Report to the Congress
on the
Findings and Recommendations Concerning the "Two-Window" Deposit System Proposal

Pursuant to Section 321 of Public Law 102-242

Federal Deposit Insurance Corporation

September 1992

REPORT TO THE CONGRESS

ON THE

FINDINGS AND RECOMMENDATIONS CONCERNING
THE "TWO-WINDOW" DEPOSIT SYSTEM PROPOSAL

PURSUANT TO SECTION 321 OF
PUBLIC LAW 102-242

FEDERAL DEPOSIT INSURANCE CORPORATION

SEPTEMBER 1992

<u>OUTLINE OF THE REPORT</u>

EXECUTIVE SUMMARY

The "two-window" proposal for banking reform reflects the view that today's banking problems are related to existing restrictions on bank affiliations, ownership and location. According to this view, banking organizations must regain the ability to compete effectively and attract new capital if the industry is to be restored to health. A two-window structure is offered as a means to permit banking organizations to compete in nonbank markets without exposing the deposit insurance funds (thus the taxpayer) to undue risk.

Under the two-window proposal, insured banks would be confined primarily to their traditional intermediation function of transforming liquid deposits into illiquid loans of short-to-intermediate term. The intent is to reduce the taxpayer's potential risk exposure as much as possible without undermining the legitimate purpose of deposit insurance. Banking organizations would be permitted to gather funds for nonbank activities through an "uninsured window" in the bank (i.e., a separate area from insured deposit windows, where customers could make various types of uninsured investments). Activities deemed impermissible for funding with insured deposits would be conducted in separately capitalized affiliates or subsidiaries, and the insured bank would be insulated from nonbank risks through safeguards involving legal and financial separation.

There would be few, if any, restrictions on bank ownership or affiliations. The legal and financial separation would presumably keep all dealings between banks and their affiliates at "arm's length." Although supervisors would have authority to audit both sides of any transaction between a bank and its affiliate, there would be no consolidated supervision; supervision and regulation of nonbank affiliates would be on a functional basis.

The benefits and costs associated with two-window restructuring are conjectural and therefore controversial. The major issue concerns the degree of insulation provided by the legal and financial separation that will protect the insured bank. Although it is generally acknowledged that there could be more frequent breaches of safeguards under a two-window system, experts differ as to the probable <u>net</u> effect on bank safety, industry profitability, and economic efficiency.

The case for implementing a two-window system at this time rests on two arguments. The first is a concern that the safety net is now or soon will be extended beyond the ability of the deposit insurance system to support it. The second argument is that banks are losing their ability to compete in the financial marketplace because of restrictions on bank activities and affiliations. While these are legitimate concerns, there are developments in the banking industry that address these concerns and thus may obviate the need for more radical reform along the lines of a two-window system.

The first development is the FDIC Improvement Act of 1991, which is intended to shore up the deposit insurance system through a variety of reforms including capital-based supervision, prompt corrective actions for troubled institutions and implementation of risk-related assessment rates. If these measures reduce the industry's reliance on the resources of the deposit insurance system, then much of the concern about the pressure on the safety net may be alleviated. Moreover, it is unlikely that the reforms envisaged in the two-window system would address the current asset-quality-related problems facing the industry.

The second development to recognize is that banking organizations are obtaining expanded powers. Indeed, bank holding companies are now represented in many types of financial services and banks are free to affiliate with a wide variety of financial-services firms. The direction is unmistakably toward expanded powers and is taking place in the context of consolidated supervision as embraced by the Basle accord. As a result, the current trend is toward the development of a more rational banking industry. Unless this trend is reversed, there does not appear to be the need for radical reform along the lines of the two-window approach.

The two-window proposal is perhaps better balanced than many other reform proposals in terms of recognizing and providing for the many competing policy considerations involved in restructuring our banking system. The two-window structure raises significant concerns at this time, but these may become less important if deposit-insurance losses fail to abate and if banking organizations fail to compete effectively in the market for financial services.

In summary, this probably is not the appropriate time to implement a significant change in the rules that govern the operations of the nation's banking system. The provisions of the FDIC Improvement Act of 1991 are designed to address the current problems facing the industry and the deposit insurance funds. In addition, banking companies are being allowed to compete in an expanding number of product markets. If these trends do not ultimately result in a healthy and viable banking system, it will be time to revisit the two-window system.

I. INTRODUCTION

The "two-window" proposal for bank restructuring -- whereby customers could choose between insured deposits and various uninsured investments -- has been offered as a possible solution for some well-known problems facing the U.S. banking system.[1] Banking organizations have been unable to adapt efficiently to recent financial innovations, advances in information technology, and other competitive pressures, and some argue that this inability has been largely due to restrictions on their product lines, location, and ownership. The result is that many banks have lost their best deposit and loan customers. With a growing pool of insured deposits pursuing a shrinking pool of traditional profit opportunities, many banks have attempted to maintain their market shares and earnings by relaxing underwriting standards and raising deposit rates. These and other competitive forces have eroded the spreads between deposit and loan rates, thus threatening the profitability of all banks. One important implication of this has been an increase in the potential cost to the public of government protection for insured deposits.

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[1]See the Testimony by L. William Seidman, FDIC Chairman, on "Proposals to Establish a 'Core' or 'Narrow Bank,'" before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, June 18, 1991.

The two-window solution for such problems involves bank restructuring designed to insulate the deposit insurance funds from unnecessary risks and to free banking organizations from unnecessary, anticompetitive constraints. There are three primary features of the two-window structure: (1) Bank risk-taking is confined by further restricting the activities that may be funded with insured deposits; (2) activities deemed improper for funding with insured deposits are permitted for uninsured affiliates (perhaps subsidiaries) within the same banking organization, but the insured entity is insulated from nonbank risks through separate capitalization and a set of reinforcing "firewalls" to maintain effective legal and financial separation; and (3) all ownership, product-line, and location restrictions now applied to banking organizations are lifted so that new capital may be attracted and banking organizations may compete on a more level playing field with nonbank and foreign firms.

The concept of two windows derives from the same basic philosophy that underlies the so-called "core-bank" or "narrow-bank" proposals for banking reform (these will hereafter be referred to as "narrow-bank" proposals).[2] Again, the purpose is to reduce the risk exposure of the deposit insurance funds (hence, the taxpayer) by restricting the permissible uses of insured

[2]See Robert E. Litan, What Should Banks Do?, The Brookings Institution: Washington, DC, 1987 and Lowell L. Bryan, Bankrupt: Restoring Health and Profitability to Our Banking System, McKinsey and Company, 1991.

deposits and by removing what arguably are unnecessary barriers to banking-organization profitability. Differences among the two-window structure and various versions of the narrow-bank proposal relate to the proper means of achieving a common set of goals. The two-window concept departs from narrow-bank proposals in the criteria used for determining acceptable uses of insured deposits, the restrictions imposed on nonbank-affiliate activities, and the structural design of the banking organization as a whole. These differences will be considered briefly in turn.

Activities funded with insured deposits. Narrow-bank proposals tend to use risk measures alone for determining what are acceptable uses of insured funds. Only the safest activities are permitted in the insured entity, and thus the proposed "bank" typically resembles a money-market mutual fund: Its deposits are transactions accounts that are serviced through investments in Treasury securities and high-grade commercial paper. In the two-window approach, the decision as to whether an activity should be funded with insured deposits involves more than risk measurement. Also important is whether there exists a legitimate economic rationale for extending the safety net to the activity in question. For example, the traditional banking business of intermediating between highly liquid deposits and illiquid commercial loans is thought to fulfill a unique and important economic purpose. Such intermediation also is intrinsically susceptible to destabilizing bank runs that interrupt real production and may otherwise impose potentially heavy social costs. Thus, there is thought to be a legitimate economic rationale for providing deposit insurance to this traditional banking function.[3] It is much more difficult to provide a defensible rationale for extending the safety net to products and services that are already traded in established, well-functioning markets, such as insurance and securities.

The two-window approach suggests that insured banks should be limited to activities that are consistent with the traditional business of banking: issuing deposits and other relatively liquid claims, clearing payments, and investing in short- and intermediate-term commercial loans and, perhaps, some consumer loans (but no equity investments)[4]. All other activities should be conducted in separately capitalized subsidiaries or affiliates that are not funded with insured deposits. If there are important synergies between traditional banking functions and certain nontraditional activities, exceptions would be permitted.

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[3]See Deposit Insurance for the Nineties: Meeting the Challenge, Federal Deposit Insurance Corporation, 1989 and Arthur J. Murton, "Bank Intermediation, Bank Runs, and Deposit Insurance," FDIC Banking Review (Spring/Summer 1989), pp.1-10.

[4]The distinction between an extension of credit and an equity investment is not always clear. A general rule offered in the two-window approach is that bank loans should be of short or intermediate term and should be made with recourse to the borrower's net worth. Firm take-out commitments should be secured for loans that support the beginning of long-term projects, and sound underwriting standards should be applied to all extensions of credit.

These basic principles can be applied to most items found on the average bank's balance sheet. For example, readily marketable investments by banks should be viewed solely as a means to satisfy liquidity needs and should be confined to investment-grade issues (excepting, perhaps, the purchase of some state and local government securities for the purpose of securing public deposits). Some liquidity is necessary, but deposit insurance should not be used simply to exploit the spreads between marketable instruments and insured deposits, according to this view. Nor should a bank's underwriting of municipal or U.S. Government securities receive safety-net protection. Similarly, foreign-exchange and securities-trading activities are properly performed outside the insured bank. Off-balance-sheet activities should be evaluated on the basis of whether they are integrally related to traditional banking business as defined above, and whether they contribute to the safety and soundness of the bank.

<u>Restrictions on nonbank-affiliate activities.</u> The operating principle embodied in the two-window approach is that insured banks should be free to affiliate with both financial and nonfinancial enterprises provided that: the bank is well-capitalized upon completion of any affiliation transaction, nonbank affiliates are separately capitalized, and supervisors are satisfied that the resulting entity will not operate in a manner that is abusive to the bank. Supervisors should have authority to preclude

affiliation if there are concerns about the quality or character of management in either the bank or the proposed affiliate. Moreover, after an affiliation takes place, there should exist clear supervisory authority to audit both sides of any transaction between the bank and its affiliate and to require reporting as necessary from both parties to the transaction.

The general rule for bank supervision in a two-window system is that all advances of bank funds should be governed by an "arm's length" requirement. The two-window framework includes firewalls and regulatory safeguards to ensure legal and financial separation.[5] For the two-window structure to function safely and properly, capital flows between the bank and its affiliates or subsidiaries must be strictly limited.

<u>The structure of the banking organization.</u> So long as firewalls exist, capital flows are properly restricted, and proper supervisory measures are taken to ensure arm's-length dealings between insured banks and their nonbank affiliates, any corporate structure is permissible under two-window banking. Narrow-bank proposals typically impose a specific structure (usually resembling

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[5]See <u>Mandate for Change: Restructuring the Banking Industry,</u> Federal Deposit Insurance Corporation: Washington, DC, 1987, Chapter 8. Note: Many elements of the two-window structure are described in <u>Mandate.</u> The remainder of this study relies heavily on the arguments in <u>Mandate</u> to represent the two-window view. In many instances, the language of <u>Mandate</u> is paraphrased or reproduced directly without attribution.

a holding company) along with a set of regulations and supervisory measures that apply to the banking organization as a whole.[6] The two-window structure is designed specifically to avoid this type of oversight and control. Consolidated supervision under this view is considered undesirable because it may impede efficiency and needlessly reduce profitability.

Because the potential benefits and costs of a two-window system are conjectural and therefore controversial, Sections II through IV of the report discuss the principal issues. Conclusions and recommendations are presented in Section V. The primary focus throughout is on the relevance and feasibilty of the basic framework suggested by two-window banking as opposed to the structural details of any particular version.

II. RISK TO THE DEPOSIT INSURANCE FUNDS

Activities in the insured bank. The banking entity in a two-window system would be restricted to traditional activities, except where important synergies with nontraditional activities have been demonstrated. The major risks posed to the deposit insurance funds by insured banks would be the traditional types of banking risk -- primarily those risks of credit quality associated

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[6] See Litan (1987), Bryan (1991), and Gerald E. Corrigan, "Financial Market Structure: A Longer View," Federal Reserve Bank of New York Annual Report (1987), pp. 3-6.

with commercial lending. Two-window proponents maintain that, if managed properly, the banking organization as a whole can be more competitive and financially healthier under their proposed system, and this may redound to the benefit of the insured bank. Moreover, the proposed firewalls and other protections would remove much of the risk to which many banks are currently exposed. Thus, the contention is that there will be risk reduction for the insurance funds if the two-window structure is adopted.

However, risk reduction is not the sole aim of the two-window approach. Narrow-bank structures would achieve greater risk reduction for the deposit insurance funds than would the two-window structure. Proponents of the two-window approach regard this extra risk exposure as worthwhile because the traditional intermediation role of banks is regarded as vital to economic activity. The two-window view is that an important component of the economy's production relies substantially upon banks for financing. This production is undertaken by firms that, for various reasons, cannot successfully borrow in markets for tradeable securities -- even when the projects to be financed are viable and productive. As a result, the threat of bank runs is socially costly because it impairs this special banking function and prevents the funding of many projects that are potentially productive.

Under this view of credit markets, there is a market failure to allocate credit appropriately in the absence of deposit insurance (or some equivalent protection) for bank intermediation.[7] To remove safety-net protections from the traditional banking function would create more social costs than benefits if this view is correct.

Such a view is controversial and a thorough treatment is beyond the scope of this study.[8] Narrow-bank proponents do not believe that the type of market failure cited above is sufficiently important to justify deposit-insurance protection for traditional banking functions. Two-window proponents presume the importance of traditional bank intermediation and the need for safety-net protection for banking. Absent this presumption, it is highly unlikely that the two-window structure could be viewed as desirable because narrow banks would expose the taxpayer to far less risk.

Profitability and diversification of risks. Expanded powers would create the opportunity for greater profits as well as greater losses within banking organizations. Financial theory indicates that a broader menu of investment choices facilitates the creation of portfolios with desired risk and return characteristics.

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[7]See Bernanke (1983), Bernanke and Gertler (1987 and 1989), Diamond and Dybvig (1983 and 1986) and the literature cited therein.

[8]See the U.S. Department of the Treasury's report to Congress, Modernizing the Financial System: Recommendations for Safer, More Competitive Banks (February 1991): Chapter 3, and the references therein for a broader overview. References cited in Section I also deal directly with this topic.

Expanded powers can reduce risks for banking organizations if appropriate diversification rules are followed, but no reliable prediction is possible for the banking industry as a whole. New investment opportunities will not be exploited identically at different institutions and similar investment choices may influence risk and return differently at different institutions, depending upon the characteristics of existing portfolios, the size of new investments relative to the existing portfolios, and managerial efficiency in capturing any economies of scope offered by new powers.[9]

Although the net effect of new powers is impossible to predict with any precision, two-window proponents argue that it is also irrelevant. What matters is that well-managed banking organizations are currently prohibited from diversifying appropriately and maximizing returns for their shareholders. These institutions are likely to become safer and more competitive with expanded powers, potentially benefiting consumers as well as shareholders and taxpayers. Poorly-managed institutions, on the other hand, will likely suffer the consequences of a new set of poor choices if expanded powers become available, and many of these firms may fail even sooner than anticipated. This is fitting and proper, in the view of two-window proponents, and a merit of the

[9]See Mandate for Change, pp. 60-63 and the references there cited for a more detailed discussion of this issue.

two-window structure is that it allows the competitive process to work without additional risk to the taxpayer.

In fact, proponents argue that the deposit insurance funds will benefit to the extent that nonbank risks are removed from the insured entity and to the extent that scope economies or other innovations save some banking franchises that otherwise would have been extinguished. Capital will be free to move to nonbank uses when banking returns are low. Meanwhile, any new risks posed by expanded powers will presumably be borne outside the safety net, as ensured by the firewalls and regulatory safeguards embedded in the two-window structure. If effective, this structure dispenses with any need for concern about the effects of new powers.

Supervisory issues. The possibility of undue concentrations of power, decreased competition, conflicts of interest, and unfair competitive advantages are among the problems that can be associated with expansion of bank powers. Concerns stemming from potentially dangerous concentrations of power include destabilization of the monetary system and disproportionate control over the country's financial resources on the part of a few large institutions. Fears surrounding the adverse effects on competition include the damage that may result from decreased competition as banks exit unprofitable businesses, or conversely, excessive competition on the part of smaller institutions, which may result in their demise.

Such concerns are real but difficult to assess. While banking organizations may be larger and fewer under a two-window system, they also may be better diversified. Thus, while any given bank failure under this system may be more costly and destabilizing, there may be fewer failures. Similarly, a decline in the number of banks need not mean that fewer banks will be competing in any given market. Technological advances in information processing and communications are constantly reducing the costs associated with entry into new markets. This suggests that if inadequate competition creates excess profits in a given market, new entrants may be attracted until above-normal profits are competed away. To the extent that expanded powers would increase either actual or potential competition, this would provide a safeguard against the costly excesses typically associated with concentrations of power. More will be said about concentration and its possible effects in Section III. For now, it is sufficient to note that legitimate concerns arise in connection with this issue. Before committing to a two-window structure, Congress may wish to consider whether remedies would be available to offset any untoward effects of concentrations.[10]

(1) Potential for abuse. Supervisory concerns center around threats to bank safety and soundness stemming from transactions that, while beneficial to an affiliate engaged in nontraditional activities, may be detrimental to the insured institution.

[10]See Mandate for Change, pp. 81-85.

Examples of such transactions are loans, capital injections, or asset purchases that can be conducted directly between the institution and its affiliate or indirectly through a parent holding company, other affiliates, or customers of the institution or affiliates.

The greatest perceived risk lies in affiliates that may be in danger of failing and in need of financial assistance. During the 1920s and early 1930s the soundness of many banks was thought to be jeopardized due to failing affiliates that banks were "bailing out." Concern over such abuses led to passage of the Glass-Steagall Act, which separated commercial and investment banking activities. Despite abundant evidence that no banks actually failed due to securities activities (see White, 1986), the concern over abuses has persisted. The separation between commercial and investment banking was reaffirmed in the Bank Holding Company Act of 1956 and its 1970 amendments.

Other conflicts may arise when an affiliate's customers or creditors are compromised to benefit an insured financial institution. While concern over potential abuse of an affiliate to benefit an insured institution is somewhat less than for the reverse situation, recent evidence indicates notorious abuse in the case of Lincoln Savings and Loan, where customers were misled into buying bonds of the parent holding company, the proceeds of which were used to cover losses at Lincoln.

Tie-ins, which occur when a business entity attempts to condition the sale of a particular product or service upon the purchase of another of the entity's products or services, also carry the potential for abuse. Problems with tie-ins relate to either lack of information or inadequate levels of competition. For example, extensions of credit to bank or thrift customers may be conditioned upon the customers' obtaining additional services from a bank, its parent company, or one of its affiliates or subsidiaries. In such cases, customers may enter into undesirable tie-in arrangements when uninformed of the consequences of their actions or if unaware of other alternatives. Antitrust concerns arise when customers purchase products or services they do not want because they have no viable alternatives. Still other tie-in abuses stem from self-dealing. An example is when a seller tries to induce potential customers to purchase services in which the seller has a personal interest, by underpricing (at the possible expense of an affiliate) a second service in which the seller's personal interest may be less direct. Such a situation can be harmful to insured institutions if the cost of such arrangements is excessive.

The two-window approach suggests that tie-ins resulting from information problems can be effectively controlled by requiring greater disclosure of costs, alternatives, and other pertinent facts. One appropriate response to tie-in arrangements arising from inadequate competition would be to foster a more competitive market. Prohibiting firms from offering multiple products is viewed as an improper policy response to this type of problem, according to two-window proponents. Tie-ins arising from self-dealing are perhaps more difficult to detect and control. Under two windows, this would be left to the usual supervisory process with the understanding that rules could be tightened and penalties increased as experience warrants.

Regulators are also conscious of possible violations of an institution's fiduciary responsibilities. An institution could compromise the interests of trust customers to benefit the bank or one of its affiliates; for instance, if it, acting as fiduciary, buys securities underwritten by it or one of its affiliates.

Improper use of insider information is also among potential abuses. Financial institutions are subject to conflicts arising from the combination of commercial lending and trust activities. For example, there is the potential for conflict between a promoter of services or products and a disinterested advisor. While financial institutions normally promote their financial services and products in the course of normal business, a conflict arises when the institution is acting as a financial advisor or fiduciary to a customer. Those opposed to expansion of banking powers cite ability to obtain low-cost insured funds, ready access to cheap borrowing through the Federal Reserve discount window and federal funds market, and special tax and accounting treatments as unfair competitive advantages enjoyed by financial institutions over other industries.

Two-window advocates argue that because banks have succeeded generally in creating an effective "Chinese wall" between their commercial lending and trust departments, it would seem that they could take similar steps if they are permitted to engage in activities that grant them access to other types of confidential information. Should the level of abuse prove unacceptable, however, additional safeguards and stiffer penalties could be implemented.

(2) **Safety and soundness.** For purposes of deciding the merits of a two-window structure, the issue of whether financial institutions can be effectively insulated from risks posed by their affiliates is more critical than the issue of determining what new activities should be permitted. The three major risks to financial institutions and ultimately the deposit insurance funds are: 1) that the institution might be held legally responsible for the liabilities of new activities, 2) that the institution might endanger its own financial health and safety by directly or indirectly assisting a failing subsidiary, and 3) that public confidence might be shaken by problems in the new activities, causing a run on the institution and perhaps its demise. These three risks can be categorized as legal, financial, and market risks, and the insured institution must be insulated from all three

in order to alleviate concerns. There has been much debate over the degree of insulation that can be achieved. Among various types of organizational structures, the general consensus is that the most insulation can be achieved via a separately incorporated affiliate under a holding company structure.[11]

(a) Legal separation. Legal separation would insulate a financial institution from claims against its assets by an affiliate's creditors, with the institution's losses being limited to the amount invested in the affiliate. Should the courts find that an institution and its affiliate are not held out to the public or operated as integrated entities, the institution may not be held liable for nonbank debts and may not be obligated to aid a troubled subsidiary. In order to be legally separate, the institution and its affiliates must conduct business in a manner so that the courts will recognize their independence.

Four general standards for ensuring that the "corporate veil" would not be pierced have been suggested.[12] First, each corporate unit must be separately financed in a manner sufficient to withstand normal business strains. Second, the day-to-day business of each unit must be kept separate, including books and records.

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[11]But see the FDIC's response to the April 1987 GAO report Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities for qualifications to this general conclusion.

[12]See the GAO report on Bank Powers (op. cit.) and the references therein for historical background on these standards.

Third, there should be formal barriers between management structures, for example, prohibitions against joint operations. Fourth, the two units should not be publicly advertised or represented as being one unit. Separation of day-to-day business may include separate accounting, personnel, policies and procedures, physical assets, and operation as a separate profit center with separate budgetary discretion. Affiliates should be charged market rates for the institution's services or facilities. Additionally, a separate name and logo and physical separation of the entities would help ensure the perception of separate legal entities.

In general, the requirement of legal separation presents few obstacles to the adoption of a two-window structure. While the two-window proposal appears to violate some generally-accepted tenets of separateness (separate facilities, day-to-day operations, personnel, policies, etc.), Congress could enact appropriate legislation to ensure legal separation under a two-window system.

(b) Financial separation. As investors are interested in maximizing the value of their holding-company stock, their interest is in funding those activities that will contribute the most to consolidated profits. In so doing there is the temptation to divert low-cost insured bank deposits to fund nonbank activities. This incentive to manage funds from a holding company perspective may also lead to shifting activities or assets between the institution and nonbank affiliates. Financial separation can provide insulation against risk to the financial institution due to transfer of funds between the institution and nonbanking activities. Financial separation implies separate funding, no commingling of assets, and arm's-length transactions between affiliates. It follows that loans or services obtained by an affiliate from the institution should be at rates comparable to those available to nonaffiliates. Financial separateness also prevents the institution from unduly transferring assets to or purchasing bad assets from an ailing affiliate.

The significance of financial separation is illustrated by the case of Hamilton National Bank of Chattanooga, which failed after it was forced by its parent holding company to purchase low-quality mortgages from a troubled mortgage company affiliate owned by the parent. There are currently in place lending limits, statutory restrictions on transfers of funds, dividend restrictions, and restrictions on amounts and terms for insider loans (see the discussion on Statutory and Regulatory Safeguards in the Appendix to this text); however, abuse of a financial institution by individual owners to benefit outside activities has resulted in a number of bank failures. The two-window system would potentially close many loopholes that permit such abuse by applying existing firewalls and safeguards to all insured institutions affiliated with nonbank firms; but it is reasonable to expect that the incidence of such abuse may nonetheless rise with expanded opportunities for affiliation under two windows. This possibility is considered further in the following section.

(c) Market separation. Full financial separation is impossible without market separation. While it may be possible to achieve legal separation or insulation from risks associated with new activities, attainment of market separation is much more difficult. There are a variety of reasons why the marketplace may closely identify or associate financial institutions with their affiliates or subsidiaries, even if there is legal separation between entities. For example, the market may have difficulty believing that regulation and supervision can offset the incentive for bank holding companies to manage the consolidated entity as one organization. The implication is that the market (public) would believe that problems in one part of the organization would affect other affiliates.

The treatment accorded subsidiaries by a parent organization is a primary factor in setting the stage for market perception of separateness while the treatment accorded the organization by the regulators also colors the market's view. If either the parent company or the regulators take actions that treat the organization as a single entity, the market may not view individual units as separate entities.

It is worth emphasizing that the market does not ignore interrelationships that exist between affiliates. Occasional bank failures due to an affiliate's activities do happen and to suggest that financial institutions can be totally insulated against risks resulting from affiliate relationships is unrealistic.

Safety-and-soundness concerns relative to market separation stem from the danger that public perception of problems in an entity may be transferred to an affiliated financial institution and cause panic leading to withdrawals, a liquidity crisis, and the potential demise of the insured institution. A number of cases have been cited historically as evidence that financial institutions are not insulated from the activities of affiliates and will even go to great lengths to preserve their reputations.

In 1970, United California Bank assumed the debts of its Swiss affiliate to prevent the affiliate's failure from losses incurred in unauthorized speculating on commodity futures. In the mid-1970s, Chase Manhattan National Bank and Manufacturers Hanover Trust Company were among a number of institutions that came to the aid of Real Estate Investment Trusts (REITs) under the banks' advisement to avoid adverse publicity from the REITs' failure. There are mixed views on the merits of these actions.

The financial support provided was generally applauded by the Federal Reserve; however, others felt that the rescue efforts went far beyond the normal bounds of the traditionally conservative American banking industry.[13] In 1980, First National Bank of Chicago participated with Salomon Brothers in the $230 million rescue of a money-market fund under its advisement. In 1982, Chase Manhattan and Manufacturers Hanover paid $190 million in interest owed by Drysdale, a government securities dealer, even though the banks were only financial intermediaries. In 1985, First Chicago incurred a loss nearly nine times the amount of its investment in Banco Denesia, a Brazilian bank. In 1987, Continental Illinois Bank supplied a $385 million capital infusion to support its subsidiary, First Options, after the bank subsidiary incurred losses in the market crash. The recent case involving Drexel, Burnham, Lambert, Inc. stands out among these examples. Drexel attempted to drain capital from a healthy subsidiary to meet the parent's commercial paper obligations. This same scenario has played out at bank holding companies. Recent examples include the cases of National Bank of Washington and Lincoln Savings and Loan. In both cases, bank deposit customers' maturing CDs were channeled into holding-company obligations. There also have been cases where excessive upstreaming of dividends or dividends-in-kind, such as management fees or asset transfers, have significantly weakened or resulted in the failure of an insured institution.

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[13] See C. E. McConnell and W.S. Marcias, Bank Loans to REITs: How Serious the Problem?, New York: Keefe, Bruyette and Woods, Inc., May 2, 1975.

Two-window proponents argue that such anecdotal evidence should be heavily discounted because these examples occurred under a different set of ground rules and a different form of supervisory treatment than would apply in the future. Others suggest that, because a two-window system places increased reliance on firewalls and regulatory safeguards, such evidence should be given considerable weight. They argue that these examples create a reasonable doubt about the effectiveness of the proposed firewalls and safeguards, thus making the two-window structure appear as a gamble that is unacceptably risky.[14]

Just as actions of financial holding company managements influence the market's perspective, so do actions of their supervisors. The 1984 financial assistance program for Continental Illinois National Bank furthered the view that bank supervisors treat banks and their holding companies as integrated entities. In Continental's case, the safety net of federal deposit insurance was extended beyond the boundaries of the bank to the parent holding company. Creditors of the holding company were protected against loss. Although the move was unusual in that it extended protection to uninsured creditors of the holding company, it was thought to be the most cost-effective course of action available at that time.

Subsequent failures and assistance transactions, however, did not protect all creditors of the holding company. The handling of

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[14] See Corrigan (1987).

First National Bank of Oklahoma, BancTexas, First City Bancorporation and Bank of New England Corporation may have helped to dispel the belief that the federal safety net had widened to extend to the parent organization. On the other hand, the 1989 FIRREA amendment to the FDI Act explicitly provides for the cross guaranty of liabilities of commonly controlled insured depository institutions. While this provision applies only to banking entities within the organization and not to nonbanks, it may take time and some further experience for market participants to appreciate such subtleties of corporate separation within banking firms. Moreover, the Federal Reserve has an explicit policy statement identifying the holding company as a "source of strength" for the bank, and the FDIC Improvement Act of 1991 indicates that the capital plan of an undercapitalized institution may not be approved unless the holding company guarantees that the institution will comply with the plan.[15]

In summary, effective insulation of a financial institution from risks associated with expanded or new powers must encompass legal, financial, and market separation. On balance, it is fair to say that past treatment of financial institutions, their parent holding companies and other affiliates by the organization's management, its regulators, and the marketplace has been

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[15]The guarantee is limited to the lesser of five percent of the institution's assets when it became undercapitalized or the amount necessary to achieve capital compliance when the institution fails to meet the plan. FDICIA §131.

inconsistent, thus blurring barriers necessary to achieve true insulation of a financial institution from risks inherent in affiliated businesses. This makes it difficult to use historical evidence for predicting the probable effectiveness of insulation under a two-window system.

(d) Assessing the prospects for insulation. Despite the ambiguity in interpreting historical evidence, supporters of firewalls point to examples where they have been effective in insulating the insured institution from risks elsewhere in the organization. In the case of Hawkeye Bancorporation, one subsidiary bank failed and the holding company was in difficulty, but the remaining banks survived. In the case of Continental Illinois, the bank did not experience significant outflows when First Options' troubles were publicized, evidence that investors do distinguish between separate legal entities. Proponents of new banking powers point to these and other cases as examples of effective firewalls. They argue new powers can: 1) result in increased efficiency due to realized synergies from economies of scope, 2) promote safety and soundness through more diversification, and 3) render U.S. banks more competitive in domestic and global financial services markets.

Most critics are concerned that firewalls may become "walls of fire" when problems arise, <u>i.e.,</u> they may go up in smoke precisely when they are most needed.[16] Moreover, they may become barriers that aggravate problems or instabilities rather than contain or limit them. Walls that are too restrictive can negate any economic advantages that could result from combining new and traditional activities. In effect, such restrictions could be self-defeating. The result might be less profits, less competition, and less innovation. In particular, smaller banks may find themselves at a greater disadvantage. Their costs of establishing separate entities to carry out new activities could be prohibitive, placing them at a competitive disadvantage versus larger banks. Rather than decrease risks, skeptics argue that strong firewalls can have the reverse effect of increasing risk by preventing greater diversification, and result in piecemeal supervision of individual parts of an organization.

Proponents of two windows acknowledge the possibility of these problems pertaining to firewalls and regulatory safeguards.[17] It is impossible to know whether insulation will be adequate (in general) or affordable for smaller institutions (in particular). They argue that the only valid test is to subject the two-window structure to the "market," and to make necessary adjustments in response to events as they unfold.

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[16] See the Testimony of E. Gerald Corrigan before the Committee on Banking, Housing and Urban Affairs, United States Senate, "Hearings on Reforming Federal Deposit Insurance, Modernizing the Regulation of Financial Services, and Maintaining the International Competitiveness of U.S. Financial Institutions," May 3, 1990.

[17] See Mandate for Change, pp. XIV and XV.

In summary, there is clearly no easy solution to balancing the need for maintaining safety and soundness of the banking system with the need for banks to pursue activities that allow banks to increase their profits, attract capital, and enhance their competitiveness. A healthy skepticism seems warranted regarding the feasibility of a two-window system, where firewalls and supervisory tools must be effective enough to ensure minimal risk to the insurance funds, yet flexible enough to allow institutions to exploit the opportunities presented by new product powers and new activities.

Historical supervisory tools such as minimum capital standards, cease and desist enforcement powers, reporting requirements and disclosure standards are perhaps the minimum safeguards necessary to provide some insulation of insured institutions from excessive risk. Additional restrictions or limitations would clearly be necessary to achieve a comfortable level of protection against potential losses to the insurance funds in a two-window system.

It must be acknowledged, however, that perfect insulation of an entity from the problems of affiliated entities is not possible. As such, this might argue for some kind of umbrella oversight or consolidated supervision in addition to the functional supervision recommended by the two-window approach.[18] Indeed, the revised Basle Concordat firmly embraces the principle of consolidated supervision,[19] and this important international agreement could be threatened by internal reforms that seem to signal a weakened commitment to this principle on the part of any participating nation. The recent case of Bank for Credit and Commerce International illustrates the perils of a system of subsidiaries not subject to prudential consolidated oversight. However, consolidated supervision arguably has the potential to impede the development of a more rational banking industry by either unnecessarily slowing the expansion of powers or discouraging nonbanking firms from providing capital to the industry.

III. EQUITY, EFFICIENCY AND FEASIBILITY

Competitive and regulatory issues. Since passage of the Glass-Steagall Act in 1933, commercial banks have been restricted in offering certain financial services, *e.g.*, securities underwriting, insurance origination, *etc*.. In addition,

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[18]Some also argue that it would be difficult to assess the effectiveness of firewalls and other safeguards unless the primary bank regulator is given some supervisory authority over nonbank subsidiaries and affiliates.

[19]See "Principles for the Supervision of Banks' Foreign Establishments" (The Revised Basle Concordat), Committee on Banking Regulations and Supervisory Practices, May 1983. The Committee recently (1992) refined and reaffirmed its previous instructions on this subject by issuing a set of minimum standards for determining whether a nation has achieved an acceptable degree of consolidated supervision.

affiliations between banks and commercial firms have been restricted since passage of the Bank Holding Company Act of 1956. Most or all of these restraints would be relaxed under a two-window system. An uninsured "window" might be completely unrestricted in its product offerings. Alternatively, Congress may choose to limit the number of nontraditional investments that may be offered in the "uninsured" area of the two-window bank.

The relaxation of current restrictions could be beneficial to the economy if: 1) competition is enhanced in the financial-services industry; 2) significant economies of scope are captured in providing financial services; and/or 3) safety and soundness in the banking system is promoted. However, it is also possible that two-window banking could weaken the economy in these same areas. The net benefit to society must be carefully considered. Whether changes are to the betterment or detriment of society may depend on the freedoms that banks are granted and the regulations to which the new activities are subjected.

(1) Competition and competitive equity. Anticompetitive behavior can occur whenever a limited number of firms compete in a market that has barriers to entry.[20] Firms in noncompetitive markets may be able to increase income by reducing the availability (or the quality) of a product. The result would be a lower

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[20]Barriers to entry can include: high start up costs; exclusive patent rights or proprietary technology; or limited issuance of charters or licenses.

quantity demanded by society due to higher prices (or poorer quality) than would be observed in an open market.

Allowing banking firms to offer new products through an uninsured window may increase competition (actual, potential, or both). However, the economic benefits of this would be significant only if barriers to entry exist in those new areas. Otherwise, banks would merely be offering products that are already available at competitive prices. Anticompetitive consequences are possible if a holding company with an insured depository institution were to have an unfair advantage in offering the new product.

An unfair advantage could arise if an institution were able to subsidize its products in competitive markets with profits earned with insured deposits.[21] Similarly, if a bank were able to bundle services that are offered in a competitive market with others for which there is less than full competition, rival firms in the competitive market could be left at a disadvantage. It is difficult to know a priori whether banking is sufficiently competitive in most areas to alleviate these concerns or whether banking organizations would gain access to monopoly franchises in nonbank markets through expanded powers. Uniformly low barriers to

[21]This type of unfair advantage can only exist if deposit insurance is underpriced by the provider. The fact that the FDIC BIF fund is currently in deficit would imply that premiums were underpriced in the past -- particularly for risky institutions. It is not clear whether the insurance premiums will continue to be underpriced in the future, but the move to risk-based premiums should reduce the degree of mispricing.

entry would provide the best available protection against competitive inequities and anticompetitive results, and lowering such barriers would become more important in a two-window setting.

(2) Economies of scope and operating efficiency. Allowing banks to offer new types of products may improve operating efficiency if economies of scope exist. These economies occur whenever the costs of producing or purchasing two products jointly are less than the combined cost of producing or purchasing them separately. Economies of scope may result from banks being permitted to employ skills in credit analysis and the pricing of risk to a broader range of financial instruments. Banks might also be able to capture economies from the joint marketing of traditional and nontraditional products. In addition, consumers may enjoy economies of time and convenience from "one stop shopping" for a variety of financial services.

(3) **Economic efficiency.** An insured financial institution could be permitted to offer investments in affiliated commercial enterprises through an uninsured "window." In such an environment, any commercial firm that felt that access to retail deposits could reduce the cost of financing its operations might purchase a financial institution. Debt or equity instruments could be issued directly to the insured affiliate's customers through an uninsured window. Alternatively, a bank holding company might purchase and

operate a widget factory using funds raised through the uninsured entity.

Despite the potential benefits previously mentioned, such arrangements could potentially have negative consequences for society on net. Competing commercial enterprises could initially be at a disadvantage, not having the same access to low-cost capital.[22] This would be especially true if deposit insurance subsidized the operations of the insured entity, supporting overhead shared with the uninsured entity. The problem could be compounded if competing commercial firms were reluctant to use the financial institution affiliated with the widget factory out of fear of revealing trade secrets (potential customers and suppliers of the widget factory might be justified in having similar fears). Ultimately, a misallocation of society's resources could result if most commercial enterprises find that they require affiliation with a commercial bank in order to survive. Since this requirement would be artificial, the value of the economy's output would be diminished with the resulting overallocation of resources to the banking sector. There is no reliable way to quantify the size of these potential costs associated with two-window banking.

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[22]Although the competing widget factory would also have the option of affiliating with a financial institution, it may be reluctant to do so. Management at the independent widget factory may not believe that it has the knowledge, skill or resources to successfully manage a financial firm. Alternatively, the same management may fear that the firm would suffer from the loss of control that would result from selling their operations to a bank holding company.

Subjective judgment must weigh heavily in assessing this benefit-cost ratio.

(4) Regulatory requirements. The degree to which the uninsured entity should be regulated, and by which regulator, depends on the types of financial instruments to be offered and the types of assets to be funded. The issue should be resolved in the context of the traditional goals of financial services regulation:

- Protecting investors (especially those who may be unsophisticated) against fraud and misrepresentation.
- Promoting economic growth and stability.
- Providing open access to the capital markets.

An implicit assumption of a two-window system is that, because there would not be a source of potential loss to the government-sponsored insurance fund, the uninsured entity would have more freedom of action than an insured financial institution. However, bank supervision predates deposit insurance and exists in nations that lack explicit forms of deposit insurance. If the liabilities offered by the uninsured entity resemble those of an insured bank, and if the asset portfolio does not markedly differ from what currently exists in a bank, it may be appropriate for the uninsured entity to be examined by bank regulators. For example, if the uninsured entity offers obligations that are redeemable on demand at par, policy concerns that have motivated the present banking regulatory structure reemerge. Prominent questions would include whether the institution would be subject to depositor runs, if such runs would have systemic repercussions, and whether the payments system could be jeopardized by the failure of one or many such institutions.

Alternatively, liabilities issued through the uninsured window might match what is currently offered by other financial-services providers (e.g., money-market mutual funds, whole life insurance, etc.). In such cases, it would be logical to impose regulatory strictures identical to those currently imposed on the providers of such products by the regulators of those existing institutions (SEC regulating mutual fund offerings, state insurance commissioners regulating insurance products, etc.). Finally, it also is possible that new types of investment products would be offered or a unique pairing of assets and liabilities would occur, for example, redeemable investment shares offered in a portfolio of highly illiquid assets. In these cases, it may be necessary to introduce new regulatory requirements to ensure that these products are consistent with the goals of financial-services regulation mentioned above.

Disclosure standards. Under a two-window system, a depository institution may be authorized to offer and sell uninsured financial instruments issued by any of its nonbank affiliates at an uninsured "window" within the institution. Sales by depository institutions of the debt and equity securities of such institutions and of their affiliates are subject currently to a variety of regulatory safeguards designed to minimize the risk of customer confusion regarding the nature of the obligations purchased. It seems clear that such safeguards should apply per force in a two-window system, so a brief review of the minimum necessary requirements is offered in the remainder of this section.

Bank securities offerings, including those to sophisticated investors, are subject to the anti-fraud provisions of the federal securities laws.[23] In connection with the offer or sale of a security, Rule 10b-5 promulgated by the Securities and Exchange Commission prohibits (1) the use of any device, scheme, or artifice to defraud; (2) the making of any untrue statement of a material fact or the omission of a material fact necessary to make the statements made not misleading, in light of the circumstances under which the statements were made; and (3) engaging in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

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[23]Section 17(a) of the Securities Act of 1933 (15 U.S.C. 17q(a); Section 10(b) of the Securities Exchange Act of 1934 (17 U.S.C. 78j(b)) and Rule 10b-5 (17 C.F.R. § 240.10b-5) promulgated thereunder. The FDIC has promulgated a regulation that substantially parallels the disclosure requirements prescribed by the Securities and Exchange Commission. 12 C.F.R. § 335.

The FDIC permits insured nonmember banks to engage in securities activities, to the extent permitted by state law, through a bona fide subsidiary or an affiliate. Certain disclosure requirements must be met in order for a subsidiary to qualify as a bona fide subsidiary and in order for affiliation with a securities firm to be permissible whenever the subsidiary or affiliate:

(1) shares the same or a similar name or logo with the bank,
(2) conducts business in the same location with the bank,
(3) advertises or promotes particular securities or solicits purchasers in advertisements, promotions, solicitations, or similar communications in which the bank also advertises, or
(4) places advertisements or promotions concerning particular securities in communications from the bank to its customers.[24]

Insured nonmember banks and their bona fide subsidiaries and affiliates must disclose to their customers and to prospective customers that securities recommended, offered, or sold by the subsidiary or affiliate are not FDIC-insured deposits, that such securities are not guaranteed by, nor are they obligations of, the bank, and that the subsidiary or affiliate and the bank are separate organizations. Disclosures must be made prominently, in writing, in account-opening documents and at least semiannually thereafter in customer statements or confirmations. Joint

[24]12 C.F.R. § 337.4(h).

advertisements, promotions, or solicitations placed in bank communications must contain the requisite disclosure.

Public offerings of securities by national banks are subject to restrictions on the content of advertising. Advertising of debt securities must state that the obligations are not deposits and are not insured by the FDIC.[25]

The Office of the Comptroller of the Currency (OCC) requires an offering circular, subject to OCC review, for all public sales of a bank's own securities, except for sales to sophisticated investors.[26] The cover page must bear a statement in capital letters and in boldface type that the obligations will not represent deposits and will not be insured by the FDIC or any other government agency.

The OCC permits the sale by a national bank of commercial paper issued by bank affiliates on an "as agent" basis to sophisticated investors in denominations of at least $25,000. The agent must fully inform the purchaser of the nature of the transaction and each certificate and confirmation should disclose that the commercial paper is not a deposit and is not insured by

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[25] 12 C.F.R. § 16.8.

[26] 12 C.F.R. § 16.5.

the FDIC.[27] The OCC has permitted the sale of other affiliate securities to sophisticated investors on an "as agent" basis.[28]

The Federal Reserve Board's supervisory policy requires that a holding company's commercial paper sold by affiliated banks state prominently on the obligation that it is not an obligation of the bank and is not insured by the FDIC. Such commercial paper may not be sold at teller windows or other retail deposit-taking locations.

In a two-window system, depository institutions would be authorized to offer and sell their affiliates' uninsured financial instruments through an uninsured "window" in the institution. To the extent these offerings are directed to the general public, there would be significant risk of customer confusion over the nature of the obligations purchased. Unsophisticated investors may confuse uninsured financial instruments with federally insured certificates of deposit or other deposit accounts. The risk of customer confusion would be particularly pronounced in the case of sales of debt instruments since debt is customarily sold in denominations and with stated interest rates similar to certificates of deposit.

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[27]Comptroller's Handbook for National Bank Examiners, Section 204.1, p. 3. Principal trades are restricted by Section 23A of the Federal Reserve Act.

[28]Fed. Banking L. Rep. (CCH) Para. 84,032 (March 24, 1987).

Depository institutions are generally authorized under current law to offer and sell their own securities and those of their affiliates provided various safeguards are followed. The consequences of failure to follow those safeguards are well-known. For about four years, American Continental Corporation (ACC) funded its operations by selling subordinated debentures through branch offices of its subsidiary thrift, Lincoln Savings and Loan. ACC declared bankruptcy in 1989 following the failure of Lincoln and the bonds became worthless. In subsequent litigation, many of the bond holders claimed that they believed that the instruments were insured deposits or believed that the bonds were as safe as insured deposits because they were sold in a federally insured thrift.

Significant violations of the former Federal Home Loan Bank Board's regulation on on-premises sales of securities occurred. An aggressive marketing campaign was undertaken. In many cases, customers whose certificates of deposit were maturing were called by salespersons who recommended purchasing the bonds. Bond rates were quoted by Lincoln's tellers and thrift employees wore shirts advertising ACC's bonds.

Sales of uninsured financial instruments on the premises of insured depository institutions could significantly increase the risk of loss to the deposit insurance funds. Substantial disclosure safeguards would be necessary in a two-window system to inform customers of the nature of their investment and to protect the depository institution from liability arising from such transactions. At a minimum, the anti-fraud provisions of federal securities laws should apply in a two-window system. Fraudulent conduct in connection with the purchase or sale of any security should also constitute an unsafe and unsound banking practice.

In a two-window system, disclosures should be in writing. Disclosures should be made clearly and conspicuously on the face of the instrument and in separate documents provided to potential and existing investors. Disclosures also should be given to all potential investors in account-opening documents and thereafter in customer statements and confirmations. Each security sold could be required to bear a legend stating that the security is not a deposit and is not FDIC-insured or guaranteed.

For additional protection, each customer should sign an acknowledgement form stating that the security is not a deposit with the depository institution, is not insured by the FDIC, and is not otherwise guaranteed by the depository institution or the Federal Government. This acknowledgement could include disclosure of the risks of the investment. Acknowledgement forms would be retained in the investor's file.

The offer and sale of securities at teller windows should be prohibited since it increases the risk of customer confusion. Sales should generally be made in readily identifiable segregated areas of the depository institution by qualified personnel. Advertisements, promotions, and solicitations should disclose that the investment instruments are not insured by the FDIC and are not obligations of the depository institution.

Accounting Standards. Although various other regulatory changes may result from implementation of a two-window system, no revision to accounting standards used for Reports of Condition and Income ("Call Reports") or generally accepted accounting principles would seem necessary. Similar transactions would be recorded and similar assets and/or liabilities would be recognized on the same basis in either an insured or uninsured institution. Nevertheless, institutions would find that additional books and records would be required: one set for the insured and one for the uninsured institution. Accounting disclosure would also necessarily increase. If the financial statements of insured and uninsured affiliates were consolidated under generally accepted accounting principles, the footnote disclosure would undoubtedly increase.

For regulatory purposes, the banking agencies would need to determine whether to permit the financial statements of an uninsured subsidiary institution to be consolidated into those of an insured parent institution. If consolidation were permitted, the Call Report disclosure would have to be expanded for assessment and other reporting purposes. If not, the insured and uninsured institutions would have to file their own Call Reports.

If the uninsured institution were an affiliate of the insured institution by virtue of their both being part of the same holding company, reports filed by holding companies with the Board of Governors of the Federal Reserve System under Regulation Y may need expanded disclosure for reporting on the uninsured institution. This additional disclosure by uninsured affiliates may be needed to permit examiners to examine both sides of any transaction.

IV. IMPLEMENTING A TWO-WINDOW SYSTEM

Section 321 of the FDIC Improvement Act asks for comments indicating how a two-window system might be implemented with the least possible disruption to banking-system stability and consumer confidence. Given the many unknowns identified in this report as to the ramifications of two-window restructuring, it is difficult to specify in any detail how implementation of such a system should proceed (if at all). Perhaps the most that can be done is to offer a few general observations that are suggested by the preceding analysis. It should be noted that these observations pertain only to the merits of implementation strategies and not to the merits of the two-window system *per se.*

It is unrealistic to believe that rules to completely accommodate this structure can be put into place overnight without incurring unnecessary risks. The banking industry and regulators will need time to adjust to the new rules. It would take time for the agencies to develop appropriate supervisory strategies, staff levels and skills necessary to operate effectively in a world where nonbanking affiliates are not directly supervised and regulated by banking agencies. Moreover, it is unreasonable to expect the agencies to foresee all problems that could arise. Gradual phasing-out of present rules will permit unintended exceptions to be identified and addressed in an orderly manner. Moreover, changing the rules applicable to an industry that is as vital to the functioning of the economy as banking warrants caution. Thus, the most reasonable approach would be to proceed in steps, with a comfort period between each step.

The first step might involve measures designed to achieve the following: Uniform restrictions for all banks governing dividend payments and general loan limits; the extension of Sections 23A and 23B of the Federal Reserve Act to cover all direct subsidiaries of banks; and the establishment of clear authority for banking agencies to require reports from nonbank affiliates.

Given these added protections, the second step might be to eliminate the Glass-Steagall restrictions on securities activities of banking organizations. Eliminating the Glass-Steagall restrictions all at once would be more equitable than a gradual phaseout of those restrictions, since this would allow securities firms to cross the line into banking at the same time that banking organizations are given the right to conduct a full-range of securities activities. The disclosure standards discussed in Section III should take effect immediately upon eliminating Glass-Steagall restrictions in order to minimize customer confusion.

It is important to recognize that the order in which new activities become available to banking companies may have an effect on the way the system evolves. Everything else equal, activities that are permitted earlier in the phaseout period are likely to be more attractive than those that become available later in the process (a "learning-curve" effect as bank managements test their capabilities for nonbank activities). Thus, the availability schedule for new activities must balance this consideration with other relevant factors, including the ability of the banking agencies to monitor the risks of the new activities.

The third step could be to put in place an orderly phaseout of certain provisions of the Bank Holding Company Act (BHCA). The timing and sequence of dismantling the BHCA involves maintaining a delicate balance between the need to remove unnecessary restrictions while keeping risks at an acceptable level.

The provision of the BHCA relating to permissible activities is an area where a gradual liberalization is appropriate. It makes sense to permit affiliations with financial firms to take place on a faster schedule than affiliations with nonfinancial companies. Other than this broad guideline and the caution expressed earlier relating to the order in which new activities become available, the exact timetable probably is not important. However, it is important that decontrol be accomplished in an orderly and timely fashion and that the schedule be legislatively predetermined. It would seem important that certainty be part of the process. If this is not present, the chances of accomplishing the ultimate goals of decontrol would be diminished.

The last remaining question relates to the activities permitted to be conducted within insured banks. As pointed out earlier, this is not a simple question, and cannot be answered by a simple enumeration of permitted activities. If proper diversification can be achieved by a bank, it would be difficult to argue that any particular activity is "too risky." However, from a practical standpoint, any individual bank probably will not be able to achieve appropriate diversification due to the difficulties in measuring the factors important to diversification. Thus, in deciding what activities can be conducted within banks, risk is an important consideration.

A more important consideration relates to the activities that have access to the federal safety net. Activities that are performed within a bank have access to the payments system, Federal Reserve credit and funding by means of federally insured deposits. Moreover, to the extent that the FDIC is successful in passing failed-bank assets to successor organizations, operating units within banks will be immune to closure. This obviously has rather profound public-policy and competitive implications, and represents a strong argument to restrict activities permitted within banks.

Historically, innovations in banking often have come about because of changes in state laws. This often has had a positive effect on the industry and has expanded the services available to consumers. Thus, a narrow list of permissible activities mandated at the federal level probably is not appropriate. Congress may wish to provide a broad outline of the types of activities that may be conducted within banks, along the lines suggested in the two-window approach. However, even in the absence of such guidelines, Congress must decide in a two-window system who would make the individual decisions regarding appropriate bank activities.[29]

In a two-window system, it is likely that individual bank supervisory agencies would still have to rely on rules that limit exposure from nontraditional banking activities and prohibit activities that, in some sense, seem inappropriate for banks to perform directly. It should be noted that this would not be a new problem created by two-window reforms. Under current law, for example, the FDIC may prohibit an insured state bank or its

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[29]In this regard, it would be relevant to consider the longstanding balance of powers between the chartering authority and the deposit insurer. Some argue that the health of the banking system depends upon the constructive debate that ensues as charterers seek to support the innovation necessary for bank profitability while the insurer seeks to limit potential losses to the insurance funds.

subsidiary from engaging in certain activities as principal if such activities are determined to pose a significant risk to the insurance fund (see Section 24, FDI Act). Similar judgments by bank supervisory agencies have always been necessary, and it is unlikely that the two-window structure would alter this reality in any fundamental way.

V. FINDINGS AND RECOMMENDATIONS

Much is at stake in the decision regarding bank reform. While the many risks involved in adopting a two-window system appear daunting, there also are risks involved in maintaining the status quo. Will deposit-insurance losses be brought under control if the safety net remains unaltered? Will expanded powers be incorporated into existing arrangements at a sufficient pace to reestablish the viability of banking organizations? The two-window structure addresses these concerns but replaces them with various other concerns reviewed in this report.

The benefits and costs associated with two-window restructuring are conjectural and therefore controversial. The major issue concerns the degree of insulation provided by the legal and financial separation that will protect the insured bank. Although it is generally acknowledged that there could be more frequent breaches of safeguards under a two-window system, experts differ as to the probable net effect on bank safety, industry profitability, and economic efficiency.

The case for implementing a two-window system at this time rests on two arguments. The first is a concern that the safety net is now or soon will be extended beyond the ability of the deposit insurance system to support it. The second argument is that banks are losing their ability to compete in the financial marketplace because of restrictions on bank activities and affiliations. While these are legitimate concerns, there are developments in the banking industry that may prove to adequately address these concerns and thus obviate the need for more radical reform along the lines of a two-window system.

The first development is the FDIC Improvement Act of 1991, which is intended to shore up the deposit insurance system through a variety of reforms including capital-based supervision, prompt corrective actions for troubled institutions and implementation of risk-related assessment rates. If these measures reduce the industry's reliance on the resources of the deposit insurance system, then much of the concern about the pressure on the safety net may be alleviated. Moreover, it is unlikely that the reforms envisaged in the two-window system would address the current asset-quality-related problems facing the industry.

The second development to recognize is that banking organizations are obtaining expanded powers. Indeed, bank holding companies are now represented in many types of financial services and banks are free to affiliate with a wide variety of financial-services firms. The direction is unmistakably toward expanded powers and is taking place in the context of consolidated supervision as embraced by the Basle accord. As a result, the current trend is toward the development of a more rational banking industry. Unless this trend is reversed, there does not appear to be the need for radical reform along the lines of the two-window approach.

The two-window proposal is perhaps better balanced than many other reform proposals in terms of recognizing and providing for the many competing policy considerations involved in restructuring our banking system. The two-window structure raises significant concerns at this time, but these may become relatively less important if deposit-insurance losses fail to abate and if banking organizations fail to compete effectively in the market for financial services.

In summary, this probably is not the appropriate time to implement a significant change in the rules that govern the operations of the nation's banking system. The provisions of the FDIC Improvement Act of 1991 are designed to address the current problems facing the industry and the deposit insurance funds. In addition, banking companies are being allowed to compete in an expanding number of product markets. If these trends do not ultimately result in a healthy and viable banking system, it will be time to revisit the two-window system.

APPENDIX

STATUTORY AND REGULATORY SAFEGUARDS

Various statutory and regulatory safeguards would be necessary in a two-window system to insulate depository institutions from risks associated with the activities of their nonbank affiliates and to ensure that a depository institution's insured deposits are not used to fund nonbank activities. Limitations on relationships and transactions between insured depository institutions and their affiliates, commonly referred to as "firewalls" are designed to help protect the deposit insurance funds and, ultimately, the taxpayer.

While a detailed description and discussion of existing statutory and regulatory limitations is beyond the scope of this study, a general description of many of the current limitations is set forth below with a discussion of their application under a two-window system.

Restrictions on Transactions with Nonbank Affiliates

Transactions between depository institutions and their nonbank affiliates are currently subject to quantitative and qualitative restrictions.[30] Because limitations on transactions with affiliates are a primary safeguard against risk to a depository institution, these statutory provisions are outlined with illustration of the types of transactions covered by these provisions.

Section 23A of the Federal Reserve Act ("Section 23A") (12 U.S.C. 371c) subjects certain "covered transactions" to volume limitations on the amount a bank may invest in a transaction with an affiliate. Section 23B of the Federal Reserve Act ("Section 23B") (12 U.S.C. 371c-1) subjects certain "covered transactions" between a bank and its affiliates to qualitative restrictions on the terms of the transaction.[31]

A "covered transaction" is a transaction by which a nonbank affiliate receives funding or financing from a bank. For example, a bank's loan to its affiliate or a bank's acceptance of an affiliate's securities as collateral for a loan to any person or company are covered transactions. A bank's transaction with any person is deemed to be a transaction with an affiliate to the

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[30]The definition of "affiliate" in Section 23A of the Federal Reserve Act (12 U.S.C. 371c) does not include a subsidiary owned by a member bank unless the subsidiary itself is a bank.

[31]The FDIA applies these limitations to nonmember insured banks. The Home Owners' Loan Act generally applies these limitations to savings associations.

extent that the proceeds of the transaction are used for the benefit of, or are transferred to, the bank's affiliate.[32]

Section 23A limits the aggregate amount of covered transactions between an institution and an affiliate to ten percent of the institution's capital stock and surplus, with an aggregate limit of 20 percent to all affiliates. Section 23A generally requires that extensions of credit to affiliates be fully collateralized and, in many cases, overcollateralized.[33] A bank and its subsidiaries generally may not purchase low-quality assets from an affiliate.[34]

The statute prohibits certain transactions altogether such as the acceptance of securities of an affiliate as collateral for a loan issued on behalf of that affiliate.[35] In addition, certain transactions are exempt from the volume and/or collateral restrictions on transactions with affiliates.[36] Nevertheless, all exempt transactions must be on terms and conditions consistent with safe-and-sound banking practices.[37]

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[32] 12 U.S.C. 371c(a)(2).

[33] 12 U.S.C. 371c(c).

[34] 12 U.S.C. 371c(a)(3).

[35] 12 U.S.C. 371c(c)(4).

[36] <u>See</u> 12 U.S.C. 371c(d).

[37] 12 U.S.C. 371c(a)(4).

Section 23B (12 U.S.C. 371c-1) subjects a bank to qualitative restrictions on transactions with affiliates. In general, a bank may engage in certain covered transactions with an affiliate only on terms and conditions that are substantially the same, or at least as favorable to the bank, as those prevailing for comparable transactions with or involving nonaffiliated companies.[38]

Section 23B also restricts the purchase of securities from a bank affiliate by bank trust departments.[39] In addition, Section 23B prohibits a bank and its subsidiaries and affiliates from advertising or entering into "any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates."[40]

Under a two-window system, protection of the depository institution from the risks of its affiliate's business would be imperative. Collateral requirements, aggregate limitations on transactions, and "arm's length" dealings between a depository institution and its affiliates would provide protection to the depository institution from the risks associated with the nonbank activities of its affiliates. Accordingly, at a minimum, a two-window system would rely on the restrictions on transactions

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[38] 12 U.S.C. 371c-1(a).

[39] 12 U.S.C. 371c-1(b).

[40] 12 U.S.C. 371c-1(c).

with affiliates set forth in current law to protect the safety and soundness of the depository institution.

Existing restrictions, however, may not adequately insulate an institution from the risks of affiliate activities, and it may be appropriate to augment or strengthen restrictions on transactions with affiliates under the two-window system. Under the two-window system, depository institutions would be permitted to affiliate with any financial or nonfinancial firm. Since a violation of the restrictions on transactions with affiliates may cause a depository institution to fail, strict limitations and enforcement would be necessary to protect the deposit insurance funds from loss.

For most purposes, the law currently treats subsidiaries of banks as affiliates of the parent bank.[41] However, transactions between a bank and its direct nonbank subsidiary are specifically exempted from the restrictions on transactions with affiliates in Sections 23A and 23B.[42]

Transactions between an insured depository institution and its nonbank subsidiaries may pose an unacceptable degree of risk to the

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[41]The general definition of "affiliate" states in relevant part that "[e]xcept where otherwise specifically provided, the term "affiliate" shall include any corporation...[o]f which a member bank, directly or indirectly, owns or controls...a majority of the voting shares...". 12 U.S.C. § 221a(b)(1).

[42]The Federal Reserve Board has authority under Section 23A to extend the coverage of Sections 23A and 23B to transactions between banks and their nonbank subsidiaries.

depository institution under a two-window system because there would be no restrictions on the activities in which an institution's subsidiary would be permitted to engage. If a two-window structure encompasses direct nonbank subsidiaries of an insured depository institution, extension of Section 23A and 23B restrictions seems necessary in order to achieve effective insulation between the institution and nonbanking activities. The FDIC has previously recommended extending the restrictions of Sections 23A and 23B to banks' direct nonbank subsidiaries (see Mandate, p. 88). The FDIC has also generally extended the restrictions of Sections 23A to securities subsidiaries of state nonmember insured banks (see 12 C.F.R. § 337.4(e)(6) and (7)).

Adequate regulation of the relationship of the insured institution to its nonbank affiliates becomes even more essential in the event that an affiliate experiences financial difficulty. It has been suggested that much of any negative impact on the bank arising from conflicts of interest between the bank and its nonbank affiliates could be addressed in large part by the existing quantitative and qualitative restrictions of Sections 23A and 23B discussed supra (see Mandate, pp. 47-48).

It also has been suggested, however, that when a bank's affiliate is experiencing financial stress, the safeguards in place to protect the bank are likely to be breached, regardless of the stringency of those safeguards.[43] Indeed, in the mid-1970s, the parent holding company of Hamilton National Bank required the bank to purchase low-quality mortgages from its failing mortgage banking affiliate in violation of Section 23A. The bank ultimately failed principally due to these transactions with its affiliate. In approving the application of Continental Illinois National Bank and Trust Company of Chicago to acquire First Options of Chicago, a registered futures commission merchant and broker-dealer, the OCC limited Continental's investments and loans in First Options to the bank's legal lending limit and required the bank to obtain the prior approval of the OCC for any additional equity investments by the bank in First Options.[44] When First Options incurred substantial losses during the stock market crash in 1987, Continental breached the firewalls imposed by the OCC by investing $385 million in First Options, exceeding the bank's lending limit.

Firewalls may be imposed in connection with the provision of various products and services. They have been imposed most frequently in connection with affiliations between securities firms and banking organizations. These firewalls are illustrative of the

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[43]See Statement of the Securities Industry Association before the Subcommittee on General Oversight and Investigations, Committee on Banking, Finance and Urban Affairs, United States House of Representatives, May 1, 1990.

[44]Comptroller Interpretive Letter No. 380, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) Para. 85,604 (December 29, 1986).

types of firewalls that could be required under a two-window system.

Since 1987, the Federal Reserve Board has authorized bank holding companies to underwrite and deal in otherwise ineligible bank securities in wholly owned, nonbanking subsidiaries.[45] In order to ensure maximum insulation of the bank, the Federal Reserve Board requires that a Section 20[46] securities firm be established as an independent subsidiary of the holding company.[47] Before beginning bank-ineligible securities activities through a subsidiary, the holding company must be strongly capitalized or have a plan to raise additional capital approved by the Federal Reserve Board.

The Federal Reserve Board orders do not permit officer, director and employee interlocks between the securities affiliate and any affiliated bank or thrift, but such interlocks are permitted between the securities subsidiary and the holding company and its nonbank subsidiaries. A securities affiliate is permitted

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[45]See approval orders of Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation, 73 Fed. Res. Bull. 473 (1987) and J.P. Morgan & Co. Incorporated, The Chase Manhattan Corporation, Bankers Trust New York Corporation, Citicorp and Security Pacific Corporation, 75 Fed. Res. Bull. 192 (1989).

[46]Section 20 of the Glass-Steagall Act (12 U.S.C. 377) prohibits member banks from being affiliated with any entity that is "engaged principally" in bank-ineligible securities activities.

[47]Corporate structure in a two-window system is discussed later in this section.

to have offices in the same building as a bank or thrift affiliate provided that the affiliate's offices are segregated in a clearly distinguishable manner from those of the bank or thrift.

Under the orders, the Federal Reserve Board must approve any funding provided to the securities affiliate by the holding company or by any of its nonbank subsidiaries. The holding company and its subsidiaries including its bank subsidiaries are prohibited from extending credit:

- o to the issuer of ineligible securities underwritten by a securities affiliate to enable the issuer to pay dividends; and
- o to customers for the purpose of purchasing bank-ineligible securities during the underwriting period or for 30 days thereafter.

Bank and thrift subsidiaries of a bank holding company may not extend credit to or for the benefit of a securities affiliate of the holding company, except to provide clearing services for U.S. Government and agency securities if the extension of credit is fully secured by such securities, is on market terms, and is repaid the same day.

A holding company must establish limits on exposure of the holding company on a consolidated basis to a customer whose securities are underwritten by a securities affiliate. The Federal Reserve Board prohibits bank and thrift affiliates from treating unaffiliated securities firms worse than their securities affiliates, unless the treatment is warranted based on objective criteria.

In authorizing nonbank subsidiaries of bank holding companies to underwrite and deal, to a limited extent, in commercial paper, municipal revenue bonds, consumer receivable-related securities, and 1-4 family mortgage-backed securities, the Federal Reserve Board imposed various conditions relating to:

(1) capital investment and capital adequacy,

(2) extensions of credit to customers of the underwriting subsidiary and purchases and sales of assets,

(3) separation of the underwriting affiliate's activity (these conditions include limitations and prohibitions on office space, director and employee interlocks, and transfers of nonpublic information),

(4) required disclosures to customers of the underwriting subsidiary,

(5) marketing and advertising activities, and

(6) investment advice.

In authorizing nonbank subsidiaries of bank holding companies to underwrite and deal, to a limited extent, in corporate debt securities, the Federal Reserve Board imposed additional conditions relating to reciprocal arrangements and discriminatory treatment of unaffiliated securities firms.

The FDIC has promulgated a regulation that permits insured nonmember banks to engage in securities activities, to the extent permitted by state law, through a "bona fide" subsidiary or an affiliate.[48] A "bona fide" subsidiary must:

- o be adequately capitalized;
- o have physically separate and distinct operations from those of the bank (This condition only applies in areas to which the public has access.);
- o maintain separate accounting and corporate records;
- o observe separate formalities, such as board of directors' meetings;
- o maintain separate employees compensated by the subsidiary (This generally applies to employees who have direct customer contact.);
- o not share common officers with the bank;

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[48]12 C.F.R. § 337.4.

- o have a majority of its board of directors who are neither directors nor officers of the bank; and
- o conduct its business pursuant to independent policies designed to disclose that the subsidiary is a separate organization from the bank and that investments offered, recommended, or sold by the subsidiary are not deposits of the bank, are not insured by the FDIC, and are not otherwise obligations of the bank.

The regulation imposes similar conditions on the affiliation of an insured nonmember bank with a securities firm.

The regulation incorporates restrictions similar to those in Section 23A, restricting the bank from purchasing, as fiduciary, any securities distributed or underwritten by the affiliate or subsidiary unless authorized by the trust agreement. The insured institution must also transact business through its trust department on terms comparable to those with unaffiliated parties.

The institution may not extend credit to any company whose stocks are underwritten by a securities subsidiary or affiliate unless the company's securities are of investment quality. In addition, the bank may not extend credit for the purpose of acquiring securities underwritten or distributed by a securities subsidiary or affiliate, any investment company advised by the affiliate, or any security issued by such a subsidiary or affiliate.[49]

The regulation formally extends the Section 23A restrictions on "covered transactions" to such securities subsidiaries or affiliates. Also, the bank may not condition any extension of credit on the requirement to engage in business with the bank's subsidiary or affiliate to underwrite or distribute the company's securities or on the condition that the company purchase securities from the subsidiary or affiliate.

Lastly, the regulation permits use of a common name, logo or location if certain disclosures are made in all joint advertisements, written communications with bank customers made by the subsidiary or affiliate, and in connection with all securities recommended, offered or sold by the affiliate or subsidiary.[50]

In a two-window world, the restrictions imposed as incorporated in the definition of a "bona fide" subsidiary or affiliate and many of the restrictions in the Federal Reserve Board's Section 20 orders encompass elements considered necessary to promote legal, economic, and market separation. These

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[49]A bank may make a loan to employees of the subsidiary or affiliate for the purpose of acquiring securities of such subsidiary or affiliate through an employee stock bonus or stock purchase plan adopted by the board of directors of the affiliate.

[50]See discussion of disclosures in Section III of this study.

restrictions include those elements typically used by courts in determining whether or not an entity is the alter ego of another corporation.

The "bona fide" subsidiary structure would help ensure the legal separateness of the subsidiary or affiliate from the insured institution. The restrictions concerning use of separate employees in customer contact positions are not only an important factor in maintaining legal separation of the corporate identities of the subsidiary/affiliate and the insured depository institution, but also in maintaining market separation in the eyes of the parties with whom the institution and the subsidiary/affiliate deal. Permitting the use of "back office" employees of the insured depository institution by the subsidiary/affiliate, however, would reduce inefficiency and cost. Likewise, the requirements for separate physical operations and independent policies and procedures help promote market separation.

A requirement for adequate capitalization, separate from the insured institution's capital, is an important factor in determining whether or not a parent will be held liable for the obligations and acts of a subsidiary. Adequate capital is critical to safety and soundness. Adequate capital enables the subsidiary or affiliate to absorb losses arising from its operations without reliance on a capital infusion. Although a definition of adequate capital could be developed, a better approach may be to utilize industry standards for the different types of businesses in which subsidiaries/affiliates may be engaged. The primary supervisor should be authorized to require capital above any industry standard if deemed warranted.

The requirement for separate accounting and records would help clarify which assets are available to meet the obligations of the subsidiary/affiliate and would promote economic separation. Separate accounting also would allow for a better indication of profitability of the operation. To achieve economies of scale, certain expenses may be shared between the insured institution and the affiliate; however, operating results should be maintained separately.

Additional restrictions, concerning purchases of assets, fiduciary responsibilities, extensions of credit limitations, and arm's-length transactions in accordance with Sections 23A and 23B of the Federal Reserve Act would also be necessary "firewalls" to protect the insured institution from the risks associated with the activities of affiliates and to ensure that nonbanking activities are funded by means other than insured deposits under a two-window system. Restrictions on tie-ins and disclosure requirements would curb the potential for customer confusion and promote market separation.

Tie-in Arrangements

Under a two-window system, bank affiliates would be authorized to offer virtually any product or service. To the extent that related products and services would be offered by the bank and its affiliates, the potential for conflicts of interest and tie-in arrangements would be increased.

Section 106 of the Bank Holding Company Act amendments of 1970 (12 U.S.C. 1972) prohibits most tie-in arrangements by banks. This section prohibits a bank from extending credit, leasing or selling property of any kind, furnishing any service, or fixing or varying the consideration for any of the foregoing, on the condition or requirement that a customer obtain or provide some additional credit, property or services from the bank,[51] its holding company, or one of its affiliates or subsidiaries. Substantial penalties may be imposed for violations and private persons may sue for triple damages or injunctive relief.[52]

Pursuant to Federal Reserve Board regulations (12 C.F.R. § 225.4(d)), bank holding companies are subject to the same prohibitions as banks with regard to tying holding company products on the condition that a bank product is obtained. The Federal

[51]Banks are permitted to tie core bank products such as loans, deposits, and trust services.

[52]12 U.S.C. 1972, 1975, 1976.

Reserve Board has permitted a bank holding company to vary the consideration on products or services offered by nonbank affiliates provided that both are core banking products or services. For example, a bank holding company may waive the annual fee on a credit card if the customer establishes a deposit account at a bank subsidiary.

Federal antitrust laws also apply to tie-in arrangements and triple damages and other relief may be granted to private persons under these laws.[53] However, unlike Federal antitrust laws, the 1970 amendments to the Bank Holding Company Act do not require private persons to establish that the bank has significant market power or that competition has diminished. Thus, for the same conduct, damages or injunctive relief are easier to obtain against a bank than against other businesses.

In the context of a two-window system, the extent to which stringent tie-in restrictions should be in place is dependent upon the level of competition and the adequacy of customer information, both of which are difficult to project and evaluate. The potential for questionable tie-in sales may increase under a two-window system in which many related products and services are offered by firms affiliated with banks.

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[53] See Section 3 of the Clayton Act (15 U.S.C. 14), Section 1 of the Sherman Act (15 U.S.C. 1) and Section 5 of the Federal Trade Commission Act (15 U.S.C. 45).

Alternatively, in the absence of power to affect competition in a tied-in product and if customers are generally aware of product and service alternatives, the factors that must be proved to demonstrate a violation of tie-in restrictions could be relaxed. Indeed, under a two-window system, competition in various product and service markets could increase.

Corporate Structure

Nonbanking activities would be conducted in a subsidiary or affiliate of the bank in a two-window system. There is no consensus regarding the appropriate corporate structure for conducting nonbanking activities. Some contend that nonbanking activities should be conducted in a subsidiary of a bank, with adequate insulation, while others contend that adequate insulation might only be possible if such activities are conducted in a subsidiary of a holding company. There are various arguments to support either view.

In support of the view that nonbanking activities should be conducted in a subsidiary of the bank, the point is raised that profits from conducting nonbanking activities through a bank subsidiary would inure to the bank. If the bank experienced financial difficulty, the nonbanking subsidiary could be sold to raise capital. On the other hand, if the nonbanking subsidiary experienced financial difficulty, the bank could divest the subsidiary before losses were suffered by the bank. Thus, the assets of the subsidiary would be available to the bank but the losses of the subsidiary would not become losses of the bank.[54]

In another view, nonbanking activities should be conducted in a subsidiary of the holding company to ensure that any losses of the subsidiary would be reflected at the parent holding company level rather than in the bank. There is concern that a bank subsidiary would be more closely tied to the federal safety net provided through deposit insurance and access to the Federal Reserve's discount window.[55] Conducting nonbanking activities in a subsidiary of the holding company also facilitates functional regulation.

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[54]See Mandate and Testimony of FDIC Chairman L. William Seidman and Comptroller of the Currency Robert L. Clarke before the Subcommittee on General Oversight and Investigations, Committee on Banking, Finance and Urban Affairs, United States House of Representatives, March 19, 1990.

[55]See General Accounting Office report Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies (GAO/GGD 90-48 March 14, 1990); General Accounting Office report Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities (GAO/GGD 87-35, April 14, 1987); and Testimony of Richard L. Fogel, Assistant Comptroller General and Manuel H. Johnson, Vice Chairman, Federal Reserve Board before the Subcommittee on General Oversight and Investigations, Committee on Banking, Finance and Urban Affairs, United States House of Representatives, March 19, 1990.

Securities firms may now receive advances from the Federal Reserve's discount window. FDICIA, §473.

Current law authorizes depository institutions to affiliate with companies involved in activities that are not closely related to banking in very limited circumstances. For example, an individual who owns a bank is not subject to the Bank Holding Company Act. Therefore, an individual who owns a bank may own various other businesses that are not deemed to be closely related to banking and a proper incident thereto under Section 4 of the Bank Holding Company Act (12 U.S.C. 1843(c)(8)).

In addition, unitary thrift holding companies whose subsidiary satisfies the qualified thrift lender test (QTL) and multiple thrift holding companies that attained such status as a result of a supervisory acquisition and whose subsidiaries satisfy the QTL test are not restricted to a statutorily prescribed list of permissible activities.[56]

Under the two-window system, there may not be a necessity for strict firewalls between a depository institution and its subsidiary where the subsidiary is engaged only in activities permissible for the institution. An operating subsidiary of a national bank may engage only in activities that are permissible for the bank to engage in directly.[57] Similarly, the OTS has proposed to authorize federal savings associations to establish

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[56] See Home Owners' Loan Act, §10, 12 U.S.C. 1467a et seq.

[57] 12 C.F.R. §5.34.

operating subsidiaries that would be permitted to engage in activities permissible for the parent association.

Current Law on Loans to One Borrower and Dividend Payments

Loans to One Borrower - Under current law, loans by a national bank to an unaffiliated borrower are generally restricted to 15 percent of capital and surplus on an unsecured basis with an additional ten percent of capital and surplus on a secured basis.[58] Insured state nonmember banks and state member banks are subject to state law restrictions on loans to one borrower.

Dividend Payments - National and state member banks are subject to statutory and regulatory restrictions on the payment of dividends to stockholders.[59] Such banks may declare dividends of the amount of net profits as the bank's board of directors deems expedient, but may not declare a dividend if it would impair the bank's capital or exceed the bank's net profits. A proposed dividend may never impair the bank's capital but may exceed the bank's net profits with the prior approval of the Comptroller of the Currency in the case of national banks or the Board of Governors of the Federal Reserve System in the case of state member

[58] 12 U.S.C. 84.

[59] 12 U.S.C. 56 and 60(b) (national banks) and 12 U.S.C. 324 (incorporating 12 U.S.C. Sections 56 and 60 (b) by reference for state member banks). See 12 C.F.R. §§ 5.61 and 5.62 (national banks) and 12 C.F.R. § 208.19 (state member banks).

banks. Thus, prior approval must be obtained if the proposed dividend would exceed the current and historical earnings of the bank for the preceding two years, less any required transfers to surplus.[60]

Although there are no specific statutory or regulatory restrictions for insured state nonmember banks, such banks may be subject to cease-and-desist proceedings for unsafe and unsound practices. (See 12 U.S.C. 1818(b).)

Dividend payments by savings associations are based on the association's capital level and supervisory condition.[61] An association meeting its fully phased-in capital requirements may pay dividends up to an amount that would reduce its surplus capital ratio to no less than one-half its surplus capital ratio at the beginning of the calendar year.[62] Regulatory approval is required for additional payments. An association not meeting its current capital requirements is prohibited from making dividend payments without the prior written approval of the Office of Thrift Supervision.[63]

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[60] 12 U.S.C. 60(b).

[61] 12 C.F.R. § 563.134.

[62] 12 C.F.R. § 563.134(b)(1).

[63] 12 C.F.R. § 563.134(b)(3).

Effective December 19, 1992, the prompt corrective action provisions of the FDICIA (Section 131), prohibit insured depository institutions from paying dividends if the payment would result in undercapitalization. The holding companies of significantly undercapitalized institutions and of undercapitalized institutions failing to submit or comply with a capital plan may not pay any dividends without prior approval of the Board of Governors of the Federal Reserve System.

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