

A Commission Report

State Regulation of Banks in an Era of Deregulation



Advisory Commission on
Intergovernmental Relations

A-110
September 1988

**Current Members
of the
Advisory Commission on
Intergovernmental Relations**

(September 1988)

Private Citizens

James S. Dwight, Jr., Arlington, Virginia
Daniel J. Elazar, Philadelphia, Pennsylvania
Robert B. Hawkins, Jr., *Chairman*, San Francisco, California

Members of the U.S. Senate

David Durenberger, Minnesota
Carl Levin, Michigan
James R. Sasser, Tennessee

Members of the U.S. House of Representatives

Sander Levin, Michigan
Jim Ross Lightfoot, Iowa
Ted Weiss, New York

**Officers of the Executive Branch,
U.S. Government**

Ann McLaughlin, Secretary,
U.S. Department of Labor
Richard L. Thornburgh, Attorney General
Vacancy

Governors

John Ashcroft, Missouri
John H. Sununu, *Vice Chairman*, New Hampshire
Vacancy
Vacancy

Mayors

Donald M. Fraser, Minneapolis, Minnesota
William H. Hudnut, III, Indianapolis, Indiana
Robert M. Isaac, Colorado Springs, Colorado
Vacancy

Members of State Legislatures

John T. Bragg, Deputy Speaker, Tennessee House of Representatives
David E. Nething, North Dakota Senate
Ted Strickland, Colorado Senate

Elected County Officials

Philip B. Elfstrom, Kane County, Illinois, County Commission
Harvey Ruvlin, Metropolitan Dade County, Florida,
County Commission
Sandra Smoley, Sacramento County, California, Board of Supervisors

A Commission Report

State Regulation of Banks in an Era of Deregulation



Advisory Commission on
Intergovernmental Relations

A-110
September 1988

Preface

In recent years a combination of innovations in the private delivery of financial services and federal and state regulatory rulings have dramatically changed the structure of the U.S. banking sector:

- New forms of financial institutions, such as the “nonbank bank,” have emerged, creating issues of how such entities should be treated for regulatory and tax purposes.
- During 1985 and 1986, most states relaxed or removed prior legislative bans on interstate banking, a development that radically altered the manner in which banks do business.
- Federal regulators have permitted banks to underwrite and deal in certain securities, thereby raising issues of whether and how to separate more risky activities from traditional bank activities of lending and deposit taking.
- Several states are experimenting with regulatory innovations and are granting powers to state banks that allow them to offer new products and services, such as securities and insurance brokerage and underwriting.

These developments have led to the creation of a wide variety of new products and services that not only promote increased competition and efficiency within the financial sector but also add to the diversity and accessibility of consumer financial services. At the same time, however, these developments create new problems of taxation and interstate jurisdictional and regulatory conflicts. They also raise issues of equal treatment among similar types of business activities and of the safety and soundness of banks and other financial institutions.

The purpose of this report is to examine the key intergovernmental regulatory issues that arise as a result of the changing economic and institutional structure of the banking and financial services industry. In order to accomplish this objective, the report is divided into three parts.

The report begins with a review of the history of bank regulation, thereby providing an important background and context for understanding the present structure of the financial industry and the reasons for establishing the current system of dual banking whereby the states and the federal government share in the responsibility for regulating banks and other financial business activities.

The study then proceeds to an analysis of the current issues of bank regulation. This part is divided into two sections. A first section presents a discussion of the purpose and scope of bank regulation—the division of responsibility among regulators, areas of jurisdictional overlap, and efforts to improve regulatory coordination. Next, a closer look is taken at the

effects of deregulation on the operation of the dual banking system. This discussion includes an explanation of the intergovernmental issues relating to the growth of interstate banking and the new banking powers relating to securities underwriting, insurance, and real estate investment activities that have been granted by some state regulators.

The final section of the report then explains and evaluates pending congressional and federal regulatory proposals to preempt state controls over the new powers of banks by granting sole regulatory and supervisory control over such powers to the Federal Reserve Board.

As a result of this study, the Commission reaches several findings with respect to the intergovernmental status of bank regulation in the U.S. and concludes that not only has the dual banking system generally led to a system whereby the goals of institu-

tional stability and soundness are responsibly balanced with the need to encourage innovation and experimentation in the provision of financial services, but also that recent proposals for a greater concentration of regulatory authority by the federal government poses significant risks of stagnation and of a further erosion of the balance of power in the federal system.

Accordingly, with respect to legislation now pending in Congress that would restrict state regulatory authority over the insurance and securities activities of state-chartered banks, the Commission recommends that the Congress refrain from enacting preemptive legislation that would further regulate an already heavily regulated industry.

Robert B. Hawkins, Jr.
Chairman

Acknowledgments

This report was written by Sandra B. McCray and presented to the Commission at its June meeting in Bismarck, North Dakota. The Commission gratefully acknowledges the contributions of the following persons who provided assistance in the design of the study as well as offered valuable comments on various drafts of the report: James Chessin, American Bankers Association; Jill Considine, Superintendent of Banks, New York; John Davis, Wright, Todd, Riese and Jones; Haskell Edelstein, Citibank N.A.; David Halvorson, New York State Banking Department; Eugene Kuthy, Michigan Commissioner of Banks; Robert E. Litan, The Brookings Institution; Ranjana G. Madhusudhan, State of New Jersey Division of Taxation; Kathleen O'Day, Federal Reserve Board; Robert Richard, Conference of State Bank Supervisors; Keith Scarborough, Independent Bankers' Association; and Steve Weiss, Office of the Comptroller of the Currency. Secretarial assistance was provided by Anita McPhaul and Lori O'Bier.

The Commission wishes to thank these people for their valuable advice and criticism, but, of course, retains full responsibility for the final document.

John Kincaid
Executive Director

Robert D. Ebel
Director, Government Finance

Contents

- Introduction** 1
- Recommendation** 3
- Findings** 5
 - 1. Principal Objectives of Bank Regulation 5
 - 2. Dual Banking System: The Traditional Approach to Regulation 5
 - 3. Experimentation, Innovation, and Competition 5
 - 4. Proposed Federal Preemption 6
 - 5. Dangers of Increased Federal Preemption 6

- Chapter 1 Regulation of Banks:*
 - Historical Context** 7
 - Birth of the Dual Banking System 7
 - Evolution of Bank Regulation 9
 - The Dual Bank System and State/Federal Regulatory Competition 9
 - The Bank Panic of 1907 and the Establishment of the Federal Reserve System 10
 - The Great Depression and the Separation of Commercial Banking from Investment Banking 10
 - Fear of Monopolistic Control in the Banking System and the Restrictions Against Interstate Banking 11

- Chapter 2 Current Issues in Bank Regulation:*
 - The Future of the Dual Banking System** 13
 - Purpose and Scope of Bank Regulation 13
 - Division of Responsibility among Regulators 14
 - Jurisdictional Overlap: Areas of Conflict . 14
 - Jurisdictional Overlap: Efforts at Coordination 16
 - Effects of Deregulation on the Dual Banking System 17
 - The Strengths of the Dual Banking System . 17
 - Interstate Banking 17
 - Grants of New Powers to State-Chartered Banks: Securities Underwriting, Insurance Activities, and Real Estate Investment 19

- Chapter 3 Federal Activity and Proposed Preemption* 23
 - Issues of Pending Legislation 23
 - Conclusion 26

Introduction

States have exhibited remarkable resilience in their regulation of banks over the years. In 1781, states took the lead in regulation by requiring banks to receive a state charter. In 1791, the federal government, using state law as a model, chartered a national bank, the First Bank of the United States. In 1816 Congress granted a 20-year charter to the Second Bank of the United States. Never popular with the public, the life spans of the First and Second Banks of the United States were short. Therefore, state banks dominate the early history of banking in this country.

In 1864 and 1865, Congress enacted two laws in an attempt to create a single national banking system. First, it passed the *National Currency Act*. Like the state laws on which it was modeled, this Act created a uniform system under which private persons could apply for and receive a national bank charter from the Comptroller of the Currency. Second, Congress levied a 10 percent tax on all state bank notes. These actions caused many state banks to change from a state to a national charter; they did not, however, have the intended effect of eliminating all state banks. States adapted to the federal legislation by offering expanded powers to banks in order to entice them into seeking a state rather than a national charter. Banks adapted by ceasing to issue the heavily taxed bank notes to borrowers and setting up deposit accounts instead. The years 1864 and 1865, therefore, mark the birth of the dual banking system: in those years, state and federal chartering of banks became a reality, and the regulatory competition between the two chartering authorities began.

From the beginning, banking has been plagued with problems of mismanagement and fraud on the part of bank owners and carelessness and inexperience on the part of regulatory authorities. Outbreaks of bank “panics” have occurred often in U.S. history. With each new bank panic and crash, Congress first formed a committee to study the problem and eventually added another layer of federal regulation. In this way, Congress created the Federal Reserve System and the Federal Deposit Insurance Corporation. For the most part, Congress has allowed state banks to avoid much of the added federal regulation. For example, the *Federal Reserve Act* made state bank membership in and regulation by the Federal Reserve Board optional. By choosing not to become members of the Federal Reserve System, state banks could escape regulation by the Federal Reserve Board. The *Glass-Steagall Act*, which prohibits banks from engaging in securities underwriting, excludes from its provisions state banks that are not members of the Federal Reserve System.

On many occasions, states have taken advantage of these exemptions from federal law by offering state banks powers often forbidden to national banks. The Comptroller of the Currency has typically re-

sponded to the state/federal imbalance by seeking similar new powers for national banks. On other occasions, the Comptroller has taken the lead in expanding bank powers by interpreting the *National Bank Act* to allow national banks to act as insurance agents, to engage in personal property leasing, and to offer discount securities brokerage services. This regulatory diversity and tension, which is at the heart of the dual banking system, is credited with encouraging innovation, increasing competition, and preventing economic concentration; at the same time, it is faulted with creating a competition in laxity.

Thus, the dual banking system has been fostered by: (1) Congressional restraint, in refraining from preempting state regulation of banking and allowing state banks to retain a degree of independence from federal regulatory authority; and (2) state adaptation to changing conditions in banking. As this report illustrates, however, the future of the dual banking system is uncertain. Recent congressional legislation and federal regulatory actions would broadly preempt state control of all new bank activities, in-

cluding securities, insurance and real estate, and transfer this control to the Federal Reserve Board. Yet, it is the dual banking system with its regulatory diversity and tension that has made it possible for banks to offer these new services in the first place. By impairing the future functioning of the system, the proposed federal legislation and regulation may signal the demise of the dual banking system and with it the innovation, competition, and avoidance of concentration that it has promoted.

The purpose of this report is to examine and evaluate the key intergovernmental regulatory issues that arise as a result of the changing economic and institutional structure of the financial services industry. The report begins with a review of the history of bank regulation and the development of the dual banking system, and then analyzes the current issues of bank regulation and the nature and scope of legislation that is pending in the Congress that would restrict regulatory authority over the insurance and securities activities of state-chartered banks.

Recommendation*

The Commission finds that the nation's dual banking system has many benefits for citizens, states, and local communities. That system has been conducive to state experimentation, banking innovation, regulatory competition, and vitality in both banking regulation and banking activity. Further concentration of regulatory authority by the federal government in an already heavily regulated industry poses risks of stagnation and of a further erosion of the balance of power in the federal system. Although there are problems in the nation's banking system, currently proposed measures for federal preemption do not address those problems. Many state regulators have used their authority responsibly in extending new powers pertaining to insurance, real estate, and securities to their state banks.

The Commission recommends, therefore, that the Congress not enact proposed legislation and that the Federal Reserve Board not promulgate proposed rules that would substantially preempt state regulatory authority over state nonmember bank activities in the fields of insurance, real estate, and securities.

*Mayor Donald M. Fraser introduced the following dissent:

I dissent from the recommendation that Congress not enact proposed legislation that would preempt state regulatory authority over state banks in the fields of insurance and securities. I believe that federal preemption of "new" bank powers, such as securities underwriting, is appropriate because such activities should take place in a subsidiary of a bank holding company and not in a bank or a direct subsidiary of a bank.

In my view, the bank holding company approach has two advantages. First, the holding company mechanism provides maximum legal separation between the bank and its securities affiliate because there is no direct ownership link between a bank and its affiliates. It is less likely, therefore, that a bank would be held liable for the actions of a securities affiliate than it would for the actions of a direct bank subsidiary. Second, the holding company structure will help to promote competitive equality among the institutions engaged in securities underwriting. If securities activities are conducted directly within a bank or in a subsidiary of a bank, they are likely to receive a benefit from the direct association with the federal safety net because of increased public confidence in securities offerings made by insured banks. The use of the bank holding company structure would help to create a level playing field by minimizing both the public confidence advantage of a bank subsidiary and the competitive edge a bank might have in raising funds in the capital markets because of its association with the federal safety net.

Findings

1. Principal Objectives of Bank Regulation

The principal public policy objectives of bank and bank holding company regulation have generally been understood to include the following: (1) protection of depositors and consumers; (2) protection of bank safety and soundness; (3) enhancement of competition; (4) avoidance of undue concentration in the banking industry; and (5) promotion of efficient credit allocation. Responsibility for achieving these objectives is vested in four principal regulatory actors: state banking supervisors, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation.

2. Dual Banking System: The Traditional Approach to Regulation

The nation's dual banking system—by which banks and banking activities are regulated by both the states and the federal government—has served the nation well for more than a century. Dual banking, moreover, conforms to the principles of federalism because regulatory authority is shared by the states and the federal government. Currently, four categories of banks exist: (1) state member banks (state banks that have chosen to become members of the Federal Reserve System and are therefore regulated by the states and the Federal Reserve Board), (2) state nonmember banks (state banks that have not chosen to become Federal Reserve members and are regulated by the states and the FDIC), (3) national banks (regulated by the Comptroller of the Currency and the Federal Reserve Board), and (4) bank holding companies (regulated by the Board and by some states). All state banks are subject to federal regulatory override, either by the Federal Reserve Board or the FDIC. The balance presently struck by Congress gives due regard for the rights of states and for the legitimate interest of the federal government in the protection of the federal deposit insurance fund.

3. Experimentation, Innovation, and Competition

The dual banking system has permitted considerable experimentation and innovation in both banking activity and governmental regulation of banking. Regulatory diversity has given banks opportunities to experiment with new services and to initiate innovations in response to changing conditions. The ability of new and existing banks to choose the set of laws and administrators under which they will operate is another important feature of the dual banking system. Congressional restraint in preempting state authority has given states opportunities to experiment and to innovate, and to tailor banking regulation to state and local needs. In turn, there have been many instances where the federal government has adopted regulatory innovations developed by states.

Dual banking has also encouraged competition between federal and state regulators and, thereby, competition within the banking industry as well. Such competition reduces the ability of industry representatives to capture regulatory authorities.

4. Proposed Federal Preemption

Although federal officials rarely criticize the principle of dual banking regulation, they have initiated a process of piecemeal preemption of state authority. Proposed federal legislation, which has recently passed the Senate, and proposed rules by the Federal Reserve Board would substantially preempt state regulatory authority over state banks and banking activities in the fields of insurance, real estate and securities. Yet, there is no evidence that the current federal oversight of these activities of state banks (by the FDIC or the Board) is not sufficient. The Chairman of the FDIC, moreover, has stated that further federal preemption of state authority in these areas is not necessary. Many state regulators have exercised their powers responsibly in these fields, and those states which have allowed their banks to diversify their portfolios have helped their banks to compete better in today's complex financial markets. There are problems in the national banking system and in some state banking systems, but the proposed legislation and rules do not address those problems.

5. Dangers of Increased Federal Preemption

Banking is already a heavily regulated industry. Dual banking regulation, however, alleviates some of the problems that can arise from government regulation. Further concentration of regulatory authority in the hands of the federal government, especially in the absence of a clear need for preemption, poses the risk of undermining the vitality present in the existing dual banking system. Proposed legislation and rules would add another layer of federal regulation on state-chartered banks and thereby imperil the future existence of state banks. Given the tremendous changes occurring in banking today, the dual system has allowed states to engage in a great deal of experimentation with regard to interstate banking, bank services for consumers, and bank activities in insurance, real estate, and securities. In some cases, states have also moved out ahead of the federal government to create uniformity, coordination, and cooperation in such matters as information sharing and bank examinations. Conflicts over regulation frequently arise, moreover, not between state and federal regulators but among federal regulators. Thus, an increase in federal regulation through further preemption of state authority is not likely to reduce conflicts among regulators, but may dampen the innovation occurring under the dual banking system and will further erode the position of the states in the federal system.

1

Regulation of Banks: Historical Context

BIRTH OF THE DUAL BANKING SYSTEM

The role of the states in the United States banking system is unique among industrialized nations. That role is usually described by reference to the dual banking system, the deceptively simple phrase used to describe the complex web of state and federal laws that control banking. Historically, the dual banking system referred simply to the power of both state and federal governments to charter and supervise banks. A key principle of the dual banking system today is that the rights of the two governments should be approximately equal in chartering banks and in regulating and examining the banks that they charter. Jealously guarded by states today as an integral part of the United States federal system of government, the dual banking system began accidentally.

Commentators identify the Bank of North America as the first bank, in the modern sense, in North America.¹ Prophetically, the bank was a product of both federal and state law. Originally established in 1781 under a charter granted by the Continental Congress, the Bank of North America obtained a second charter in 1782 from the state of Pennsylvania when doubt arose as to the validity of the federal charter.²

Soon thereafter other states began to charter banks. In 1784, the Massachusetts legislature granted a charter to the Bank of Massachusetts; in 1790, Maryland chartered the Bank of Maryland; and in 1791, New York incorporated the Bank of New York. By 1816, 246 state-chartered banks existed.³ State legislatures granted these early charters to individual banks by special act.⁴ Each charter could therefore contain restrictions and grants of power specific to only one bank. Some generalizations are possible, however. For example, most charters permitted banks to issue notes, receive deposits, make loans, and provide services to the chartering government. Typical restrictions included prohibitions against trading in goods and against owning real estate other than that needed and used to house bank activities or acquired as loan collateral.

Most early state-chartered banks confined their lending activities to short-term loans. Banks made their short-term loans by giving borrowers bank notes rather than deposits as is the present practice. The borrower could redeem the bank notes in hard currency from the bank's capital or sedentary deposits to pay his debts. Frequently, borrowers used the bank notes as currency, giving the notes to their creditors in payment of their debts rather than redeeming them. Creditors, in turn, could either redeem the notes or use them in payment of their own debts.⁵ Sometimes the holders presented their notes for redemption in hard currency while the loans on which the notes were based were still outstanding. This

practice dangerously depleted the banks' reserves and often caused insolvency. Banks sought to avoid this fate by preventing redemption of the notes. Banks accomplished this by placing their notes in circulation far from the point of redemption or by persuading note holders not to redeem them.⁶

Several factors contributed to the specialization in short-term loans. For example, early banking theory was heavily influenced by the "real bills" doctrine and by English law. The real bills doctrine, developed by Adam Smith, held that banks could preserve their liquidity only by confining their activity to short-term, self-liquidating loans to finance the conversion of raw materials into goods and their transportation to market. According to this theory, banks that made longer loans would face the risk of insufficient funds to lend during periods of increased economic activity and to satisfy demands of depositors for hard-currency.⁷ Another important factor in the early specialization of banks in short-term lending involved the belief, inherited from English Parliamentary law, that a separation between banking and commerce was necessary to restrain banks from monopolizing commerce as well as banking.

These two factors—the real bills doctrine and the fear of economic concentration—led banks and some state legislatures to define the business of banking narrowly. Yet, securities underwriting, especially of federal and state government bonds, was deemed a permissible activity even under the restricted definition of the business of banking.⁸ Alongside this narrow view of the proper business of a sound bank existed another, competing view. Some states issued bank charters that permitted or required banks to hold stock in other companies, to combine insurance and banking, and to establish and/or manage transportation systems and utilities.⁹

The idea of a national bank, held in abeyance after skepticism arose over the validity of the federal charter granted to the Bank of North America by the Continental Congress, was renewed on the adoption of the Constitution. Alexander Hamilton, long a proponent of national banking, became the first Secretary of the Treasury of the new republic. Under Hamilton's patronage, and over the objections of both Secretary of State Thomas Jefferson and Attorney General Edmund Randolph who deemed the creation of a national bank unconstitutional, Congress granted a 20-year charter to the First Bank of the United States in 1791.¹⁰

In 1811 the First Bank of the United States faced another challenge to its existence. Upon application for a renewal of its charter, opponents of the bank argued that a grant of a corporate charter was an attribute of sovereignty that could exist only by express power. Because the Constitution was silent regarding the authority of Congress to incorporate a bank, no

such power could be implied. This time, the opponents won and Congress refused to renew the bank's charter.

A mere five years later, however, Congress granted a 20-year charter to the Second Bank of the United States.¹¹ The turnabout came as the country faced extraordinary demands on its financial resources caused by the War of 1812 and the beginning of commercial farming and manufacturing. Although these developments created an urgent need for an orderly banking and currency system, state banks were profiting from the increased borrowing and were in no mood to provide stability through the use of hard currency. Because Congress believed it did not have constitutional power to regulate state banks, it chose to bring order to the nation's banking system by establishing its own competing bank.¹²

This bank fared little better than did many state banks, however. Indeed, it fell prey to the same forces—lack of understanding of commercial banking and lack of competent management—that had undermined the stability of the state bank system. Equally important, farmers and small businessmen, opposed to the tight credit policies of the bank, accused it of exercising monopolistic privilege. Popular reaction against the Second Bank of the United States grew. In 1832 President Jackson vetoed the legislation renewing the Second Bank's charter, which was due to lapse in 1836. Realizing that the tide had turned against him, the president of the Second Bank of the United States, Nicholas Biddle, became reckless. From 1835 to mid-1836, when it ceased doing business as a national bank and became a state-chartered bank, the Bank of the United States increased its securities holdings from \$4 million to more than \$20 million. Lacking adequate liquidity to support the immense increase in its assets, the bank borrowed from abroad. Then, when its foreign sources of liquidity dried up, the bank suspended all payments in hard currency.

Meanwhile, conditions in state-chartered banks were also ripe for a general bank crisis. The aggregate value of the state bank notes in circulation had risen from \$61 million in 1830 to \$149 million in 1837.¹³ The crisis hit on May 10, 1837. All the banks then in operation suspended payment in specie. Some historians maintain that Biddle had masterminded the general suspension, which he could do because of the greater size of U.S. Bank (now operating as the U.S. Bank of Pennsylvania) relative to other state banks, and because the U.S. Bank held a significant number of the notes issued by other state banks.¹⁴

The so-called free banking era began in 1838. In that year New York passed its Free Banking Act, which standardized the bank chartering process by setting uniform minimum capital and regulatory standards for all chartered banks.¹⁵ The New York

law was a reaction to the specific problems that led to crisis of 1837 and to the general public outcry against monopolistic banking. Under the new law, New York granted a charter to any bank that deposited with the state comptroller U.S. bonds, state bonds, or real estate bonds and mortgages. In exchange, the bank received an equivalent amount of bank notes for circulation. Because many blamed the crash of 1837 on the mixing of commercial and investment banking, the New York act prohibited its chartered banks from investing and trading in securities.¹⁶

Other states soon followed the New York lead by passing similar free banking laws and increasing their supervision of banks. Despite the reforms, state banks continued to fail at a high rate. In fact, between 1840 and 1847 the number of state banks actually declined. Unfortunately, the volume of bank notes in circulation did not decrease proportionately to the bank failures. Instead, the notes issued by defunct banks continued to circulate along with the notes of viable banks. By 1862, 7,000 different kinds of notes issued by 1,600 different banks were in circulation. Another 5,000 counterfeit notes circulated along with the legitimate notes.¹⁷

Once again the banking system was in disarray. Commercial transactions stalled as uncertainty grew over the worth of the notes in circulation. Creditors who were willing to accept bank notes in payment of debts demanded that the notes be discounted. Notes issued by the stronger banks of New England were accepted at par, those of New York banks were subject to a 10 percent discount, and notes from banks west of the Appalachians were at a 50 percent discount. Popular reaction against banks increased. Iowa outlawed banks from 1846 to 1857; in 1845 the Texas constitution banned banks completely.¹⁸ Other states responded to the public outcry by instituting bank examinations designed to increase their safety and soundness.¹⁹

Spurred into action by the need to finance the Civil War and the need for a uniform currency, Congress passed the *National Currency Act* in 1864.²⁰ The *National Currency Act*, renamed the *National Bank Act* in 1874, and hereafter referred to as the *National Bank Act*, established national banks and gave them authority to issue bank notes secured by government bonds. Congress intended that this act would hasten the passing of state banking. When it became evident that state banks would not die easily, Congress passed a 10 percent tax on state bank notes in order to pressure state banks to convert to national charters.²¹ Although the number of state banks dwindled from 1,466 in 1863 to 247 in 1868,²² the tax did not have the hoped-for effect of causing the end of state-chartered banks. State banks adapted to the federal tax on their notes by discontinuing the use of notes and initiating

the use of deposits and checks. With this classic industry response to government regulation, the dual banking system was born.

EVOLUTION OF BANK REGULATION

Five themes have dominated bank regulation in the United States: (1) federal/state regulatory competition, (2) multiple regulation and supervision of banks, (3) separation of commercial and investment banking, (4) restrictions on interstate banking, and (5) fear of monopolistic control in the banking system.²³ The first of these themes originated as a corollary to the dual banking system, the second and third arose largely from a series of crises in the banking system, and the fourth and fifth spring from a deeply rooted fear of economic concentration.

The Dual Bank System and State/Federal Regulatory Competition

Regulatory competition between national and state-chartered banks began with the passage of the *National Bank Act*. Consider, for example, the following difference in state/federal charter requirements. Like the New York Free Banking Act on which it was based, the *National Bank Act* required national banks to keep a large portion of their capital in securities on deposit with the Comptroller of the Currency. Unlike the New York law however, the federal act dictated that national banks deposit only federal securities. In exchange, the national bank received notes equal to 90 percent of the value of the deposited bonds.²⁴ While these stringent requirements enabled the U.S. government to guarantee the payment in full of national bank notes, they also artificially restricted the expansion of national banks by tying their expansion to the supply of Treasury securities rather than to the needs of business. For example, when the federal government reduced its level of outstanding debt, as it did after the Civil War, the supply of Treasury securities fell, causing a contraction in national bank note circulation.

State bank charter laws also required banks to pledge securities against their bank notes with the state comptroller. The state legislation, however, was far less restrictive than were the national laws. For example, state banks were not restricted in the kinds of securities they could deposit, and their note issues were not limited to 90 percent of the market value of the deposited securities.²⁵ Consequently, state banks could expand more freely than national banks. State banks had other advantages over national banks. For example, Congress limited the lending activities of national banks to commercial credit, whereas many state laws allowed banks to make mortgage loans. Some state laws permitted branch banking, while the *National Bank Act* prohibited this practice.²⁶

The advantages of a state charter were not lost on national banks. During the period from 1863 to 1900, the state banking system underwent a remarkable revitalization as national banks converted to state charters. By 1900 state banks had edged out national banks in both numbers (5,000 state banks to 3,790 national banks) and in deposits (state banks holding 55 percent of all deposits).²⁷ The potential threat that these charter conversions posed to the national bank system was, in turn, not lost on Congress. In 1913 Congress authorized national banks to engage in real estate lending. Thus began the state/federal regulatory competition that has, over the years, been scorned as a competition in laxity and praised as a model of regulatory excellence.²⁸

For several decades after the Civil War, the business of securities underwriting flourished as railroads issued bonds to finance construction of lines across the West.²⁹ Because many state laws allowed banks and/or trust companies to underwrite securities, state banks and state incorporated trust companies participated in the underwriting of these issues. National banks, on the other hand, were excluded from this lucrative business by regulatory and judicial prohibitions against securities underwriting.³⁰ Very soon, however, national banks circumvented this inequity by engaging in securities activities through state bank and trust company affiliates.³¹ Later, they persuaded the Comptroller of the Currency to relax his prior ban on securities activities and finally induced Congress to “level the playing field.” The *McFadden Act* of 1927 enabled national banks to underwrite those securities that the Comptroller of the Currency approved.³²

The Bank Panic of 1907 and the Establishment of the Federal Reserve System

From 1863 to 1913, regulation and supervision of national and state banks was entrusted to the Comptroller of the Currency and state bank superintendents, respectively. The banking panic of 1907 resulted in the addition of another layer of federal regulation in the form of the Federal Reserve Board. Two-hundred-forty-six banks failed during the 1907 crash.³³ The origin of the crash is generally attributed to speculation in railroad and copper stocks by individuals and large New York banks and trust companies.³⁴ When the price of copper stocks declined, panic set in and depositors rushed to withdraw their cash. Banks and trust companies, operating on desperately small reserves, were unable to meet the demands of depositors and closed.³⁵

The 1907 panic precipitated the establishment in 1908 of the National Monetary Commission, which was charged with the responsibility of analyzing the crash of 1907. This commission focused its attention on the problems of insufficient reserves and the in-

elasticity of the currency. Its recommendations included the establishment of a central bank controlled by private bankers.³⁶ In 1913, the Pujo Committee was formed to investigate the so-called money trust. The Pujo Committee found numerous abuses and illegalities in the use of securities affiliates by banks and advocated the separation of commercial and investment banking. Congress eventually adopted elements of both studies.

First, Congress established a central bank with its passage of the *Federal Reserve Act* in 1913.³⁷ The act established 12 regional Federal Reserve Banks that operated under the general supervision of a Federal Reserve Board located in Washington, DC. According to the provisions of the act, every national bank had to become a member of the Federal Reserve System and to submit to regulation by the board. State banks could become members of the system on a voluntary basis.³⁸ For the first time, state banks (which chose to become members of the Federal Reserve System) became subject to federal regulation and supervision. The act obliged state member banks to meet the same capital requirements as national banks and the same limitations with regard to payment of unearned dividends and withdrawal or impairment of capital.³⁹ Another bank panic would occur before the recommendations of the Pujo Committee concerning the separation of commercial and investment banking would become law.

The Great Depression and the Separation of Commercial Banking from Investment Banking

Although speculation in securities by banks had been identified as a cause of several of the early bank panics, and although the Pujo Commission Report⁴⁰ had concluded that national banks could not legally purchase and sell equity securities, national banks continued to expand their securities activities through affiliates. National bank affiliates originated and distributed a wide variety of securities, including those of foreign governments, cities, states, and foreign business corporations.⁴¹

As the volume of this activity increased, a great number of abuses arose. One category of abuse involved the mixing of commercial and investment banking functions. For example, unsuccessful sales of securities issues by their affiliates induced some banks to make excessive loans to their securities affiliates or to purchase securities from their affiliates for bank fiduciary accounts. Conversely, a bank loan to a company which later failed was often propped up through the purchase and sale of the company's stock through the affiliate.⁴²

These and similar abuses went virtually unchecked. Prior to the stock market crash of 1929 and the bank reform of 1933, federal law was silent with regard to the use of securities affiliates by national

banks. Federal law neither authorized nor prohibited the use of such affiliates. Unlike state bank superintendents, the Comptroller of the Currency did not even have legal authority to examine the securities affiliates of national banks. Following the stock market crash, Congress began investigations into the activities of securities affiliates. Although all the witnesses agreed on the need for regulation of securities affiliates, they differed sharply on the need to ban such affiliates. Senator Glass, the chairman of the subcommittee conducting the investigations, favored the abolition of all securities affiliates. Others favored government regulation of the securities activities of banks. During the course of the congressional hearings, 5,844 banks failed.⁴³ The numerous bank closings were often accompanied by indictments of bank officials for fraud and forgery. As the financial position of banks continued to deteriorate, 18 states declared bank holidays and 7 states placed restrictions on withdrawals. When President Roosevelt declared the national bank holiday on March 5, 1933, opposition to the Glass bill evaporated, and the *Banking Act* of 1933 became law.

The 1933 act (1) established a Federal Deposit Insurance Corporation; (2) required separation of securities affiliates from commercial banks and their holding companies; (3) prohibited interest on demand deposits; and (4) permitted intrastate branch banking for national banks if and to the extent that state law granted branching to state banks. The Federal Deposit Insurance Corporation (FDIC), which insured bank deposits up to \$2,500, was modeled in part on earlier state deposit insurance schemes.⁴⁴ With the establishment of the FDIC, Congress subjected state nonmember banks to federal regulation for the first time and placed a third level of federal regulation on national banks.

The portion of the bill that dealt with securities, popularly known as the *Glass-Steagall Act*, created a wall between commercial and investment banking. Sections 16 and 20 banned both national and state member banks from underwriting corporate equity and debt securities and from affiliating with entities that were principally engaged in such activities. Section 21 prohibited any entity engaged in securities underwriting from taking deposits. Unlike the ban in section 20, section 21 did not prohibit affiliation between such entities. Section 32 prevented personnel interlocks between member banks and securities underwriters.⁴⁵ The *Glass-Steagall Act* exempted state nonmember banks from its provisions, an important exclusion that states are exploiting today.⁴⁶

FEAR OF MONOPOLISTIC CONTROL IN THE BANKING SYSTEM AND THE RESTRICTIONS AGAINST INTERSTATE BANKING

Early in the history of state banking, most states either prohibited or limited intrastate branch bank-

ing. States justified their restrictions on branching as necessary to prevent undue concentration in the banking system. Branch banking, it was thought, would cause the death of small independent banks, thereby hindering the development of the west. Opponents of branching argued that branch banks would secure the "easiest obtainable and most desirable business . . . leaving the unit banks to take care of the enterprises of the town which have not already reached a condition of independence," thereby causing the collapse of independent banking.⁴⁷ The loss, in turn, of these small unit banks would be catastrophic to the nation since "the rapid economic development of America had been largely due to the policy of the pioneering unit banks which recognized the principle of service."⁴⁸

The *National Bank Act*, which provided that the usual business of a national bank shall be transacted at an office or banking house located in the place specified in its organization certificate, did not displace these state-imposed geographic restrictions. Shortly after the passage of the act, the Comptroller of the Currency interpreted its provisions as forbidding national banks to operate branches. Succeeding Comptrollers followed this precedent.⁴⁹ No such ban prevented state banks from branching intrastate, and many did so as states gradually relaxed their laws. Congress took a small step toward remedying this imbalance by amending the *National Bank Act* in 1927. The amendment, popularly known as the *McFadden Act*, permitted national banks to operate branches within the state in which their home office city is located, if and to the extent that state law allowed state banks branching power.

If federal law outlawed branch banking, it did not stop national banks from operating nationwide through a system of joint ownership of separately chartered banks. Typically, the joint ownership took one of two forms: (1) chain banking, which united several banks through common ownership and directors; and (2) group banking, which united banks through the formation of a parent holding company.

During the 1920s, group banking gradually replaced chain banking as the dominant device for linking banks nationwide.⁵⁰ The number of bank holding companies declined during the early 1930s, but then they grew virtually unchecked until 1956.⁵¹ In that year, Congress passed the *Bank Holding Company Act*,⁵² which prohibited interstate banking through subsidiary banks. According to one section of the Act, the Board of Governors of the Federal Reserve must approve all bank acquisitions by a bank or a bank holding company. Another section, popularly known as the Douglas amendment,⁵³ provides that the Board of Governors cannot approve the acquisition of a subsidiary bank outside the holding company's principal state of operation unless the laws of the

state in which the bank is to be acquired or established expressly allow such entry. The 1956 act applied only to multibank holding companies, but in 1970 Congress amended the act to extend its provisions to one-bank holding companies.

ENDNOTES

- ¹Paul Studenski and Herman Krooss, *Financial History of the United States*, 2nd ed. (New York: McGraw-Hill, 1963), p. 31; Benjamin Klebaner, *Commercial Banking in the United States: A History* (New York: Dryden Press, Holt, Rinehart & Winston, 1974), p. 2.
- ²Bray Hammond, *Banks and Politics in America From the Revolution to the Civil War* (Princeton: Princeton University Press, 1957), pp. 48-52.
- ³Klebaner, p. 7.
- ⁴Edward L. Symons, "The 'Business of Banking' in Historical Perspective," 51 *George Washington Law Review* (1983): 676.
- ⁵John Kenneth Galbraith, *Money: Whence It Came, Where It Went* (Boston: Houghton Mifflin, 1975), p. 20.
- ⁶Studenski and Krooss, pp. 73-74.
- ⁷Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 287, 5th ed. (1930); Robert Litan, *What Should Banks Do?* (Washington, DC: The Brookings Institution, 1987) p. 14.
- ⁸Litan, pp. 14-15.
- ⁹Symons, pp. 688-89.
- ¹⁰Studenski and Krooss, pp. 60-61.
- ¹¹John J. Knox, *A History of Banking in the U.S.* (New York: Augustus M. Kelley, 1966, reprint of 1900 ed.), p. 75.
- ¹²Stephen J. Friedman and Connie M. Friesen, "A New Paradigm for Financial Regulation: Getting from Here to There," 43 *Maryland Law Review* (1984): 413.
- ¹³Knox, p. 76.
- ¹⁴Ibid. For a complete recounting of the events that led to the bank crisis of 1837, see Hammond.
- ¹⁵Howard Hackley, "Our Baffling Banking System," 52 *Virginia Law Review* (1966): 570.
- ¹⁶Litan, p. 17; Klebaner, p. 95.
- ¹⁷Galbraith, p. 88.
- ¹⁸Hackley, p. 574.
- ¹⁹Klebaner, pp. 40-44.
- ²⁰13 Stat. 112 (1864).
- ²¹Studenski and Krooss, pp. 154-55.
- ²²Litan, p. 21.
- ²³Friedman and Friesen, p. 416.
- ²⁴Studenski and Krooss, p. 155.
- ²⁵Ibid., p. 114.
- ²⁶Ibid., p. 178.
- ²⁷Litan, p. 22.
- ²⁸Kenneth Scott, "The Dual Banking System: A Model of Competition in Regulation," 30 *Stanford Law Review* (1977): 1.
- ²⁹Litan, p. 22.
- ³⁰*First Nat'l Bank of Charlotte v. Nat'l Exchange Bank*, 92 U.S. 122 (1875); Friedman and Friesen.
- ³¹W. Nelson Peach, *The Securities Affiliates of National Banks* (Baltimore: Johns Hopkins University Press, 1941), p. 53.
- ³²44 Stat. 1224, 1227 (1927); Peach, pp. 40-42.
- ³³Galbraith, p. 111.
- ³⁴Studenski and Krooss, p. 253.
- ³⁵Ibid., pp. 253-54.
- ³⁶Ibid. p. 255.
- ³⁷38 Stat. 251.
- ³⁸38 Stat. 259.
- ³⁹Ibid.
- ⁴⁰Report of the Committee Appointed Pursuant to House Resolutions 429 and 504 to Investigate the Concentration and Control of Money and Credit, 1913.
- ⁴¹Peach, p. 104. Historians differ on the causes of the numerous bank failures preceding and during the Great Depression. No attempt is made here either to evaluate those differences or to make an independent analysis of the causes. This section merely describes those events that led to the passage of the *Glass-Steagall* bill, without judging the wisdom of Congress in doing so.
- ⁴²Ibid.
- ⁴³Ibid, p. 156.
- ⁴⁴Hackley, p. 577.
- ⁴⁵Litan, p. 27.
- ⁴⁶The *Competitive Equality Banking Act* of 1987 (P.L. 100-86) contained provisions that temporarily extended the prohibitions of the *Glass-Steagall Act* to FDIC-insured state nonmember banks. The temporary extension expired March 1, 1988.
- ⁴⁷Statement of Comptroller of the Currency Dawes in 1924, quoted in Klebaner, p. 126.
- ⁴⁸Ibid.
- ⁴⁹Ibid., p. 59.
- ⁵⁰Klebaner, p. 60.
- ⁵¹Ibid., pp. 127, 159.
- ⁵²70 Stat. 133 (1956). Codified at 12 USC 1841-50 (1982).
- ⁵³12 USC sec. 1842(d) (1982).

2

Current Issues in Bank Regulation: The Future of the Dual Banking System

PURPOSE AND SCOPE OF BANK REGULATION

The public policy objectives of bank and bank holding company regulation include the following: (1) protection of bank safety and soundness; (2) enhancement of competition; (3) avoidance of undue concentration; (4) protection of consumers and depositors; and (5) promotion of efficient credit allocation.¹ Traditional bank regulation seeks to implement these goals through the use of statutory provisions and regulatory guidelines designed for that purpose. Yet, many regulatory provisions do not fall neatly into one of the five categories. Instead, some can be justified under two or more categories, and others appear to further one goal while frustrating another. A review of some bank regulatory provisions illustrates the overlap and contradictions.

State and federal entry controls, such as the requirements of a charter, minimum capitalization, and deposit insurance fall within the category of preservation of safety and soundness. In practice, however, chartering requirements (particularly the omnipresent statutory provision directing the chartering authority to consider whether another bank is needed in the community in which the applicant bank proposes to locate) have been used to protect the monopoly franchise of existing banks, frustrating the pro-competitive objective of category two.

Portfolio regulation is another method by which governments control the safety and soundness of banks. Under this subheading belong investment standards, reserve requirements, and single borrower limits. Federal laws and most state laws permit banks to purchase government obligations but ban the purchase of corporate equities. Legislators have deemed the degree of risk in dealing in common stocks inimical to bank soundness. For similar reasons, state and federal laws restrict bank investment in real estate. Both of these limitations, however, are also thought to further the objective of avoiding undue concentration of economic resources (category 3). Single borrower limits, by which states restrict the magnitude of loans that a bank can make to any one borrower to a specified percentage of the bank's capital, have the effect of lowering risk by promoting portfolio diversification. Single borrower limits are also credit allocation devices (category 5).

Legislators have addressed category 2 concerns (the enhancement of competition) by imposing restrictions on the establishment of branches, requiring regulatory approval of bank mergers and holding company acquisitions. In practice, however, regulators can and do use each of these provisions as devices to control economic concentration.

Among the regulatory tools that are intended to protect borrowers and depositors are deposit insur-

ance, usury laws (legal ceilings on loan interest rates), disclosure requirements and anti-discrimination provisions. Again, many of these provisions serve a dual purpose, and others have unintended consequences. Deposit insurance safeguards consumer savings, but it is also the primary vehicle for the prevention of bank runs, a category 1 concern. Bankers argue that usury ceilings have credit allocation consequences, e.g., by allocating credit away from states that have strict usury laws.

None of the specific regulatory provisions crosses all five categories. No one of the four regulators—state bank superintendents, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation—oversees all of these regulatory provisions.

Division of Responsibility among Regulators

The legislation that empowers each of the four bank regulators and delineates their tasks suffers from the same defects as do all laws. The language is frequently imprecise; later amendments often contradict the original law with which they must coexist; and over time new grants of power create duplication and overlapping jurisdiction. Regulators and bankers are quick to take advantage of these flaws.

The original dual bank regulatory scheme was relatively simple. It divided regulatory power between the two chartering authorities. According to the early scheme, state authorities chartered, regulated, supervised, and examined all state-chartered banks. The Comptroller of the Currency (OCC) had identical privileges with respect to nationally chartered banks. State law dominated in the area of branching, however.

Gradually, this simple system became more complex as Congress reacted to the various bank panics and crises by adding new layers of federal regulation. The *Federal Reserve Act* of 1913 gave the Federal Reserve Board (Board) some control over “member banks.” For example, the act required member banks—all national banks and those state banks that voluntarily became members of the Federal Reserve System—to maintain reserves against their deposits. Also, state member banks became subject to the same capital requirements as national banks and to the same restrictions with respect to purchasing or lending on their own stock and payment of unearned dividends.

The *Banking Act* of 1933 added another layer of federal regulation with the creation of the Federal Deposit Insurance Corporation (FDIC). Although established primarily as an insurance agency, Congress gave the FDIC significant power over state “nonmember banks”—state banks that had not chosen to become members of the Federal Reserve Sys-

tem. One provision of the act required all state-chartered banks that wished to have their deposits insured by the FDIC to apply to that agency for insurance. With the creation of the FDIC, federal law as well as state law controlled entry into the state banking system. New state banks seeking charters applied first to the state banking authorities and then to the FDIC for approval, whereas national banks received insurance automatically on being granted a national charter. In return for federal insurance of their deposits, state nonmember banks submitted to federal regulation for the first time. The FDIC’s regulatory control over state nonmember banks has grown significantly since 1933. For example, all bank mergers resulting in an insured state nonmember bank and all new branches of insured nonmember banks must be approved by the FDIC. Today, insured nonmember state banks are the largest class of federally regulated banks, comprising about 90 percent of the nearly 10,000 state banks.

Congress added a final layer of federal regulation in 1956 with the passage of the *Bank Holding Company Act (BHCA)*. Actually, the *Banking Act* of 1933 had previously given the board some power to regulate bank holding companies. Because the 1933 act covered only bank holding companies that owned a Federal Reserve member bank, it created an incentive for national banks to convert to state charters in order to escape holding company regulation by becoming nonmember banks. The *BHCA* closed this gap by subjecting all bank holding companies to the authority of the Federal Reserve Board.² According to the act, a bank holding company, defined as an organization that owns 25 percent or more of the stock of a bank, must obtain the approval of the Federal Reserve Board before formation.

Given the heavy federal overlay on state bank regulation, it is no longer possible to classify bank regulation within the dual banking system along state/federal lines. To understand bank regulation today, one must first identify in which of four categories a particular bank belongs: (1) state member banks (regulated by states and the Board); (2) state nonmember banks (regulated by states and the FDIC); (3) national banks, (regulated by the OCC and the Board), and (4) bank holding companies (regulated by the Board and by some states).

Jurisdictional Overlap: Areas of Conflict

The diffusion of power among regulators can serve a salutary purpose, such as preventing industry representatives from capturing their regulators. It can also create interagency conflicts and turf battles. In some areas of bank regulation, interagency strife has arisen among the three federal regulators, involving the states only peripherally. In other areas, federal regulators have tangled directly with state

authorities by challenging state authority to regulate state-chartered banks.

Turf battles among the federal regulators are endemic to the system. Legislation delineating the respective powers of the three agencies is necessarily general; the regulators flesh out the law by interpreting its meaning and application to specific situations through regulations, interpretative guidelines, and policy statements. Over the years the conflicts between the OCC and the Federal Reserve Board have dominated the clashes among the federal regulators. In the mid 1960s their interagency disputes became headline news.³ Congress documented their disagreements in subcommittee hearings on bills to consolidate federal bank supervisory functions.⁴

Typically, the disputes have involved differing interpretations of the law, each agency interpreting the law so as to increase its regulatory power. Consider, for example, the following conflicting interpretations of a federal funds transaction—a transaction in which a member bank whose reserves on deposit with its Federal Reserve bank are deficient will “buy” reserves from another member bank that has excess reserves on deposit with its Federal Reserve bank. In 1963, the OCC ruled that a federal funds transaction was neither a borrowing by the purchasing bank nor a loan by the selling bank for purposes of the statutory limit on loans and borrowings by national banks. The Board, however, ruled that federal funds transactions constitute loans and borrowings for purposes of the limitation on loans by member banks to their affiliates, a section of the law administered by the Board.

A similar “turf” battle occurred in a dispute over which of the two regulators would control the conditions under which a national bank could “accept”—i.e., guarantee payment of—drafts or bills of exchange that grow out of the importation or exportation of goods, the domestic shipment of goods, and/or the storage of certain goods covered by a warehouse receipt. The Board asserted control over the acceptance powers of national banks pursuant to a provision of the *Federal Reserve Act* that limited the amount that a member bank may “accept” for any one person as well as the aggregate amount of all such acceptances.⁵ The OCC ruled that national banks were not subject to such limitations, basing this ruling on the *National Bank Act*. The making of acceptances, the Comptroller contended, was an “essential part of banking”; as such, it was within the “incidental” powers granted all national banks and not subject to any limitations in the *Federal Reserve Act*.⁶

More recently, the *Wall Street Journal* has reported the observations of a participant in a meeting among the three federal regulators and Vice President Bush as follows: “The yelling, bickering, and wild accusation were so heated that Vice President

George Bush finally gave them all a blistering for their backbiting and bureaucratic rivalries.”⁷ Among the issues that divided the federal regulators were the following: (1) loans to other countries (the Board encouraging banks to continue lending to Third World countries, the FDIC and the OCC taking a more restrictive view of such loans); (2) nonbank banks (the Board refusing to approve applications for nonbank banks while the OCC frequently approved them); (3) capital requirements (the Board allowing banks to include goodwill and other intangibles in the calculation of their required capital, while the OCC and FDIC require banks to deduct goodwill and other intangibles from capital).

Similar examples of past disputes abound, and comparable conflicts exist today. One current battle among the federal regulators—whether the Board has the power to regulate the subsidiaries of all banks (including nonmember banks) that are members of a bank holding company—significantly affects the dual banking system. The dispute involves an interpretation of the provisions of the *Bank Holding Company Act*. The operative provisions of that act are found in section 3, which governs the acquisition of banks by a bank holding company;⁸ section 4, which controls the nonbanking activities of a bank holding company and its nonbanking subsidiaries;⁹ and section 7, which contains a provision to reserve powers to the states.¹⁰

Federal (the OCC and the FDIC) and state authorities argue that the history of the *Bank Holding Company Act* indicates that Congress intended to restrict the Board’s power under that act to bank holding companies and their nonbank subsidiaries. Legal commentators agree that the act does not give the board authority to regulate the activities of banks themselves.¹¹ That power remains with the primary regulators of the banks: the OCC and the state banking supervisors. The Board cannot, under this view, order a bank to divest itself of an “improper” subsidiary because the Board lacks power to limit the activities of banks. State regulators cite these arguments and also point to section 7 of the *BHCA* as authority for their position. That section provides:

Reservation of Rights to the States. The enactment of this chapter shall not be construed as preventing any State from exercising such powers and jurisdiction which it now has or may hereafter have with respect to banks, bank holding companies and subsidiaries thereof.

The Board has taken an opposing position. The Board admits that it cannot regulate the direct activities of state banks that are members of a bank holding company, but claims that it has the authority to regulate *subsidiaries* of all banks that are part of a bank

holding company system through section 4 of the *BHCA*. The specific language relied on by the Board prohibits a bank holding company from “acquiring direct or indirect ownership or control of any voting shares of any company which is not a bank. . . .” According to the Board, “by encompassing indirect as well as direct ownership interests, [section 4] of the Act prohibits a holding company bank as well as the holding company itself from owning more than 5 percent of the voting shares of any company engaged in impermissible nonbank activities. . . .”¹² The position of the board in this regard is somewhat anomalous: it admits to not having power over “improper activities” when conducted in the bank, but asserts control over the same activities when they are conducted in a bank subsidiary. Nevertheless, in a recent decision, the D.C. Circuit Court of Appeals agreed with the board, ruling that the *BHCA* gives the board authority to restrict the activities of subsidiaries of national banks that are owned by a bank holding company.¹³

No similar disputes exist among state regulators. This lack of conflict cannot be attributed, however, to the enlightened attitude of state regulators. It is, rather, a product of restrictive laws. Until recently, state and federal laws prohibited interstate banking and limited the activities of banks. These laws confined banks to one state, thereby escaping conflicts among regulators in different states; the laws also created a separation between the business of banking and that of other regulated entities, thereby avoiding jurisdictional disputes among regulators in the same state. Deregulation has removed many of these former restrictions. Based on the federal experience, one cannot rule out the possibility of conflicts among state regulators in the future.

Jurisdictional Overlap: Efforts at Coordination

Congress established the Federal Financial Institutions Examination Council (Council) in 1979 to “promote consistency in federal examinations and progressive and vigilant supervision.”¹⁴ The five-member council consists of the Comptroller of the Currency, the chairman of the FDIC, a member of the Board of Governors of the Federal Reserve System appointed by the chairman of the Board, the chairman of the Federal Home Loan Bank Board, and the chairman of the National Credit Union Administration. States are represented as nonvoting members of an advisory council.

To implement the general statutory mandate, Congress set forth three specific goals for the council: (1) to prescribe uniform principles, standards, and report forms for federal examinations of financial institutions by the five regulators represented on the council, (2) to develop uniform reporting systems for federally supervised financial institutions, their hold-

ing companies and their nonfinancial subsidiaries, and (3) to conduct schools for examiners employed by the five agencies.

These goals have proved elusive. For example, in 1985, the council approved a Uniform Report of Examination for commercial banks. Only the Federal Reserve implemented the new report, and in 1987 the council rescinded its earlier action approving the uniform report.¹⁵ Nine years after it was created, the council is still unable to agree on a uniform report of examination. Although the council conducts a school for examiners pursuant to goal (3), the agencies involved view the council’s training program as peripheral to their own individual bank examiner schools. Consequently, the council’s schools have contributed little toward uniformity in the training of bank examiners. It is evident that the council has made scant progress toward realizing the goals of its empowering legislation. Cooperative efforts among state and federal regulators have fared better. The council has approved a General Policy for Sharing Confidential Information with State Banking and Thrift Regulatory Agencies.¹⁶

Although they are novices at the supervision and examination of banks across state lines, many state bank regulators have made admirable progress in creating uniformity and coordination of bank examinations with their counterparts in other states. No statutory organization, analogous to the federal council, exists to mandate uniformity in state bank regulatory practices. Nevertheless, the Conference of State Bank Supervisors (CSBS) has sometimes played a similar role in providing support for state efforts toward uniformity and cooperation.

Formed in 1902, the CSBS is a professional organization governed by a 12-member board composed of state bank supervisors and an advisory council made up of state-chartered bankers. The organization provides training (introductory through advanced) for state bank examiners and seminars for bank department supervisory personnel and attorneys throughout the nation. In 1987, CSBS conducted 25 schools and seminars for over one thousand students. The training programs have helped to create uniform standards in state bank examinations across the country.

The CSBS also conducts an accreditation program for state banking departments. Accreditation is a rigorous process, beginning with a self-evaluation conducted according to a set of criteria developed by CSBS, proceeding to an on-site evaluation and report thereof under the direction of the CSBS Performance Standards Committee, and a review by the organization’s Audit Committee. Thirteen state banking departments have achieved accreditation, and others have begun the process.

gional reciprocal interstate banking laws, and 16 states allow nationwide interstate banking.²³

In addition, some states require the parent bank holding company to meet the credit and deposit needs of low and moderate income and minority residents, to meet the credit needs of small business in the community served, and to show that it has complied with the federal *Community Reinvestment Act*.²⁴ Other states require that the entering bank or its parent bank holding company must provide "net new funds" to the state.²⁵

Regional reciprocal interstate banking laws have spawned a host of agreements among states and among the different regulators within states. Michigan, Georgia, Virginia, and California have been particularly active in these areas. For example, Michigan has entered into information-sharing agreements with the states in its statutory reciprocal interstate banking group.²⁶ The agreement between Michigan and Illinois is representative. According to that agreement, the Michigan Financial Institutions Bureau agrees to share with the Illinois Commissioner of Banks examination reports and other pertinent information on Michigan state banks controlled by a bank holding company that seeks to acquire an Illinois bank or bank holding company. The Illinois commissioner has made a reciprocal agreement with the Michigan Financial Institutions Bureau. Michigan has also entered into an agreement for the sharing of information with the Federal Reserve Board, the OCC and the FDIC. Within Michigan, the Financial Institutions Bureau has signed reciprocal information sharing agreements with the state's revenue commissioner and the Michigan State Police.

Examination coordination among regulators is also a key component of effective bank supervision. The Michigan bank supervisor, the state supervisors within Michigan's regional group and the three federal regulators cooperate closely in their examinations of bank holding companies and their affiliates that are located in one or more of the states within the reciprocal region. Typically, the federal and state regulators coordinate their examinations of the state and national banks that are a part of the bank holding company system; in such cases, the examinations of each member of the holding company and the holding company itself will take place simultaneously.²⁷ The joint examinations and information sharing allows all four regulators to learn promptly of a problem arising in a bank holding company or one of its banks (national or state, member or nonmember) and to discover whether the problem has spread to other banks within the holding company system. At the conclusion of the examinations, each regulator issues a separate examination report for each bank examined, and copies are distributed to all other participating regulators.²⁸

The southeastern regional reciprocal group²⁹ has a similar information sharing and examination coordination plan in place. Georgia and Virginia have been leaders in this region. The procedures used in these states are similar to those in the Michigan plan in that they call for information sharing among the states in the reciprocal group and coordination of examinations among the states, the FDIC, the OCC and the board. Both Georgia and Virginia have given their bank supervisors broader regulatory authority than exists in Michigan, however. In Georgia and Virginia, the superintendents have legislative power to examine bank holding companies.³⁰

Bank supervisors in both states maintain that the additional powers allow them to perform their duties with greater care.³¹ Not only do the policies set at the holding company level affect the stability of the banks themselves, but the financial condition of the holding company itself also can have a direct impact on the safety and soundness of its banks. The problems in the bank holding company of Continental Illinois are cited as examples of both propositions. Georgia regulators add that their policies with regard to the frequency of examination of holding companies are more strict than the policies of the Board. For that reason, the Georgia department can spot and act on problems at the bank holding company level more quickly than the Board. In Georgia, state bank regulators handle the examinations of 95 percent of the state's bank holding companies.³²

The Virginia commissioner notes that the broader power to examine the entire system enables the department to serve banks better, too. Instead of a piecemeal approach to bank examination, the Virginia department is able to provide a comprehensive report on the effect that the policies of the holding company are having on the entire system. The Virginia approach has been very beneficial to the dual banking system. For example, in 1977, 40 percent of all bank assets in Virginia were held by state banks, and in 1986 that percentage increased to 60 percent.³³ Control over the bank holding company also provides an effective regulatory tool in that the state bank supervisor can monitor the acquisitions of the bank holding company and require divestiture of a subsidiary in the case of serious infractions of the law.

Recently, the California Superintendent of Banks drafted a policy statement setting forth certain basic principles of regulatory cooperation for the regulation of interstate banking. Signed by 12 western states,³⁴ the document calls for officials of each signatory state to meet during the fourth quarter of each year to schedule and coordinate examinations, requires each state to accept the work performed by other signatory states as part of its supervision of interstate banking entities, and encourages signatory

states to seek any needed statutory authority to allow them to share information.³⁵

One state, Connecticut, has experimented with creating a level regulatory playing field among competing industries through its statutory control over holding companies. In 1983 the Connecticut legislature established a "Commission to Study Legislation to Limit the Conduct of Business in Connecticut by Subsidiaries of Banking Holding Companies and the Impact of Non-Depository Institutions on Traditional Banking Activities." The commission found that the "greatest amount of activity in the financial services industry came in recent years . . . through the emergence of far-flung networks of outlets that organizations such as Sears, Merrill Lynch, Shearson/American Express . . . created to compete on a local level with services that banks traditionally provided."³⁶

As a result of the commission's report, the Connecticut legislature passed legislation requiring all banks and savings and loan associations, corporations that own one or more banks or savings and loans, and the nonbanking subsidiaries of such corporations to obtain permission from the commissioner of banking prior to engaging in a "banking business" in an office in Connecticut. The statute defined a banking business as including the following activities: receiving deposits, paying checks, lending money, and any other activity determined by the banking commissioner to be so closely related to banking as to be a proper incident thereto. In 1984, the Connecticut commissioner found that several activities of Dean Witter, a Sears securities subsidiary, fell within the terms of the statute. Specifically, Dean Witter was involved in receiving deposits by brokering certificates of deposit for various financial institutions and by offering a "sweep account," by which a customer might elect to have the free funds in his account automatically invested in an account in one of Sears Savings Banks.

Sears and Dean Witter challenged the Connecticut law, contending that it violated the Commerce and Supremacy Clauses of the U.S. Constitution. The U.S. district court upheld the law, a decision that was upheld by the 2nd Circuit Court of Appeals.³⁷ Sears chose not to appeal the case further.

GRANTS OF NEW POWERS TO STATE-CHARTERED BANKS: SECURITIES UNDERWRITING, INSURANCE ACTIVITIES, AND REAL ESTATE INVESTMENT

At present, many states are actively experimenting with granting banks the power to engage in activities previously forbidden to them, such as securities and insurance brokerage and underwriting, and real estate investment and development. Banks have

pushed for these new powers, arguing that allowing them to offer these new products and services will benefit everyone: consumers, who will enjoy reduced prices as a result of the increased competition; businesses, which will enjoy improved access to capital markets; state and local governments, which will likely pay lower interest rates on issues of municipal revenue bonds; banks, which will become more efficient and profitable through diversification and economies of scope; and the FDIC, which will face less exposure as banks become stronger.

As noted, the 1933 *Glass-Steagall Act* created a wall separating banking and securities activities. Sections 16 and 20 of the *Glass-Steagall Act* prohibit federally chartered and state-chartered member banks from purchasing, dealing in, or underwriting non-government securities for their own account (sec. 16) and from affiliating with any corporation engaged principally in the prohibited activities (sec. 20). Section 21 of the act forbids the *same entity* from both engaging in securities activities and receiving deposits. The *Glass-Steagall* prohibitions do not apply to two kinds of entities: state nonmember banks and securities firms that own nonbank banks.³⁸

The exemption for state nonmember banks was intentional; Congress did not believe that it had the constitutional authority to regulate state-chartered banks, a view that is discredited today.³⁹ Consequently, the securities activities of state nonmember banks are governed solely by state law and the FDIC. All state nonmember banks are subject to an FDIC rule that requires them to conduct securities activities in a "bona fide subsidiary."⁴⁰

The FDIC rule defines a bona fide subsidiary as one that is adequately capitalized and physically separate in its operation. It must maintain separate corporate records and have separate employees who are compensated by the subsidiary. The subsidiary must conduct business pursuant to independent policies and procedures, and obey certain "fire wall" provisions designed to prevent risky financial activities from endangering the traditional banking operations of making loans and receiving deposits.⁴¹ The rule limits the securities subsidiary's underwriting activities to investment quality debt and equity issues and mutual funds. The FDIC does not require state nonmember banks to form a bank holding company prior to engaging in securities activities.

Today, 23 states allow their state-chartered banks to engage in various securities activities.⁴² New York has taken the lead among the states in aggressively seeking new securities powers for its state banks. In December 1986, New York's Superintendent of Banks issued an interpretation of the state's mini *Glass-Steagall Act*. Like the federal law, the New York *Glass-Steagall Act* prohibits affiliations between a bank and a securities subsidiary that is "engaged

principally” in underwriting securities. According to the superintendent’s interpretation of the phrase “engaged principally,” a state bank can affiliate with a securities firm if the firm’s “impermissible” (i.e., forbidden under the state’s mini *Glass-Steagall Act*) securities underwriting activities constitute less than 25 percent of its total securities underwriting activities.⁴³

Recently, the New York superintendent has sought a limited repeal of the state’s mini *Glass-Steagall Act*. The proposed legislation would allow securities affiliates of state banks to underwrite and deal in mutual funds, municipal revenue bonds, investment grade corporate bonds, commercial paper, and asset-backed securities.⁴⁴ The proposal contains a number of “fire wall” restrictions. For example, a bank could contribute no more than 10 percent of its capital, through loans or investments, to a securities affiliate (the aggregate limit is 20 percent). Other restrictions would (1) require disclosures to customers that securities subsidiary obligations are neither insured by the FDIC nor backed by the parent bank, (2) forbid loans to customers for the purchase of securities from the bank subsidiary for the underwriting period and 30 days thereafter, and (3) prohibit the securities subsidiary from selling securities to the bank or its trust accounts during the above period.⁴⁵

States have also relaxed their prior prohibitions against engaging in insurance activities, such as acting as an insurance agent or broker or underwriting insurance policies. Thirteen states now allow banks to underwrite insurance and/or act as an insurance agent or broker.⁴⁶ Other state laws mirror the federal prohibitions against bank involvement in insurance.

According to the Garn-St.Germain *Depository Institutions Act* of 1982, insurance is not deemed a service “closely related to banking”; therefore, bank holding companies subject to the regulatory control of the board are banned from engaging in such activities. Exceptions to the general prohibition allow banks to sell general insurance in towns with populations of less than 5,000 and small bank holding companies (those with less than \$50 million in assets) to sell insurance anywhere. Also, under the act, banks can sell credit-life, accident and health, and involuntary unemployment insurance, as well as property insurance on collateral that secures loans of \$10,000.

Some states have long considered insurance to be a permissible activity for banks either without restrictions or with limited restrictions. For example, the North Carolina banking code never contained provisions forcing a separation between banking and commerce. The 54 state nonmember banks in North Carolina are free to invest in a variety of commercial businesses, including insurance underwriting and brokerage, subject to the approval of the bank commissioner. Approval is granted if the commissioner

finds that the activity is consistent with the continued safety and soundness of the bank (e.g., the bank has sufficient capital, earnings, and liquidity and is well managed). Once approval is received, the bank may conduct the approved activities within the bank or in a subsidiary, according to its business judgment. Presently, two banks are engaged in general insurance underwriting; one in the bank directly, the other in a bank subsidiary. Three banks act as general insurance brokers.⁴⁷

Indiana law has allowed banks to act as agents or brokers for property and casualty insurance since 1933. Indiana banks can choose to offer these services either directly in the bank or through a bank subsidiary.⁴⁸ Currently, about 50 nonmember banks act as insurance agents or brokers, and 15 of those sell insurance out of state.⁴⁹

Until recently, most state laws prohibited banks from investing in real estate. A typical state statute would limit a bank’s investment in real estate to that needed and used for its home office. Approximately 25 states have eased those restrictions and now permit state banks to invest in and develop real estate and/or act as a real estate broker, subject to certain limitations.⁵⁰ Virtually all of these states have imposed investment limitations on the real estate powers of their banks. For example, California law permits its banks to invest in, purchase, develop, manage, and sell real property, but limits that authority to (1) 10 percent of the bank’s assets if the activities are conducted in a bank subsidiary, or (2) the amount of the bank’s capital if the real estate activities are conducted in the bank directly.⁵¹

Some states tie the aggregate amount of funds that a bank may invest in real estate to the bank’s performance in meeting the community’s credit needs. For example, the state of Washington limits the total amount of funds that a bank may invest in real estate to 2 percent of its capital, surplus, and undivided profits. The percentage can be increased, however, if the bank has received a high score in meeting its community’s credit needs. Washington law lists several factors to be considered in assessing the bank’s record of performance, including: (1) the institution’s participation in governmentally insured or subsidized loan programs for housing, small businesses, or small farms; (2) the geographic distribution of the institution’s credit extensions, credit applications, and credit denials; (3) evidence of prohibited discriminatory or other illegal credit practices; and (4) the institution’s participation, including investments, in local community development projects. A bank that receives a community reinvestment score of “1” (excellent performance) can increase its aggregate investment in real estate to 10 percent; a score of “2” (good performance) enables a bank to increase its real estate investment to 8 percent, and so on.⁵²

ENDNOTES

- ¹ Peter D. Saba, "Regulation of State Nonmember Insured Banks' Securities Activities: A Model for the Repeal of *Glass-Steagall*," 23 *Harvard Journal of Legislation* (1986): 211, quoting Paul Volcker in "How the Financial System Can Best Be Shaped to Meet the Needs of the American People, Financial Deregulation: Hearings Before the House Committee on Banking, Finance and Urban Affairs, 98th Cong., 2d Sess. 1680 (1984).
- ² The 1956 *Bank Holding Company Act* (and the Douglas Amendment thereto) applied only to multibank holding companies. In 1970, the act was amended to bring one-bank holding companies under the supervision of the Federal Reserve Board and to subject them to the geographical restrictions of the Douglas Amendment.
- ³ See, for example, *Business Week*, January 4, 1964, p. 21; *Washington Post*, January 3, 1964, sec. A, p. 14, col. 1; *New York Herald Tribune*, March 23, 1965, p. 31, cols. 2-5; p. 32, col. 1.
- ⁴ Hearings Before the Subcommittee on Bank Supervision and Insurance of the House Committee on Banking and Currency and the House Committee on Banking and Currency on H.R. 107 and H.R. 6885 with Respect to the Consolidation of Bank Examining and Supervisory Functions (1965).
- ⁵ 12 U.S.C. sec. 372 (1964).
- ⁶ Hackley, "Our Baffling Banking System" 52 *Virginia Law Review* (1966): 599, 616.
- ⁷ *Wall Street Journal*, January 23, 1985, p. 1
- ⁸ 12 U.S.C. sec. 1842 (1982).
- ⁹ *Ibid.*, sec. 1843.
- ¹⁰ *Ibid.*, sec. 1846.
- ¹¹ Carter Golembe & H. Holland, "Expansion Possibilities for Nonmember Banks," *Banking Expansion Report*, 10, January 15, 1982; Saba, pp. 225-26.
- ¹² 50 *Federal Register*, p. 4522, n. 3 (1985) (emphasis in original).
- ¹³ *American Insurance Assoc. v. Clarke*, D.C. Civil No. 85-1489, decided August 23, 1988.
- ¹⁴ Federal Financial Institutions Examination Council, 1987 *Annual Report*.
- ¹⁵ *Ibid.* p. 4.
- ¹⁶ The FDIC has contributed significantly toward federal/state cooperation and coordination. For example, many states presently use examination report forms provided by that agency; in 1987, 474 state examiners attended training courses at the FDIC training center and an additional 120 participated in courses held at field locations; and the agency allows states direct access to its computer database.
- ¹⁷ Hackley, p. 15.
- ¹⁸ Hearings on the Operation of the National and Federal Reserve Banking System Before the Senate Committee on Banking and Currency, 72d Cong., 1st Sess., part II, p. 395 (1932), quoted in Scott, p. 1. For a list of quotes, see generally, Scott, *ibid.*
- ¹⁹ Some legal commentators have argued for unification at the federal level while retaining state regulation and supervision of state banks. See, e.g., J. L. Robertson, "Federal Regulation of Banking: A Plea for Unification" 31 *Law & Contemporary Problems* (1966): 673.
- ²⁰ W. Brown, *The Dual Banking System in the United States* (Washington, DC: American Bankers Association, 1968): pp. 59, 64.
- ²¹ National banks, too, have actively experimented with new powers. For example, beginning in 1961, Comptroller of the Currency James J. Saxon, issued a series of rulings in which he interpreted the *National Bank Act* to allow national banks to expand their powers in order to improve their competitive position. Comptroller Saxon authorized national banks to engage in the insurance, personal property leasing, and data processing businesses; to operate travel agencies; to engage in branch banking via courier services; and to engage in securities activities, such as revenue bond underwriting. Some of the Comptroller's rulings were struck down by the courts. See, Dunn, "Expansion of National Bank Powers: Regulatory and Judicial Precedent Under the *National Bank Act*, *Glass-Steagall Act*, and *Bank Holding Company Act*" 36 *Southwestern Law Journal* (1982): 765.
- ²² The U.S. Supreme Court has upheld the constitutionality of such laws. *Northeast Bancorp v. Board of Governors*, 472 U.S. 159 (1984).
- ²³ Twelve of the 28 regional reciprocal state laws have a trigger date to nationwide interstate banking. See Conference of State Bank Supervisors, *State of the State Banking System* (1988).
- ²⁴ As of mid-1987, the following states had such laws: District of Columbia, Illinois, Indiana, Maine, Maryland, Michigan, Minnesota, Nevada, New Hampshire, New York, Pennsylvania, Utah, Vermont, Washington, West Virginia, and Wyoming. See *Legislative Sourcebook on Financial Deregulation* (Washington, DC: National Center for Policy Alternatives, Public Capital Series, 1988), p. 113.
- ²⁵ *Ibid.* The states that have such requirements include Illinois, Maine, Minnesota, New Hampshire, and Vermont.
- ²⁶ The members of the group include Illinois, Indiana, Ohio, Wisconsin, and Minnesota.
- ²⁷ According to a representative of the Michigan Financial Institutions Bureau, the need for such cooperation became evident with the failure of Penn Square Bank. Penn Square, an Oklahoma bank, sold loan participations to larger banks in several states. Michigan National Bank was one of the purchasers of Penn Square loan participations, which it then distributed among several other Michigan banks in its holding company system, including several state-chartered banks. As the Penn Square loans began to go bad, the four regulators (the Federal Reserve Board, the Comptroller, the FDIC and State Supervisor) had little contact with each other even though all banks in the Michigan National Bank holding company system were affected. As a result, some inconsistency occurred in regulatory classification of the loans. The new policy of simultaneous examinations and information sharing would avoid such problems. Phone conversation with Don Mann, Director, Bank and Trust Division, Michigan Financial Institutions Bureau, April 21, 1988.
- ²⁸ *Ibid.*
- ²⁹ The southeastern regional reciprocal group includes: Georgia, Virginia, Maryland, North and South Carolina, Florida, Tennessee, Alabama, Kentucky, Mississippi, Washington DC, and Louisiana.
- ³⁰ Sixteen other states have passed similar legislation. See, Conference of State Bank Supervisors, *State of the State Banking System*.
- ³¹ Phone conversations with John Kline, Deputy Commissioner for Bank Supervision, Georgia, May 3, 1988, and with Sidney Bailey, Commissioner of Financial Institutions, Virginia, April 20, 1988.
- ³² Phone conversation with John Kline, May 3, 1988.

- ³³Phone conversation with Sidney Bailey, April 20, 1988.
- ³⁴Those states are Alaska, Arizona, California, Idaho, Montana, Nevada, New Mexico, Oregon, Texas, Utah, Washington, and Wyoming.
- ³⁵From documents provided by John R. Paulus, California Deputy Superintendent of Banks.
- ³⁶Report to the General Assembly of the State of Connecticut of the Findings and Recommendations of the Commission to Study Legislation to Limit the Conduct of Business in Connecticut by Subsidiaries of Banking Holding Companies and the Impact of NonDepository Institutions on Traditional Banking Activities, 5-7, 10-11 (January 5, 1983).
- ³⁷*Sears Roebuck and Co., v. Brown*, 806 F2d 399 (2nd Cir.1986).
- ³⁸A nonbank bank is an entity that either accepts deposits or engages in the business of making commercial loans, but not both. Formerly, such an entity was not a "bank" for purposes of the *BHCA*, which defined a bank as an entity that does both. Congress closed the nonbank bank loophole in the *Competitive Equality Banking Act* of 1987 (P.L. 100-86), by redefining a bank as an institution that is insured by the FDIC. About 170 nonbank banks established prior to March 5, 1982, are protected in part by the grandfather clause in the Act. Securities firms that are affiliated with a nonbank bank are not subject to the prohibitions of the *Glass-Steagall Act*. First, they do not come within section 21 because that section only bans a securities firm from directly taking deposits; it does not prohibit deposit taking if it is done through a subsidiary or affiliate. Second, the use of a nonbank bank allows the securities firm to avoid regulatory oversight by the board.
- ³⁹Saba.
- ⁴⁰12 *Code of Federal Regulations*, sec. 337.4(b)(1)(ii) (1985).
- ⁴¹For a complete list of the required provisions, see 12 *Code of Federal Regulations*, sec. 337.4(a)(2)(i)-(ix).
- ⁴²Fourteen states allow banks to engage in some securities underwriting and 17 allow securities brokerage. Some states allow both. See Conference of State Bank Supervisors, *State of the State Banking System*.
- ⁴³"NY Ruling to Pressure Congress," *American Banker*, January 2, 1987, p. 1.
- ⁴⁴"NY Regulator Prepares Draft Bill Allowing Banks in Securities," *American Banker*, March 10, 1988, p. 16.
- ⁴⁵*Ibid.*
- ⁴⁶Conference of State Bank Supervisors, *State of the State Banking System*. Three of these states allow insurance underwriting and 13 permit banks to own or operate an insurance agency.
- ⁴⁷Phone conversation with William Graham, North Carolina Commissioner of Banks, May 16, 1988.
- ⁴⁸Phone conversation with Jim Cooper, Administrative Assistant, Indiana Department of Financial Institutions, May 17, 1988.
- ⁴⁹Phone conversation with William King, President of the Indiana Bankers Association, May 17, 1988.
- ⁵⁰Conference of State Bank Supervisors, *State of the State Banking System*. Twenty-five states allow banks to engage in real estate development and six allow them to act as a real estate broker.
- ⁵¹As of December 31, 1987, the total investment of California state chartered banks in real estate development amounted to one-half percent of total state bank assets. Data supplied by John R. Paulus, California Deputy Superintendent of Banks.
- ⁵²*Washington Revenue Code Annotated*, sec. 30.60.010; 30.04.212 (1986). The Washington law is modeled after a 1984 New York law.

3

Federal Activity and Proposed Preemption

ISSUES OF PENDING LEGISLATION

Historically, the relaxation of regulatory restraints over bank activities at the state level has spurred similar changes at the federal level. This action/reaction regulatory response is central to the dual banking system. It continues today.

States began to remove their prior geographic barriers and restraints on bank products and services in the late 1970s. In the mid 1980s, congressional committee hearings and federal agency reports on expanded bank powers mushroomed, and culminated in proposed legislation and agency rules. The future shape of bank powers and bank regulation as sculpted by proposed federal legislation and regulations sharply curtails state control over banking.

The issue at the heart of the state/federal tension is the form in which banks shall be allowed to exercise their new powers. Bank regulators agree that the regulatory goals of safety and soundness dictate that certain securities activities, such as underwriting commercial paper, investment grade corporate bonds and asset-backed securities, which are subject to SEC requirements, should be conducted in an entity separate from the bank.¹ Most regulators would add insurance underwriting to the list of activities that should be physically separated from the bank.

As noted, the FDIC has issued a rule that requires state nonmember banks to conduct their securities activities in a bona fide bank subsidiary. Similar FDIC rules on insurance and real estate subsidiaries stalled when a turf dispute arose between the FDIC and the board.² The FDIC rules do not change the balance of power between state and federal regulation. As is the case now, (1) state law controls whether a state nonmember bank can engage in securities activities; (2) if the state bank engages in securities activities pursuant to state law, it can do so only in a separate bank subsidiary; and (3) two regulators, the FDIC and the appropriate state superintendent will supervise the bank, the board has no authority over either the bank or its securities subsidiary.³ The balance struck by Congress under the current scheme gives due regard for the rights of states and the interest of the federal government in the protection of the federal deposit insurance fund.

Under proposed federal legislation, however, the board would have the sole authority over the securities activities of banks. The 1988 Proxmire-Garn bill (S.1886) would substantially repeal the *Glass-Steagall Act*. Passed in the Senate by a vote of 94-2, S. 1886 permits banks to underwrite and sell a broad range of securities through affiliates owned by federally regulated bank holding companies. Like the proposed New York State law, S. 1886 contains fire wall limitations on loans and other interaffiliate transactions between banks and their securities affiliates to

prevent risky investment activities from endangering federally insured bank deposits.

Unlike the FDIC rule that requires state nonmember banks to house their securities activities in a separate subsidiary but allows states to permit or prohibit such activities in the first instance, the Proxmire-Garn bill would broadly preempt state control over the securities activities of state nonmember banks.

S.1886 entirely removes such state control and adds a third layer of regulation on state nonmember banks. Under the bill, all banks (national, state member, and state nonmember) can engage in securities activities only if (1) they do so through a bank holding company, (2) they receive approval from the Board to engage in such activities, (3) they become subject to the Board's regulatory and supervisory authority. Thus, states that have determined that certain securities activities are permissible for their banks, subject to certain restrictions, will no longer be allowed to sanction those activities. Conversely, other states that have found securities activities too risky for their banks will no longer be permitted to ban such activity. S. 1886 denies states the right to prohibit securities activities if they are conducted by a state bank that has received the Board's approval.

The usual justification that is offered for the broad preemption of state authority over nonmember banks is that the federal deposit insurance fund will be put at risk if a bank's securities activities are not conducted in an affiliate of a bank holding company, rather than in the bank directly or in a subsidiary of the bank.

This statement implies that (1) all securities activities are more risky than traditional bank activities, and (2) the insulation between banking and securities activities necessary to protect the federal deposit insurance fund can be accomplished only through the use of a bank holding company, rather than through a bank subsidiary.

Few regulators have agreed with the first point. Economists, too, make risk-based distinctions among various securities products. For example, one economist, Anthony Saunders, has measured the degree of risk between corporate bonds (which banks cannot underwrite because of the *Glass-Steagall Act* and which would be permitted by S. 1886 only in an affiliate of a bank holding company) and general obligation municipal bonds (which banks are allowed to underwrite directly within the bank).⁴ According to Saunders, the fluctuations in yields of corporate bonds were lower between January 1978 and March 1983 than were the fluctuations in yields of the general obligation municipal bonds.⁵ Robert Litan, in his recent book *What Should Banks Do?*, makes the point that:

. . . considered in isolation, underwriting securities involves less risk than extending and holding loans. In a typical securities offering, the underwriter bears the risk of loss for only a few days, whereas a commercial bank bears the risk of a loan default until the loan is repaid. In addition, by definition, the underwriter deals in assets that are liquid and readily traded; despite the progressive securitization of commercial bank balance sheets, most bank loans remain illiquid because they are specific to the borrower.⁶

The second point raises two subissues: how to control the potential conflicts of interest and cross-subsidization that may arise as a result of banks entering into securities activities, whether through a bank holding company affiliate or a bank subsidiary (the "fire wall" problem); and how to ensure that banks do not become legally liable for debts incurred by their securities activities whether conducted through a bank holding company affiliate or a bank subsidiary (the "piercing the corporate veil" problem).

S. 1886 contains numerous fire wall provisions that are designed to insulate a bank from the activities of its securities affiliate, including prohibitions against extending credit to its securities affiliate, purchasing for its own account the financial assets of a securities affiliate, and extending credit to an issuer of securities underwritten by the securities affiliate for the purpose of paying the principal of those securities or interest or dividends on those securities. Identical provisions can be put in place for banks and their securities subsidiaries.⁷ Indeed, in the insurance industry, such fire wall provisions between insurance companies and their subsidiaries have been in place for many years.⁸ As noted previously, the New York State bank superintendent has proposed similar fire wall provisions for state banks that engage in securities activities through subsidiaries.

By placing securities activities in a separate corporate entity, whether it be an affiliate of a bank holding company or a bank subsidiary, a bank can take advantage of the legal principle of limited liability. That principle holds that every corporation is a legal entity distinct and separate from its shareholders; accordingly, a bank would not be legally liable for the debts or actions of its subsidiary or affiliate.

Samuel Chase, an expert in the area of the application of the principle of limited liability to banks, has noted that unless banks ignore or abuse the principle, courts will not breach the separateness of the corpo-

rations.⁹ Typical abuses that may cause a court to “pierce the corporate veil” and hold a bank liable for the debts of its subsidiary or affiliate include: (1) misleading representations and actions (i.e., a bank represents that it stands behind a subsidiary or an affiliate and a third party relies on the representation to his detriment); (2) illegitimate activities or purposes; (3) failure to observe corporate distinctions; and (4) inadequate capitalization of the subsidiary or affiliate.¹⁰ In the above four circumstances in which a court may pierce the corporate veil, courts make no distinction between an affiliate and a subsidiary except in the fourth circumstance. It is less likely that a bank would be held liable for the debts of an undercapitalized securities affiliate than it would be for the debts of an undercapitalized subsidiary. Thus, the use of a undercapitalized subsidiary may create more risk of piercing the corporate veil than would the use of an undercapitalized affiliate.

There is some reason to believe that the use of a bank holding company affiliate under the current practice of the Board and the FDIC will weaken the legal insulation of banks from the losses and debts of their bank holding company securities affiliates. According to Chase, several current policies of federal regulators undermine the insulation between a bank and its affiliate. For example, the Federal Reserve Board’s prescription of capital adequacy standards for bank holding companies, which are nearly identical with those required for banks, sends an “unmistakable signal to the private markets that the government assumes an important measure of responsibility for the financial soundness of entire bank holding companies as opposed to banks.”¹¹ The board’s “source of strength” doctrine, by which the board requires a bank holding company to provide financial aid to its problem banks, “reinforces the impression that the Federal Reserve takes responsibility for assuring the financial strength of companies that own banks and nonbank subsidiaries of those companies.”¹²

Some commentators note that both managers and customers of bank holding company banks view such institutions as integrated entities.¹³ This fact has led at least one legal scholar to disagree with Chase’s legal analysis. Philip Blumberg has concluded that the “piercing” doctrine, which is based on a separate entity theory, is gradually being replaced by an “enterprise” approach. The latter approach requires an analysis of the underlying economic realities of the relationships between units in order to determine whether a common enterprise exists.¹⁴ A finding of the existence of a common enterprise would allow a court to treat the holding company and its affiliates as one entity without the need to pierce the corporate veil. Blumberg notes, however, that in the vast majority of cases, courts apply the separate entity theory.

Another scholar, Robert Litan, favors the holding company mechanism for reasons unrelated to legal theories. Litan cites three advantages of the holding company approach. First, the use of a holding company structure would end the disparity between the activities open to bank holding companies and those open to state banks. Second, the holding company organization would be more likely to prevent deposit insurance from subsidizing nonbanking activities;¹⁵ and third, the use of the holding company mechanism would vest agencies at the federal level with all responsibility for supervising the transactions and affiliations between nonbank and bank activities.¹⁶

After reviewing all possible structures that a bank or bank holding company could establish for its expanded activities, the U.S. General Accounting Office concluded that “one cannot say that one structure insulates the bank while another does not.”¹⁷ The GAO report also noted the disadvantages to banks associated with the use of a bank holding company structure, such as additional administrative cost, delays in obtaining regulatory approvals, loss of the benefits of product diversification and loss of economies of scope. The latter two disadvantages are particularly important because the advantages promised as a result of permitting banks to engage in securities activities were to come from product diversification and economies of scope.

In sum, while there is some evidence to support the case for all securities activities to be conducted in an affiliate of a bank holding company rather than in an independent bank subsidiary in order to protect the federal deposit insurance fund, that evidence is rebutted by the dominant legal theory of corporate separateness and by the Board’s own policies, such as its “source of strength” doctrine and capital adequacy guidelines for bank holding companies. Conversely, there is much evidence that the use of a bank holding company affiliate as the vehicle for expanded powers will decrease the promised benefits of the additional powers.¹⁸

The Proxmire-Garn proposal would also preempt state laws that govern the insurance activities of banks. S. 1886 prohibits all bank holding company banks and bank subsidiaries from providing insurance as principal, agent, or broker. The bill makes an exception for a state bank that is a member of a bank holding company. Such a bank or its subsidiary can sell insurance as an agent or broker if (1) the bank is located in the same state in which the operations of the bank holding company parent are principally conducted; (2) the activities are authorized by the state; and (3) the insurance is sold only to residents of that state or to companies headquartered in the state. The bill flatly prohibits national banks from engaging in most insurance activities. Thus, the pro-

posed law not only prevents state banks from competing in the large interstate insurance market but also creates a statutory imbalance in the powers permitted state banks and those granted to national banks.

As currently drafted, the Proxmire bill preempts state laws only with respect to the securities and insurance activities of banks, yet it may become a model for future federal regulation of all new bank activities. The Federal Reserve Board recognizes this fact. In testimony before the Senate Committee on Banking, Housing and Urban Affairs, Federal Reserve Chairman Greenspan noted that S. 1886 is "precedent setting because it establishes a framework that can be tested and, if it proves adequate as we expect it will, should serve as a foundation on which to build more generally for the future."

In fact, the Board has attempted to preempt state control over the real estate activities of state banks in much the same way that the Proxmire bill does with regard to securities. In January 1987, the Board published its proposed rules on the permissibility of real estate investment activities for bank holding companies. The Board's proposal would preempt state laws governing the real estate activities of state banks by prohibiting state banks that are members of bank holding companies from engaging in such activities through bank subsidiaries unless and until they meet the regulatory and supervisory limitations set by the Board. The Board's proposed real estate rule is still pending.¹⁹

As evidence of the need for greater federal control, proponents of federal preemption point to the growing crisis in the savings and loan industry. These advocates maintain that the problems in the thrift industry can be traced to state legislators and regulators who removed all prior restrictions on the investments of state-chartered thrifts, allowing them to speculate without restraint. The resulting failures and liquidations have cost the Federal Savings and Loan Insurance Corporation (FSLIC) billions of dollars and have left that fund bankrupt.

Financial institution analysts portray a more complex picture of what went wrong with the thrift industry, however. Most analysts agree that the industry's problems began more than a decade ago and that blame for its woes must be shared by Congress, federal and state regulators, and the industry itself. A recent story in the *New York Times* quoted in the Congressional Record summarizes the assignment of culpability as follows:

Federal regulators, who frequently bowed to political pressure from an industry known for its powerful grass-roots lobbying, have come under fire for deregulating the thrift industry piecemeal and

granting too much leeway in accounting practices. The [Federal Home Loan] Bank Board, the industry's primary regulator, is criticized for being too close to the thrift units it regulated, and for responding with inadequate resources and ill-trained examiners when the situation began to unravel.

And the industry . . . was unable to cope with the high interest rates that sprang from the late 1970s and spurred deregulation. Many executives lacked expertise to compete in the new world of finance. Several states—particularly Florida, Texas, and California, trying to protect the interests of their state-chartered savings and loans—passed their own . . . sweeping deregulatory provisions.

In 1984, [Congress] failed to support the Bank Board and the Federal Deposit Insurance Corporation in attempting to stop money brokers from placing large sums of insured deposits at risk-taking thrifts and banks.²⁰

The enormous losses that the thrift industry has borne and continues to bear are sobering. Few would argue, however, that state regulators are the primary culprits and that wholesale preemption of state laws is the cure.

CONCLUSION

The dual banking system has allowed states to carry out their historic mission as laboratories for experiments. Many of the regulatory tools and bank products in common use today were first introduced at the state bank level. States are continuing to perform this role today. State legislators and regulators are involved in a variety of activities from removing or relaxing prior bans on interstate banking and coordinating bank examinations with their counterparts across state lines and within the federal system, to designing systems under which banks can safely offer new products and services, to creating a legislative scheme under which banks and bank-like institutions and products compete on a level regulatory field.

When conducted with due regard for the safety and soundness of the banking system, these state experiments further the regulatory goals of enhancement of competition, avoidance of undue concentration, protection of consumers and depositors, and promotion of efficient credit allocation. The first two goals in particular will suffer if Congress and federal

regulators require that new bank products and services be conducted only under the umbrella of a bank holding company, since new bank products and services will be conducted primarily by the bigger bank holding companies.

Despite its continuing vitality, the dual banking system is fragile. Its survival depends on state legislators who will have to pass laws and appropriate funds to enable state banking departments to meet the challenge of an increasingly sophisticated industry, and on state bank supervisors, who will have to work together to meet the regulatory and supervisory challenges that the new powers bring.

Ultimately, however, without congressional restraint, the dual banking system will not survive. Pending congressional and federal regulatory proposals would broadly preempt state control over the new powers of banks, granting sole regulatory and supervisory control over such powers to the Federal Reserve Board. State banks could avoid such control only by refraining from engaging in new activities or from offering new products, an action that may in itself drain the vitality from the dual banking system and hasten its demise.

ENDNOTES

¹Some state regulators believe that banks should be allowed to conduct certain securities powers directly. Included among the securities powers deemed permissible activities by a bank are: underwriting U.S. Treasury obligations, state and local general obligation bonds, municipal revenue bonds, and mutual funds registered with the SEC. Statement of Jill M. Considine, New York State Superintendent of Banks, before the New York State Senate Banks Committee, March 8, 1988.

²In December 1987, the FDIC rule on insurance and real estate was formally withdrawn, based on the amount of time that had elapsed since the proposal was published for comment and the lack of substantial evidence regarding the degree of risk to the insurance fund. The staff is currently reevaluating the issue. Information provided by Robert F. Mjailovich, Associate Director, Division of Bank Supervision, FDIC.

³As noted previously, a dispute currently exists as to whether a securities, real estate, or insurance subsidiary of a state nonmember bank that belongs to a bank holding company is subject to further regulation by the Federal Reserve Board. The board has attempted to assert its power over such activities by refusing to approve bank holding company acquisitions of banks that engage in

such activities either directly or through a subsidiary. According to the board, banks that are members of a bank holding company cannot engage in securities underwriting, real estate, and/or insurance because they are impermissible activities under the *BHCA*.

⁴Anthony Saunders, "Bank Safety and Soundness and the Risks of Corporate Securities Activities," in Ingo Walter, ed., *Deregulating Wall Street* (New York: John Wiley and Sons).

⁵*Ibid.*, p. 174.

⁶Litan, p. 89.

⁷Firewalls can also be put in place to insulate traditional bank activities from securities activities conducted within the bank itself. For example, life insurance companies have for years maintained separate accounts for certain customers that cannot be commingled with their general assets. See "Corporate Separateness as a Tool of Bank Regulation," Samuel Chase & Company. Study prepared for the Economic Advisory Committee of the American Bankers Association (1983), p. 22.

⁸Samuel Chase and D. Waage, "Corporate Separateness as a Tool of Bank Regulation," prepared for the Economic Advisory Committee of the American Bankers Association (1983), p. 26.

⁹*Ibid.*, pp. 9-12. Samuel Chase, "Insulating Banks from Risks Run by Nonbank Affiliates," prepared for the American Bankers Association (1987), pp. 12-15.

¹⁰*Ibid.*

¹¹*Ibid.*, p. 30.

¹²*Ibid.*, p. 31.

¹³Litan, p. 104.

¹⁴Blumberg, *The Law of Corporate Groups* (1985).

¹⁵Litan recognizes, however, that the holding company mechanism will not necessarily prevent banks from assisting their nonbanking affiliates if the affiliates face financial trouble, and that even in a holding company system banks can induce their parent holding companies to assume risks in diversifying their activities. Litan, pp. 146, 104.

¹⁶*Ibid.*, pp. 147-48.

¹⁷U.S. General Accounting Office, *Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities*, (Washington DC: U.S. General Accounting Office, 1987).

¹⁸See, e.g., Litan, p. 147, and GAO, *Bank Powers*.

¹⁹See "Regulations Regarding Real Estate Investment and Development Activities of Subsidiaries of Holding Company Banks" 52 *Federal Register* 213, November 4, 1987, p. 42301.

²⁰Nathaniel Nash, "The Industry Owes Its Troubles to Congress, Regulators—and Itself," *New York Times*, June 12, 1988.



What is ACIR?

The Advisory Commission on Intergovernmental Relations (ACIR) was created by the Congress in 1959 to monitor the operation of the American federal system and to recommend improvements. ACIR is a permanent national bipartisan body representing the executive and legislative branches of Federal, state, and local government and the public.

The Commission is composed of 26 members—nine representing the federal government, 14 representing state and local government, and three representing the public. The President appoints 20—three private citizens and three federal executive officials directly and four governors, three state legislators, four mayors, and three elected county officials from slates nominated by the National Governors' Association, the National Conference of State Legislatures, the National League of Cities/U.S. Conference of Mayors, and the National Association of Counties. The three Senators are chosen by the President of the Senate and the three Representatives by the Speaker of the House of Representatives.

Each Commission member serves a two-year term and may be reappointed.

As a continuing body, the Commission addresses specific issues and problems, the resolution of which would produce improved cooperation among the levels of government and more effective functioning of the federal system. In addition to dealing with important functional and policy relationships among the various governments, the Commission extensively studies critical governmental finance issues. One of the long-range efforts of the Commission has been to seek ways to improve federal, state, and local governmental practices and policies to achieve equitable allocation of resources and increased efficiency and equity.

In selecting items for the research program, the Commission considers the relative importance and urgency of the problem, its manageability from the point of view of finances and staff available to ACIR, and the extent to which the Commission can make a fruitful contribution toward the solution of the problem.

After selecting specific intergovernmental issues for investigation, ACIR follows a multistep procedure that assures review and comment by representatives of all points of view, all affected levels of government, technical experts, and interested groups. The Commission then debates each issue and formulates its policy position. Commission findings and recommendations are published and draft bills and executive orders developed to assist in implementing ACIR policy recommendations.

**Recent Publications
of the
Advisory Commission on
Intergovernmental Relations**

State Constitutional Law: Cases and Materials, M-159, 9/88, 480 pp.	\$25.00
Changing Public Attitudes on Governments and Taxes: 1988, S-17, 9/88, 88 pp.	\$10.00
Local Revenue Diversification: Local Income Taxes, SR-10, 8/88, 52 pp.	\$5.00
Metropolitan Organization: The St. Louis Case, M-158, 9/88, 176 pp.	\$10.00
Significant Features of Fiscal Federalism, 1988 Edition	
Vol I, M-155, 12/87, 128 pp.	\$10.00
Vol II, M-155 II, 9/88, 152 pp.	\$10.00
Both Volumes Purchased Together	\$15.00
Interjurisdictional Competition in the Federal System: A Roundtable Discussion, M-157, 8/88, 32 pp.	\$5.00
State-Local Highway Consultation and Cooperation: The Perspective of State Legislators, SR-9, 5/88, 54 pp.	\$5.00
The 1986 Federal Tax Reform Act: Its Effect on Both Federal and State Personal Income Tax Liabilities, SR-8, 1/88, 38 pp.	\$5.00
Governments at Risk: Liability Insurance and Tort Reform, SR-7, 12/87, 42 pp.	\$5.00
The Organization of Local Public Economies, A-109, 12/87, 64 pp.	\$5.00
Measuring State Fiscal Capacity, 1987 Edition, M-156, 12/87, 152 pp.	\$10.00
Is Constitutional Reform Necessary to Reinvigorate Federalism? A Roundtable Discussion, M-154, 11/87, 39 pp.	\$5.00
Local Revenue Diversification: User Charges, SR-6, 10/87, 64 pp.	\$5.00
The Transformation in American Politics: Implications for Federalism, B-9R, 10/87, 88 pp.	\$5.00
Devolving Selected Federal-Aid Highway Programs and Revenue Bases: A Critical Appraisal, A-108, 9/87, 56 pp.	\$10.00
Estimates of Revenue Potential from State Taxation of Out-of-State Mail Order Sales, SR-5, 9/87, 10 pp.	\$3.00
A Catalog of Federal Grant-in-Aid Programs to State and Local Governments: Grants Funded FY 1987, M-153, 8/87, 36 pp.	\$10.00
Fiscal Discipline in the Federal System: National Reform and the Experience of the States, A-107, 8/87, 58 pp.	\$10.00
Federalism and the Constitution: A Symposium on Garcia, M-152, 7/87, 88 pp.	\$10.00
Local Perspectives on State-Local Highway Consultation and Cooperation, SR-4, 7/87, 48 pp.	\$5.00

The reports of the Advisory Commission on Intergovernmental Relations are released in five series: the "A" series denotes reports containing Commission recommendations; the "M" series contains Commission information reports; the "S" series identifies reports based on public opinion surveys; the "B" series reports are abbreviated summaries of full reports; and the "SR" series are staff information reports. Reports may be obtained from ACIR, 1111-20th Street, NW, Washington, DC 20575.