Federal Deposit Insurance Corporation

12 C.F.R. 332, 333, 337

Advance Notice of Proposed Rulemaking

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

ACTION: Advance Notice of Proposed Rulemaking.

SUMMARY: FDIC is soliciting comment on the need for rulemaking to govern the direct or indirect involvement of insured banks in the following activities: real estate; insurance brokerage and underwriting; data processing for third parties; and travel agency activities. Specifically FDIC is soliciting comment on whether or not such activities on the part of insured banks pose any safety and soundness problems, present any conflicts of interest, or are consistent with the purposes of Federal Deposit Insurance. Comment is also being solicited as to whether or not limitations should be imposed on the ability of a firm engaged in any of the subject activities to own an insured bank. In order to obtain the broadest possible discussion of the issues, this notice is directed to all insured banks rather than merely to those state insured banks for whom the FDIC is the primary federal supervisory authority.

DATE: Comments must be received by [60 days from publication in Federal Register]

ADDRESS: Send comments to Hoyle L. Robinson, Executive Secretary, FDIC, 550 17th Street, N.W., Washington, D.C. Comments may be hand delivered to Room 6108 between the hours of 8:30 a.m. and 5:00 p.m., Monday through Friday.

FOR FURTHER INFORMATION CONTACT: John F. Bovenzi (202-389-4321), Division of Research & Strategic Planning, Pamela E.F. LeCren or Barbara R. Messé (202-389-4171), Legal Division, or Ken A. Quincy (202-389-4141), Planning and Program Development Branch, Division of Bank Supervision.

SUPPLEMENTARY INFORMATION: For much of the last half century commercial banks and thrifts operated in a very insulated environment. In part, this was due to a healthy economy and government policies designed to control the cost of funds and limit competition among financial institutions. In addition, the clear separation which existed between the product lines of banks, thrifts, other types of financial companies and commercial firms served to limit bank competition. The environment in which banks function today, however, is rapidly changing. The traditional boundaries distinguishing "banking" from "other financial services" and from "commerce" are beginning to erode with ever increasing cross-industry acquisitions, expansion by banks in new product markets, and changes in state laws authorizing banks to engage directly or indirectly through subsidiaries in activities heretofore open to banks only in limited instances.

While much of the change has been gradual, in recent years the transition process has quickened dramatically. Technological innovations, the removal of deposit interest ceilings, relaxation of geographic limitations and entry by nonbank financial servicers and commercial firms into previously sheltered bank product lines (either directly, or by establishing or acquiring what is referred to as "a nonbank bank", or by acquiring or establishing a savings and loan institution) have all been important factors which have transformed the financial marketplace.

These changes have been especially noticeable in the case of entry by nonbank financial servicers into traditional bank product lines. In 1978, Merrill Lynch began marketing its Cash Management Account which can be characterized as a checking account that offers market rates of interest. This type of service has gradually become more sophisticated. For example, Fidelity Group through its Asset Management Account offers complementary services which include direct payroll deposit and telephone bill-paying services. Merrill Lynch, the Fidelity Group, Dean Witter, the Calvert Group and the VanGuard Group are among the securities firms now offering insured accounts.

Insurance companies have also become involved in activities traditionally associated with banking. In addition to the above-mentioned services, most large insurance companies are actively engaged in short-term corporate lending (i.e., offering revolving credit lines and term loans from two to ten years). Moreover, some insurance firms, such as Prudential and Travelers, are practicing spread lending by borrowing money in the commercial paper or Eurodollar markets to finance their shorter-term loans.

Many nonbank financial firms have purchased or established their own "nonbank bank" which, under current law, is permissible if the bank either does not accept demand deposits or does not offer commercial loans. Dreyfus Corporation, American Express, E. F. Hutton and Marsh & McLennan are among the firms currently operating "nonbank bank" affiliates. Merrill Lynch, Aetna and Prudential, among others, are proceeding with plans to acquire or establish nonbank banks.

In addition, a wide array of commercial enterprises are affiliated with or control savings and loan institutions or "nonbank banks". Gulf & Western, Sears Roebuck & Co., Parker Pen Corporation, Landmark Land Company, J. C. Penney, and Kroger Company are but a few of the many business firms that fall within this category.

Not only are nondepository institutions invading traditional bank markets, they are also entering into each other's traditional product lines. To give one example, Sears, in addition to owning a savings and loan institution, owns and operates an insurance firm (Allstate), a real estate firm (Coldwell Banker), and a securities firm (Dean Witter). By combining various services within a single commercial enterprise, such companies may be able to achieve certain economies of scale which could allow them to realize an important competitive advantage over banks and thrifts, their less diversified rivals.

Conversely banks are beginning to explore product markets and services heretofore considered by some to be "non-banking" products and services. The banks that the FDIC supervises are state chartered and as such their powers and authorities are defined by state law. Recently the California legislature enacted a law which, although not yet effective, will authorize securities and real estate activities by banks. Several state legislatures are actively considering, or have already enacted, legislation permitting state chartered institutions to engage in insurance activities. (See for example, recent legislation in South Dakota and legislative initiatives in Delaware, Maine and Minnesota). In Massachusetts, Connecticut, and New York, mutual savings banks are already authorized to indirectly engage in certain insurance activities.

Several states have what is commonly referred to as a "leeway investment" provision under authority of which banks may invest a certain percentage of their capital in <u>any</u> endeavor. Washington Mutual Savings Bank, Seattle, Washington is currently operating a full service brokerage subsidiary under authority of such a provision. Similarly, last year Boston Five Cent Savings Bank, Boston, Massachusetts organized two wholly owned subsidiaries to advise and distribute shares in a mutual fund pursuant to authority contained in a leeway investment provision.

The FDIC is presently engaged in a rulemaking procedure with regard to nonmember bank indirect securities activities through subsidiaries (<u>See</u> 48 FR 22155, May 17, 1983). The purpose of the proposed regulation is to ensure the safe and sound operation of insured nonmember banks and compliance with section 21 of the Glass-Steagall Act (12 U.S.C. 378) which prohibits deposit taking institutions from directly engaging in the sale, distribution, or underwriting of securities. The FDIC undertook rulemaking in this area because of expectations that bank entry into the securities area through subsidiaries will increase. For example, the North Carolina legislature recently lifted a prohibition on the underwriting of securities by bank subsidiaries.

Banks can no longer simply rely on low cost deposits as a source of funds to generate income. Banks are therefore considering entry into the above and other activities as a way of expanding their sources of income. Those activities include insurance brokerage and underwriting, real estate brokerage and development (the term "real estate development" and "real estate underwriting" are meant to be interchangeable), data processing for third parties, travel agency activities, as well as any number of other financially related services. As banking powers are expanded by the state legislatures or powers previously conferred but not exercised are activitated, the FDIC has both the responsibility and the authority to carefully weigh these developments in its capacity as a supervisor of insured nonmember banks and insurer of the nation's banking system. The FDIC is committed to a dual banking system and is mindful of the issues raised by any effort by a federal agency to review the propriety of banks engaging in activities authorized by their state chartering authorities or their primary federal regulatory agency. At the same time, the FDIC cannot lose sight of its obligation to monitor marketplace developments and changes in law in order to assess the potential impact of such changes on bank safety and soundness.

The FDIC is issuing this Advance Notice of Proposed Rulemaking as part of its comprehensive review of the developments detailed above. The FDIC invites comments addressing two broad issues: (1) what, if any, guidelines or regulations should govern the direct or indirect involvement of FDIC-insured banks in expanded financial activities (specifically insurance brokerage and underwriting, real estate brokerage and underwriting, data processing for persons or companies other than banks, travel agency services, and other financially related services, i.e., courier services, leasing, management consultant services); and (2) what, if any, limitation should there be on the ownership of insured banks by companies engaged in the activities listed above.

The second issue arises as over the past decade an increasing number of companies have taken advantage of the narrow definition of the term "bank" in the Bank Holding Company Act (12 U.S.C. 1841(a)) and acquired so-called "nonbank banks". If a bank targeted for acquisition does not make commercial loans or does not engage in the business of accepting demand deposits, the targeted institution is not a "bank" within the meaning of the Bank Holding Company Act. The acquiring company is therefore not a bank holding company and its activities, as well as those of its other subsidiaries, are not limited to activities permissible to bank holding companies under Federal Reserve Board Regulation Y (12 C.F.R. Part 225).

The FDIC is interested in receiving comment on whether or not the affiliation of a bank with a company engaged in nonbanking activities (i.e., the ownership of a bank by such a company) is inherently inappropriate from a safety and soundness or other standpoint; is inappropriate depending upon the activities of the parent company and the activities of the parents' other subsidiaries; and whether or not such a relationship is appropriately limited to companies that are engaged in the financial-services industry rather than general commerce. In this vein, the FDIC is interested in receiving comments on what constitutes the financial-services industry, i.e., what standards should be used to differentiate between commercial banking, other financial services and commerce in today's changing environment.

The other major issue the FDIC wishes to explore focuses on bank expansion into additional activities. The FDIC is requesting comments from the public, bankers, and industry representatives that will help inform the FDIC as to how each of these industries function and what regulatory requirements currently govern these industries. What are the capital requirements, if any, for such endeavors? What type of risks, if any, are incurred in these businesses which are not inherent in banking? Does the successful operation of these types of businesses require management skills and expertise that bankers do not possess? Would these activities unduly divert bank management's attention away from traditional banking endeavors to the detriment of the banking operation?

In order to facilitate receipt of comments, the FDIC has posed the following specific questions in addition to those set forth above. The questions are designed to explore safety and soundness issues, conflicts of interest, and whether the activities under consideration are consistent with the purposes of federal deposit insurance. Commentors are reminded that the FDIC is specifically considering the two major issues outlined above in the context of the following activities: insurance brokerage and underwriting, real estate brokerage and underwriting, data processing for persons or companies other than banks, travel agency services, and other financial services. Comments addressing the specific questions as well as any other comments on the general subject matter are welcomed.

1. Are there potential conflicts of interest associated with a bank's direct or indirect involvement in any of these activities? If so, are existing federal laws, such as the anti-tying provisions of the Bank Holding Company Act amendments of 1970 (12 U.S.C. 1971), sufficient safeguards against abuse?

2. Should disclosure requirements be imposed concerning any conflicts of interest that might exist; i.e., disclosure to the bank's customer of the bank's relationship to the subsidiary, parent, or sister affiliate whenever the bank is brokering a product or service offered by the parent, a subsidiary, or a sister affiliate?

3. Do conflicts of interest concerns arise from a dual employment arrangement; i.e., should it be permissible for a bank employee to also function as a representative of an affiliated company which is engaged in activities? Does the response to this question depend upon the type of activity in which the affiliate engages?

4. To the extent that any of the activities are regulated by state or federal law, does bank entry pose a problem of overlapping supervisory responsibility or conflicting regulatory requirements (i.e., capital requirements, etc.)? Are these problems, if they exist, more or less prevalent in an in-house operation than they would be if the activity were conducted by a separate subsidiary of the bank? Would regulatory differences lead to competitive inequities between banks and their nonbank competitors? If so, how might these inequities be resolved?

5. If banks enter into any of these endeavors under authority of state or federal law, is there any safety and soundness, operational, or other reason to require that the services be conducted in a separate subsidiary as opposed to an in-house department of the bank? Does a response to this question depend upon the involvement in the activity, (i.e., underwriting versus selling of the product or the service, or the type of activity; i.e., travel agency activities versus insurance activities.)?

6. Are there fundamental differences between banking and any of the listed activities (structural, risk related, diversification, profitability, potential liabilities, requisite expertise) that dictate a response one way or the other as to the propriety of banks engaging in these activities whether directly or indirectly through subsidiaries?

7. Section 23A of the Federal Reserve Act, as amended, (12 U.S.C. 371c) does not cover extensions of credit by a bank to its own subsidiaries as those subsidiaries are not included in the definition of affiliate. In view of that fact, should regulations be enacted imposing the same or similar restrictions as those found in Section 23A on extensions of credit by a bank to its subsidiaries? Should such restrictions be imposed only in certain instances, i.e., depending upon the activity conducted by the subsidiary?

8. If an insured bank establishes or acquires a subsidiary that engages in any of these activities, should the bank's investment in such subsidiary be limited?

9. Should the investment be considered part of, or be excluded from, the parent bank's "capital" as defined for regulatory purposes?

10. If the FDIC were to adopt the posture that any activity was permissible if conducted by a separate subsidiary that was adequately capitalized and from which the parent bank was insulated (i.e., potential liabilities, losses, etc.), should the FDIC attempt to define what constitutes adequate capital?

11. Should there be a prior approval requirement before an insured bank directly engages in or establishes or acquires a subsidiary that engages in any of the activities under review?

12. If no prior approval requirement is instituted for either in-house activities or a subsidiary, would a prior notice requirement be appropriate?

13. Should an insured bank's entry, either directly or indirectly, into any of these activities be limited by a bank's asset size, its composite rating, or by some other criteria?

14. Should the FDIC consider the initiation of any of the above activities directly by a state nonmember insured bank (or its subsidiary) to constitute a change in the character of the institution's business such that Section 333.2 of FDIC's regulations (12 C.F.R. 333.2) would apply? If so, upon what basis?

15. Should the FDIC consider the initiation of any of the above activities directly by a state nonmember insured bank (or through a subsidiary) to be inconsistent with the purposes of Federal Deposit Insurance; i.e., should Section 332.1 and .2 (12 C.F.R. 332.1, .2) be amended to take one or more of these activities into account? If so, upon what basis?

16. Are existing antitrust laws adequate safeguards against excessive concentrations of economic power that may result from bank participation in insurance, real estate or any of the other areas being reviewed? If not, would it be appropriate to limit bank entry into new activities to de novo entry, (i.e., not through the acquisition of an ongoing business)?

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By Order of the Board of Directors this 30th day of August, 1983.

Hoyle L. Robinson

Hoyle L. Robinson
Executive Secretary

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