a)(5) are met.

332.8 Waiver.

The Board of Directors, in its discretion, may by resolution waive all or any portion of this part when it deems it necessary and in the public interest to do so. In doing so, the Board of Directors may impose such conditions as it determines to be appropriate.

332.9 Compliance.

(a) Existing operation moved to subsidiary.

Any insured bank that prior to (insert date of publication in the Federal Register) engaged in any activity prohibited to an insured bank by section 332.3 shall comply with that section within one year from (insert the effective date of the regulation); provided, however, that the bank may complete any real estate development project that is ongoing as of (insert date of publication in the Federal Register) as well as any real estate development project for which, as of such date, the bank had entered into a binding contractual obligation. No new real estate development project may be entered into after (insert effective date of the regulation) other than in compliance with this part.

(b) Existing subsidiary or affiliate.

Any insured bank that prior to (insert date of publication in the Federal Register) acquired or established a subsidiary that engages in any activity prohibited to an insured bank under section 332.3, or prior to such date became affiliated with a company encompassed by section 332.6, shall comply

with this part within one year from (insert the effective date of the regulation); provided, however, that such bank shall comply with sections 332.3 and 332.6 within 180 days of the effective date of the regulation and section 332.7 within 90 days of such date.

332.10 Enforcement.

Any insured bank that is not operating in compliance with this part shall be deemed to be operating in an unsafe and unsound condition and in a manner inconsistent with the purposes of federal deposit insurance and will be subject to termination of deposit insurance in accordance with section 8(a) of the Federal Deposit Insurance Act (12 U.S.C. 1818(a)).

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By Order of the Board of Directors this 3rd day of June, 1985.

Federal Deposit Insurance Corporation

Hoyle L. Robinson
Executive Secretary

(SEAL)