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The Merger of Banking and Insurance: Will Congress Close the South Dakota Loophole?

In recent years, banks have attempted to diversify their financial services. Such bank product expansion efforts have encountered historical and legislative barriers separating banking and commerce. The current desire of banks to enter the insurance market illustrates the tension between bank service diversification and traditional restraints on banking activity. Although federal legislation since the Great Depression has averted a merger of the banking and insurance industries, Congress recently has been inactive in this area. Capitalizing on Congress’ inaction, South Dakota enacted legislation in March 1983, authorizing South Dakota chartered banks to engage in “all facets of the insurance industry.” In effect, the South Dakota legislation would allow bank holding companies to circumvent federal banking law, which specifically restricts the insurance activities of all bank holding companies. On January 5, 1984, however, the Federal Reserve Board


4 114 Cong. Rec. S11,147 (daily ed. Sept. 13, 1984) (statement of Senator Pressler); Langley, FDIC Proposes to Let 14,700 Banks Enter Securities and Other Businesses Via Units, Wall St. J., Nov. 27, 1984, at 3, col. 2 (noting that proposed FDIC rules would permit state chartered banks to “enter the insurance, real estate, data-processing, securities and travel agency businesses”).

5 Banks may be chartered by either a state or the federal government. Federally chartered banks must be members of the Federal Reserve System, and they are insured by the Federal Deposit Insurance Corporation. State chartered banks may join the Federal Reserve System; those that do must obtain federal deposit insurance. State chartered banks that are not members of the Federal Reserve System, however, may also purchase federal deposit insurance. Scott, The Dual Banking System: A Model of Competition in Regulation, 30 STAN. L. REV. 1, 3 (1977).


"Board") refused to approve proposed acquisitions of South Dakota banks by several bank holding companies under this legislation.\textsuperscript{8} Instead, the Board suspended the processing of the applications, awaiting a response from Congress.\textsuperscript{9}

Senate Bill 2851 ("S. 2851"), proposing the Financial Services Competitive Equity Act,\textsuperscript{10} passed by the Senate on September 13, 1984, purported to close the so-called "South Dakota loophole."\textsuperscript{11} Specifically, S. 2851 would prohibit, except in certain specified instances, a bank holding company or any subsidiary or affiliate thereof from providing insurance as a principal, agent, or broker.\textsuperscript{12} Although S. 2851 passed the Senate, it died in conference with the House of Representatives at the close of the 98th Congress.\textsuperscript{13} On November 26, 1984, in response to Congress' inaction, the Federal Deposit Insurance Corporation ("FDIC") announced proposed rules which, if approved, would sanction the South Dakota legislation by permitting state chartered banks to engage in any insurance activity authorized by the chartering state.\textsuperscript{14}

This note addresses the question of bank expansion into the insurance industry and concludes that the merger of the banking and insurance industries would be undesirable. Part I reviews the historical and legislative background surrounding bank product expansion, depicting a tradition of separating banking and commerce. Part II discusses the 1983 South Dakota banking legislation as a paradigm of the challenge to federal banking law mounted by the states.\textsuperscript{15} Finally, Part III reviews S. 2851, the Senate's response to the proposed entry of banks into the national insurance market through the acquisition of state chartered banks and the implica-

\textsuperscript{8} Fed. Res. Bull. 19 (1984). Citicorp was the first bank holding company to take advantage of the South Dakota banking law. In July 1983, the South Dakota Banking Commission approved Citicorp's bid to acquire at least 80% of the voting shares of the American State Bank of Rapid City, South Dakota. Bank America Corporation and First Interstate Bancorp followed Citicorp, each attempting to acquire a South Dakota chartered bank by September 1983. Note, supra note 7, at 175 n.36.


\textsuperscript{10} 114 CONG. REC. S11,162 (daily ed. Sept. 13, 1984).

\textsuperscript{11} 114 CONG. REC. S11,146 (daily ed. Sept. 13, 1984). The South Dakota loophole refers to the assertion that the Garn-St. Germain Act's insurance restrictions do not affect a bank holding company's state chartered banking subsidiary. See note 64 infra.


\textsuperscript{13} Any bill that does not pass both houses before the close of that Congress' second session is discarded. In other words, "[t]he life of a bill is the life of a Congress." W. Keefe, The American Legislative Process, Congress and the States 51 (6th ed. 1985).

\textsuperscript{14} See note 4 supra.

\textsuperscript{15} Delaware, Indiana, Iowa, Minnesota and Wisconsin have also considered legislation expanding the insurance authority of state chartered banks. Wilson, Separation Between Banking and Commerce Under the Bank Holding Company Act—A Statutory Objective Under Attack, 33 Cath. U.L. Rev. 163, 165 n.8 (1983).
tions of Congress' failure to enact S. 2851, the Financial Services Competitive Equity Act.

I. Historical and Legislative Background

The history of American banking is a pattern of legislative and economic upheavals generally precipitated by military conflicts and the industry's desire to capitalize on investment opportunities by circumventing current banking legislation. Before the Civil War, the American banking system followed the English system which separated commercial banking from investment or speculative banking. Investment banking was considered too risky for an institution entrusted with the public's money. The post-Civil War period presented banks with investment opportunities that challenged the previously accepted dichotomy between commercial banking and investment banking. The banking industry's response was the trust company, a creature of state corporate law, and therefore largely immune from restrictive federal and state banking laws. By the turn of the century, the trust company had merged commercial and investment banking, accepting demand deposits from the general public while promoting and selling securities for corporate customers.

World War I contributed to the merger of commercial and investment banking by introducing the banking industry to the government bond market. Banks encouraged the purchase of government bonds through generous repayment plans, and distributed the bonds to investors. After the war, drawing on their experience in the government bond market, some commercial banks entered the investment banking field. This shift away from the separation of commercial and investment banking accelerated during the 1920's, although commercial banks still comprised only a

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17 Id.
18 Id. at 487.
19 Id. at 488. Although the trust company solicited deposits from the public, it was generally considered beyond the reach of federal banking statutes, particularly the National Bank Act. Id. at 488.
20 Id. at 488. State and federally chartered banks pressured lawmakers for the freedom to compete with trust companies. State legislatures responded by providing state chartered banks with broader investment banking privileges. Congress, however, remained silent, placing federal banks at a competitive disadvantage. Id. at 488-89. Federal banks reacted by creating subsidiaries, incorporated under state law, which were free to compete in the investment banking field. One method federal banks used to establish a subsidiary was to create a holding company, which owned both the parent bank and the investment banking affiliate. Thus, the bank holding company concept arose at the turn of the century to facilitate bank service diversification. Id. at 489 n.18.
21 Id. at 491.
22 Id.
small share of the investment banking market.\textsuperscript{23} Then, in 1927, Congress passed the McFadden Act which expressly permitted national banks to enter investment banking,\textsuperscript{24} and commercial banks nearly doubled their participation in new bond issuances.\textsuperscript{25}

The stock market crash of 1929, however, caused a chain of bank failures, and commercial banks' investment affiliates proved a prime target for proponents of bank reform.\textsuperscript{26} Denouncing the abandonment of financially sound and stable banking for "excessive marginal speculation" and "stock gambling," Senator Carter Glass led the movement for comprehensive bank reform.\textsuperscript{27} His efforts culminated in the Banking Act of 1933\textsuperscript{28} ("the Glass-Steagall Act"), which mandated a return to the total separation of commercial banking and investment banking.\textsuperscript{29}

This return to the traditional functions of commercial banking occurred during the midst of the Depression. Confronted with fierce competition in a tight commercial loan market, national banks tried to maximize profit opportunities through diversification, while at the same time avoiding the Glass-Steagall Act's restrictions. The industry turned to the bank holding company.\textsuperscript{30} By carefully structuring the bank holding company to prevent its ownership of a Federal Reserve member bank and its ability to vote a member bank's shares, the holding company remained outside the scope of the Glass-Steagall Act.\textsuperscript{31}

\textsuperscript{23} Id. at 495.
\textsuperscript{25} Perkins, supra note 16, at 495.
\textsuperscript{26} The highly publicized failure of the Bank of the United States in 1930 introduced unwary depositors to the abuses of speculative banking practices. The New York bank's president, Bernard Marcus, misappropriated a substantial amount of the bank's funds, which he personally invested through the bank's investment affiliates. When the bank closed its doors, its obligations included over $200 million in deposits. Id. at 497.
\textsuperscript{27} Id. at 499.
\textsuperscript{28} Banking Act of 1933 (Glass-Steagall Act), ch. 89, § 1, 48 Stat. 162, (codified at 12 U.S.C. § 227 (1982)).
\textsuperscript{29} The Act provides that "no member bank shall be affiliated with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale or distribution . . . of stocks, bonds, debentures, notes, or other securities." 12 U.S.C. § 377 (1982).
\textsuperscript{31} The Glass-Steagall Act placed the bank holding company within the Federal Reserve Board's jurisdiction only if at least one bank in the holding company was a member of the Federal Reserve system and the holding company attempted to vote its stock in the member bank. Banking Act of 1933 (Glass-Steagall Act), ch. 89, § 19, 48 Stat. 186, amended by 12 U.S.C. § 61 (1982). Bank holding companies not regulated by the Federal Reserve Board were free to engage in nonbanking activities forbidden to federal banks. Chase, supra note 30, at 1230.
Such bank holding companies flourished from 1933 to 1956.\textsuperscript{32} This growth, and the corresponding combination of banking and nonbanking activities, concerned members of Congress.\textsuperscript{33} In 1956, Congress passed the Bank Holding Company Act of 1956, requiring all bank holding companies to divest their nonbanking subsidiaries within two years.\textsuperscript{34} Significantly, however, the Act specifically excepted from the divestiture requirement the "shares of any company all the activities of which are of a financial, fiduciary or insurance nature" which the Federal Reserve Board has "determined to be so closely related to the business of banking . . . as to be a proper incident thereto."\textsuperscript{35} Pursuant to this exception, the Federal Reserve Board permitted certain bank holding companies to engage in the sale of property, casualty insurance, and life insurance. But underwriting insurance was still prohibited.\textsuperscript{36}

In 1970, Congress amended the Bank Holding Company Act, changing the standard which had previously guided the Board's decisions regarding a bank holding company's insurance activities.\textsuperscript{37} Specifically, Congress added to the "so closely related to . . . bank-

\begin{itemize}
\item \textsuperscript{32} From 1933 to 1956, the number of independent banks decreased by approximately 5,000. Chase, \textit{supra} note 30, at 1231.
\item \textsuperscript{33} Even a bank holding company subject to Federal Reserve Board regulation under the Glass-Steagall Act was free to combine banking activities with nonbanking activities other than investment banking. \textit{Id.} at 1229 n.16. In June 1955, the House Committee on Banking and Currency reported:

\begin{quote}
One of the regulated bank holding companies which owns more than 50 percent of the capital stocks of banks with total deposits of slightly over $2 billion . . . owns all of the capital stock of a life insurance company . . . with over $5 billion of life insurance in force . . . in 47 states, 7 Canadian provinces, Hawaii and Alaska and the District of Columbia. In addition, the holding company owned from 92.5 to 100 percent of the capital stock of four fire and casualty insurance companies which write practically all forms of insurance other than life.
\end{quote}


\begin{enumerate}
\item Multistate bank holding companies were not responsive to the needs of the public;
\item Bank holding companies were subject to a conflict of interest in executing their banking and nonbanking functions;
\item Bank holding companies tended to diminish or eliminate competition;
\item Bank holding companies were a means of evading federal and state laws.
\end{enumerate}

\item \textsuperscript{37} Bank Holding Company Act Amendments of 1970, 12 U.S.C. \S 1841 (1982).
\end{itemize}
element a requirement that the proposed insurance activity be reasonably expected to produce benefits to the public (greater convenience, increased competition, or efficiency gains) that would outweigh possible adverse effects (undue concentrations of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices).  

During the 1970's, the Board's broad interpretations of the "closely related/public benefits" test were challenged in court.

38 See text accompanying note 35 supra.

39 12 U.S.C. § 1843(c)(8) (1982). Although this conjunctive amendment appeared to further restrict bank holding company acquisitions, the legislative history and subsequent Federal Reserve Board decisions proved the contrary. The legislative history supporting the 1970 "public benefits" amendment to the Act reveals a distinct disagreement between the House and Senate. Representative Wright Patman, Chairman of the House Conferees for the bill, stated that the public benefits test was accepted by the conferees in lieu of a more expansive "functionally related" test. The rejection of the functionally related test, according to Representative Patman, demonstrated "that the Congress was not convinced that such expansion and liberalization was justified." 116 Cong. Rec. 41,950 (1970). Specifically, Representative Patman noted that the bill defined permissible bank holding company acquisitions "in [such] a way that insurance companies or insurance agents cannot be made a part of a bank holding company." Id. at 41,952.

On the other hand, Senator Sparkman, the Senate's leading conferee, stated that the addition of the public benefits test "provides that permissible activities may be related to the business of banking generally, rather than perpetuating the concept that such activities must be related to the specific business carried on by the subsidiary banks of the particular holding company." Id. at 42,424. Significantly, both Senators Sparkman and Bennett, in response to a question from the Senate floor quoting Representative Patman's above-cited remarks (concerning insurance activities of bank holding companies), explicitly stated that they disagreed with Representative Patman's interpretation of the conference committee's intent. Id. at 42,429. Senator Bennett added that the Federal Reserve Board had approved the insurance activities of bank holding companies for 14 years, "and there was no intent on the part of the conference committee to overrule these past discussions." Id.

Not surprisingly, the Federal Reserve Board agreed with the Senate's interpretation of the 1970 amendments. In 1971, the Federal Reserve Board's Regulation Y provided that "acting as insurance agent or broker in offices at which the holding company or its subsidiaries are otherwise engaged in business" was closely related to banking as long as the insurance sold was directly related to the extension of credit or the provision of other financial services by the bank holding company or its subsidiary. 36 Fed. Reg. 15,525 (1971) (codified as amended at 12 C.F.R. § 225.128 (1984)). In 1971, the Board sanctioned the underwriting of "credit life insurance and credit accident and health insurance that is directly related to extensions of credit by the bank holding company system." 37 Fed. Reg. 28,046 (1972) (codified at 12 C.F.R. § 225.135 (1984)).

40 In Alabama Ass'n of Ins. Agents v. Board of Governors, 533 F.2d 224 (5th Cir. 1976), aff'd on rehearing, 558 F.2d 729 (5th Cir. 1977), cert. denied, 435 U.S. 904 (1978), the court upheld the provision of property damage and liability insurance in connection with the traditional banking functions of extending credit and providing other financial services by either a bank or nonbank subsidiary of a bank holding company. But in Florida Ass'n of Ins. Agents v. Board of Governors, 591 F.2d 334 (5th Cir. 1979), the court reversed a Federal Reserve Board order allowing three bank holding companies to sell insurance in Florida because the Board had ignored "the applicability and effect of state law inasmuch as it bears upon the public interest determination required by the Act." Id. at 342. See also Independent Ins. Agents v. Board of Governors, 658 F.2d 571 (8th Cir.), reh'g denied, 664 F.2d 177 (8th Cir. 1981); NCNB Corp. v. Board of Governors, 599 F.2d 609 (4th Cir. 1979).
Although the courts occasionally modified the Board’s pronouncements concerning insurance activities of bank holding companies under this test, the decisional law did not clarify the scope of permissible activities.

In October 1982, the Garn-St. Germain Depository Institutions Act (“Garn-St. Germain Act”), expressly prohibiting bank holding companies from conducting most insurance activities, was enacted. Specifically, the Garn-St. Germain Act provided that “it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent or broker.” Thus, as before, Congress sought to separate banking from other forms of commerce, in this case the underwriting or sale of insurance. Although the Garn-St. Germain Act’s insurance restrictions clearly extended to federally chartered banks, some doubt existed as to whether the Act’s restrictions covered state chartered bank holding company subsidiaries. In March 1983, capitalizing on this uncertainty, South Dakota enacted legislation expressly permitting its banks to engage in the insurance business.

41 Wilson, supra note 15, at 168.
44 Id. The Garn-St. Germain Act excluded from this general prohibition the following:
   1. The provision by a bank holding company of credit life, disability and involuntary unemployment insurance as underwriter or agent;
   2. The provision by a bank holding company’s finance subsidiaries of credit property insurance on loans not greater than $10,000 ($25,000 if the loan is secured by a residential manufactured home);
   3. The provision by a bank holding company of insurance agency services in places where the population does not exceed 5,000 or where the bank holding company demonstrates a lack of adequate insurance agency facilities;
   4. Insurance agency activities conducted or approved by the Federal Reserve Board on or before May 1, 1982;
   5. The supervision by a bank holding company of agents who sell fidelity, property and casualty, and group employee insurance to the bank holding company;
   6. The provision by a bank holding company with total assets not exceeding $50 million of any insurance agency services, subject to the limitation of 1, 2 and 3 above;
   7. Any insurance agency activities undertaken by a bank holding company before January 1, 1971.

46 As one commentator noted, “[o]ver time, the policy of separation has ebbed and flowed. But it has been reaffirmed periodically on several occasions in the 20th century.” Shull, The Separation of Banking and Commerce: Origin, Development and Implications for Antitrust, 28 ANTITRUST BULL. 255, 271 (1983).
47 Note, Avoiding Glass-Steagall, supra note 1, at 105; See notes 48-66 infra and accompanying text.
II. South Dakota's Response to the Garn-St. Germain Act

Less than six months after the enactment of the Garn-St. Germain Act, South Dakota amended its banking statutes. An effort to create jobs and attract new business to South Dakota, the new legislation permits a South Dakota bank, "directly or through subsidiaries, to engage in all facets of the insurance business." Further, the new law allows bank holding companies not presently conducting banking business in South Dakota to acquire or establish a South Dakota bank. The intended effect of the legislation is to permit any bank holding company to avoid the Garn-St. Germain Act's insurance restrictions by acquiring a South Dakota chartered banking subsidiary. The bank holding company could then market any insurance product nationwide.

The South Dakota legislation is controversial. Proponents of the South Dakota legislation, contending that the restrictions on insurance activity imposed by the Garn-St. Germain Act do not extend to the state chartered banking subsidiaries of a bank holding company, base their contention primarily upon two grounds. First, they note that the restrictive language of section 4(a)(2) of the Bank Holding Company Act does not refer to a bank holding company's banking subsidiaries, but rather includes only the bank holding company itself and its nonbanking subsidiaries. Therefore, they argue that according to ordinary principles of statutory construction, Congress must have intended to exclude the bank holding company's banking subsidiaries from the scope of the Act.

On the other hand, opponents of the South Dakota legislation...
maintain that "bank holding company" as used in the Bank Holding Company Act, refers to both the banking and nonbanking components of the entity. Moreover, critics of the South Dakota legislation contend that if a bank holding company acquires a state chartered bank which owns an insurance company, the bank holding company would have control of a company that is not a bank. This, they argue, is a direct violation of section 4(a)(1) of the Bank Holding Company Act, which provides that "no bank holding company shall . . . acquire direct or indirect ownership or control of any . . . company which is not a bank."

Proponents of the South Dakota banking legislation also cite Federal Reserve Board Regulation Y, section 225.4(e)(2), which states:

So far as federal law is concerned, a state chartered bank or a subsidiary thereof may . . . acquire or retain all . . . of the shares of a company that engages solely in activities in which the parent bank may engage, at locations in which the bank may engage in the activity, and subject to the same limitations as if the bank were engaging in the activity directly.

Advocates of the South Dakota legislation contend that this language indicates that state law, not federal law, determines the scope of activities available to state chartered banks. Thus, section 225.4(e)(2) supports the proposition that a state chartered bank may undertake nonbanking activity subject only to the limitations of the chartering state's banking law.

54 Wilson, supra note 15, at 176. During Senate debate of S. 2851, Senator Mitchell remarked:

This much I say unequivocally: At no time during the drafting, explanation, or discussion of [title VI of the Garn-St. Germain Act] was there any suggestion that the language now contained in title VI was intended not to apply to the subsidiaries of bank holding companies. It was and is intended to apply to bank holding companies and their subsidiaries.


55 Id.


57 12 C.F.R. § 225.4(e) (1983). After the enactment of the South Dakota banking legislation, the Federal Reserve Board modified § 225.4(e)(2). In 1984, the Board promulgated § 225.22(d)(2), which replaces § 225.4(e)(2). Section 225.22(d)(2) provides:

A state chartered bank or its subsidiary may, insofar as federal law is concerned and without the Board's prior approval . . . acquire or retain all . . . of the securities of a company that engages solely in activities in which the parent bank may engage, at locations at which the bank may engage in the activity, and subject to the same limitations as if the bank were engaging in the activity directly.

12 C.F.R. § 225.22(d)(2) (1984) (emphasis added). Section 225.22(d)(2) is not less supportive of South Dakota's banking legislation than its predecessor, § 225.4(e)(2). To the contrary, the added language "without the Board's prior approval" appears more favorable to the South Dakota banking law, because it reinforces the fact that state chartered banks are, to a large extent, beyond the reach of federal regulators.

58 Wilson, supra note 15, at 178-79.
This interpretation of section 225.4(e)(2), however, has been criticized as conferring more freedom on bank holding companies than Congress intended.\(^5\) Section 4(c)(5) of the Bank Holding Company Act, the statutory underpinning for the Board's section 225.4(e)(2), permits a bank holding company to acquire any "shares which are of the kinds and amounts eligible for investment by national banking associations under the provisions of section 24 of this title."\(^6\) But section 24\(^6\) has not been construed to allow national banks to engage in all facets of the insurance industry. Rather, courts have limited section 24's application to banks acting as agents, or underwriting credit life and credit disability insurance.\(^6\) Moreover, when the Board issued section 225.4(e) in 1971, it indicated that its decision to exclude state chartered banks from the nonbanking restrictions of the Bank Holding Company Act was influenced by the "absence of evidence that acquisitions by holding company banks are resulting in evasions of the purposes of the Act."\(^6\) Presumably if a bank holding company acquired a South Dakota bank solely to circumvent federal banking restrictions, the Board would reexamine this regulation.\(^6\)

Congress could not have intended to restrict the insurance activities of a bank holding company and its nonbanking subsidiaries and at the same time permit the states to define the insurance opportunities available to the same bank holding company's state chartered subsidiary. Such an interpretation of congressional in-

\(^5\) Id.
\(^6\) Wilson, supra note 15, at 178 n.69 (citing Independent Bankers Ass'n v. Heimann, 613 F.2d 1164 (D.C. Cir.), cert. denied, 449 U.S. 823 (1980)).
\(^6\) Testifying before the Senate Banking Committee, Federal Reserve Board Chairman Volcker remarked:

The Federal Reserve in administering the Bank Holding Company Act, has for years maintained a policy of permitting state chartered bank affiliates of bank holding companies to engage in any activity such a bank is permitted to engage in under its state charter. This policy has been premised upon the view that a certain degree of experimentation and difference in approach among the states is a legitimate and desirable aspect of our dual banking system, and that differences in powers allowed by states would be acceptable to the extent they would not dominate established congressional policy. In view of current developments, I believe that policy should be reviewed to consider whether the result is to undercut the federal standards set forth in the Bank Holding Company Act, particularly when the wider powers might clearly be exercised largely beyond the borders of the state providing the authority.

tent fails to recognize that the bank holding company, together with its banking and nonbanking affiliates, is a single enterprise, existing pursuant to federal banking law.\textsuperscript{65} Notwithstanding the debate over the legality of the South Dakota banking legislation, however, the South Dakota law challenged the federal government’s domain over the bank holding company. In response, the Senate passed S. 2851, the Financial Services Competitive Equity Act.\textsuperscript{66}

III. S. 2851—The Financial Services Competitive Equity Act

On September 13, 1984, the Senate passed S. 2851, the Financial Services Competitive Equity Act, which purported to close the “South Dakota loophole” by explicitly extending the Garn-St. Germain Act’s insurance restrictions to all state chartered bank holding company subsidiaries.\textsuperscript{67} S. 2851 was “designed to clarify and revise the statutory framework under which financial institutions operate and compete,”\textsuperscript{68} and represented comprehensive banking legislation incorporating eight other Senate banking bills proposed over a fifteen-month period.\textsuperscript{69} Although S. 2851 would have placed the bank holding company, and its state chartered affiliates, squarely within the bounds of federal banking law, the bill died in conference at the close of the 98th Congress.\textsuperscript{70} Nevertheless, the Senate’s decision to extend the Garn-St. Germain Act’s insurance restraints to state chartered bank holding company affiliates was prudent for three reasons.

First, because the bank holding company is a creature of federal law, subject to its attendant benefits and drawbacks, it should

\textsuperscript{65} See notes 71-77 infra and accompanying text.


\textsuperscript{67} Specifically, S. 2851 would have changed § 4(c)(8) by replacing “it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance” with “it is not closely related to banking or managing or controlling banks for a bank holding company or any subsidiary or affiliate thereof to provide insurance.” S. 2851, 98th Cong., 2d Sess., 114 Cong. Rec. S11,165 (daily ed. Sept. 13, 1984) (emphasis added). Also, S. 2851 would have amended § 7 of the Bank Holding Company Act by providing that “a state-chartered bank subsidiary of a bank holding company may not engage in activities or make investments outside the state where it is chartered unless those activities are permitted under Section 4(c) of this Act.” Id. at S11,166.


\textsuperscript{69} Id. at 7-8. S. 2851 was created by the Senate Committee on Banking, Housing and Urban Affairs (“Senate Banking Committee”) on June 27, 1984. The bill was essentially a revised version of S. 2181, a bill introduced by Senator Garn, Chairman of the Senate Banking Committee. S. 2181 had incorporated seven other Senate bills which addressed topics including the definition of the term “bank,” interstate regional banking agreements, usury preemption, and credit card fraud. The application of the Garn-St. Germain Act’s insurance activity restrictions to banking subsidiaries of bank holding companies was added to S. 2851 by the Senate Banking Committee on June 27, 1984. Id. at 8.

\textsuperscript{70} See note 13 supra.
be regulated by Congress.\textsuperscript{71} Since certain structural and regulatory advantages encourage a state chartered bank to become a bank holding company or bank holding company affiliate,\textsuperscript{72} the Senate concluded that a bank holding company may not concurrently accept these benefits and avoid federal restrictions by embracing favorable state law.\textsuperscript{73} One significant purpose of the dual system of federal and state bank regulation supports the Senate's conclusion.\textsuperscript{74} The dual system is useful because it enables a commercial bank to select the regulatory structure under which it will operate.\textsuperscript{75} Essentially, differences between the competing regulatory schemes, discernible to the commercial banker, make the dual banking system viable.\textsuperscript{76}

The South Dakota banking legislation threatens the dual banking system because it permits a South Dakota chartered bank to merge the competing regulatory structures. Under the South Dakota law, a South Dakota chartered bank would obtain the benefits of affiliation with a national bank holding company while marketing any insurance product nationwide, consequently avoiding federal bank holding company insurance restrictions. Thus, a South Dakota chartered bank would operate within both federal and state regulatory structures instead of choosing one regulatory scheme. Permitting state chartered banks to market insurance in any state under a hybrid scheme of favorable federal and state legislation is contrary to the dual banking system.\textsuperscript{77}


\textsuperscript{72} \textit{Id.} at S11,141 (Senator Dodd's reference to "tax advantages"); \textit{Id.} at S11,143 (Senator Mitchell's reference to "tax and branching opportunities not available outside the holding company structure"); \textit{Id.} at S11,147 (Senator Heinz' reference to an "Edge Act Corporation," described at 12 U.S.C. §§ 611-631 (1982)).

\textsuperscript{73} \textit{Id.} at S11,142, S11,143, S11,147.

\textsuperscript{74} See note 5 \textit{supra}. Although the dual system of banking regulation has occasionally been criticized, the following observation represents the more typical view: "The dual banking system . . . is a vital national goal with roots deep in our constitutional history, and one of the very reasons why this country has achieved an economic growth unparalleled among the nations of the world." Scott, \textit{supra} note 5, at 1 (citing \textit{Hearings on the Operation of the National and Federal Reserve Banking System Before the Senate Comm. on Banking and Currency}, 72d Cong., 1st Sess., pt. II, at 395 (1932)).

\textsuperscript{75} Scott, \textit{supra} note 5, at 8. For example, a state chartered bank may evaluate the benefits and detriments of membership in the Federal Reserve System according to its organizational goals and choose to accept or decline Federal Reserve membership. \textit{Id.} at 13. A commercial bank, in most instances, may also change its charter from state to federal and vice versa. \textit{Id.} at 9-12.

\textsuperscript{76} \textit{Id.} at 13.

\textsuperscript{77} During debate of S. 2851, Senator Heinz remarked: "It is not in the interest of a safe and sound banking system to have a patchwork quilt of laws which permit different holding companies to engage in different activities, based solely on where the bank is located." 114 \textit{Cong. Rec.} S11,146 (daily ed. Sept. 13, 1984). Federal Reserve Board Chairman Volcker has cautioned against "widely divergent and inconsistent laws . . . with deposit-taking or-
The second reason to reaffirm the separation of the banking and insurance industries follows from the recognition that almost all state chartered banks are insured by the FDIC. Because a bank holding company is not insulated from the misfortunes of its subsidiaries, a state chartered bank's failure in the national insurance market could threaten the stability of the parent holding company. If the insurance subsidiary's failure rendered either the subsidiary or the bank holding company unable to meet its obligations, federal deposit insurance would protect the claims of depositors. Because the ultimate responsibility for the solvency of all federally insured bank holding company subsidiaries rests with the federal government, not the chartering states, S. 2851 prudently extended the Garn-St. Germain Act's insurance restrictions to a bank holding company's state chartered subsidiaries.

This argument implicitly recognizes that a large bank holding company serves sophisticated national and international investors, acutely cognizant of the bank holding company's stability. These investors could perceive the failure of a bank holding company's national insurance subsidiary as a challenge to the stability of the entire holding company. Federal banking policy since the Depression, however, has sought to minimize bank failures, responding to public demand for a fundamentally safe banking structure. A
bank's use of FDIC protection as a hedge against failure in competitive nonbanking markets, however, is inconsistent with the objectives of federal deposit insurance. Furthermore, to attain the optimum allocation of resources in a competitive market, financial markets must remain free to bestow success and impose failure upon competitors. A large bank holding company's failure, however, would most likely be averted by government intervention. Thus, a bank holding company's entry into the national insurance market with a federal guarantee against failure clashes with free market principles.

The third reason to explicitly extend the Garn-St. Germain Act's insurance restrictions to state chartered bank holding company subsidiaries is to prevent "tie-in" sales of insurance and banking services. Although federal banks and bank holding companies

that a merger or sale of Continental was not feasible, principally due to Continental's size. Therefore, the FDIC purchased for $3.5 billion loans valued on Continental's books at $4.5 billion, by assuming Continental's debt to the Federal Reserve System. In addition, the FDIC paid $1 billion for two series of preferred stock, one of which is convertible into 80% of Continental's common stock. In all, the FDIC invested $4.5 billion in Continental to avert the failure of the then ninth largest bank holding company. See Bailey, Anatomy of Failure, Continental Illinois: How Bad Judgments and Big Egos Did It In, Wall St. J., July 30, 1984, at 1, col. 6; Bailey, U.S. Pledges More Aid if Necessary For Survival of Continental Illinois, Wall St. J., July 27, 1984, at 3, col. 1.

In Doherty v. United States, 94 F.2d 495 (8th Cir.), cert. denied, 303 U.S. 658 (1938), the court noted that "Congress created a scheme for insuring to a limited extent the deposits of the banks participating in the plan for insurance for the manifest purpose of stabilizing or promoting the stability of banks, and to aid the government in its evergrowing financial transactions." Id. at 497. Earlier, in Weir v. United States, 92 F.2d 634 (7th Cir.), cert. denied, 302 U.S. 761 (1937), the court observed: "In pursuance of this power of protection and preservation, Congress has created, as an agency of the government, the Federal Deposit Insurance Corporation to promote the soundness of banking and aid the government in the discharge of its fiscal transactions." Id. at 636.


114 CONG. REC. S11,149 (daily ed. Sept. 13, 1984). Generally, a tie-in sale is an agreement between a buyer and seller such that the seller agrees to sell his product to the buyer only if the buyer purchases a different product or service. Federal banks and bank holding companies are expressly prohibited from entering into most tying arrangements. 12 U.S.C. § 1972 (1982). A 1977 Federal Reserve Board study, however, determined that about 25% of all customers who purchase credit life insurance felt that the purchase was either "strongly recommended" or "required." Despite this finding, the Federal Reserve Board study concluded that explicit contractual tying was "virtually nonexistent and implicit tying did not appear to be a widespread problem." Hearings on Tie-ins of the Sale of Insurance by Banks and Bank Holding Companies Before the Senate Comm. on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess. 48 (1979). The Federal Reserve Board study's conclusion has been challenged as inconsistent with the data presented in the study. Id. at 301, 302 (statement of Emmett J. Vaughn, Professor of Insurance, University of Iowa). In addition, Lewis Goldfarb, Assistant Director for Credit Practices of the Federal Trade Commission's Bureau of Consumer Protection, stated that "the study's findings are inconsistent with our experience." Id. at 93. Mr. Goldfarb also remarked that the study "does not support the conclusion that tying of insurance to credit is not widespread in consumer credit markets." Id. at 94.
are prohibited from engaging in coercive tie-in sales.\textsuperscript{87} voluntary tying arrangements are beyond federal regulation.\textsuperscript{88} The Senate concluded that the potential for voluntary tie-in sales of insurance products in the banking industry, and the difficulties attendant to regulating this conduct, outweighed the benefits of diversifying bank services.\textsuperscript{89}

The Senate’s conclusion is supported by the findings of prior Senate investigations.\textsuperscript{90} Moreover, a loan applicant, typically at a bargaining disadvantage with the bank, may reasonably conclude that his willingness to purchase additional bank services, such as credit life insurance or property and casualty insurance, could improve the likelihood of obtaining the loan on more favorable terms. By eliminating the borrower’s incentive to investigate other insurance alternatives, his decision to purchase insurance is swayed significantly by factors not pertinent to a free market decision.\textsuperscript{91}

S. 2851 properly extended the Garn-St. Germain Act’s insurance restrictions to state chartered bank holding company affiliates. S. 2851 preserved the commercial bank’s freedom to choose one regulatory structure within the dual banking system by prohibiting a bank holding company from operating within both federal and various state regulatory schemes. Furthermore, the bill recognized that because the vast majority of state chartered bank holding company affiliates are federally insured, their nonbanking activities should coincide with federal banking policy objectives. The FDIC has expressed its willingness to permit a state chartered bank to engage in any insurance activity authorized by the chartering state. Congress must therefore act to prevent the potential merger of the

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\[A\] potential borrower might place his casualty insurance business with a bank-affiliated insurer in the hope that such action would improve his chance of the bank granting him a mortgage loan on the insured premises on favorable terms. This would have the same effect as a coercive tie-in: competition in the tied product (i.e., insurance) would be lessened to the extent that customers no longer purchased it entirely on its own economic merit.

\textit{Hearings on Bank Holding Company Amendments before the Senate Comm. on Banking and Currency, 91st Cong., 1st Sess. 93 (1969)}.
\item[89] 114 CONG. REC. S11,149 (daily ed. Sept. 13, 1984). Banking commentators contend, however, that competitive forces within the banking and insurance industries would prevent voluntary tie-ins. A customer confronted with a coercive tie-in would seek another credit source. \textit{Hearings on S. 2181 and S. 2134 Before the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess. 438 (1984)} (statement Frederick S. Hammer, Executive Vice President, Chase Manhattan Bank).
\item[90] See notes 86, 88 supra.
\end{footnotes}
banking and insurance industries. Accordingly, Congress should enact legislation similar to S. 2851, prohibiting the interstate marketing of insurance by state chartered bank holding company subsidiaries.

IV. Conclusion

The American banking system, by law and custom, has been segregated from other forms of commerce. Congress has included insurance among the commercial ventures forbidden to the banking industry, concluding that the risks to the stability and soundness of the banking structure associated with underwriting and marketing insurance overshadow the societal benefits derived from more diversified bank services. The ownership of a state chartered bank, accountable to the chartering state's legislature, by a federally regulated bank holding company, has challenged Congress' determination.

In 1983, South Dakota enacted legislation authorizing its banks to engage in any form of insurance enterprise nationwide. The apparently incongruous assertion that Congress intended to regulate bank holding companies and their nonbanking subsidiaries, but not their banking subsidiaries, has proved convincing to FDIC officials. On November 26, 1984, the FDIC proposed rules that would allow state chartered banks, if permitted by state law, to underwrite insurance as long as the insurance operation is conducted through a "bona fide" subsidiary.92

The Senate response to South Dakota's legislation was S. 2851, the Financial Services Competitive Equity Act. S. 2851 expressly prohibited any bank holding company's state chartered banking subsidiary from providing insurance services beyond those authorized for member banks. Because S. 2851 died in conference, however, the FDIC appears willing to remove the barriers between a bank holding company's state chartered banking subsidiaries and the insurance industry. Consequently, the dual system of federal and state bank regulation is threatened. If the decision to merge banking and insurance nationwide is motivated by a particular state's desire to create jobs, no comprehensive federal banking plan will survive. Congress, as it has done before,93 should preserve the separation between banking and other commercial activities, in-

92 Langley, supra note 4.
cluding the underwriting or sale of most insurance, by enacting the Financial Services Competitive Equity Act.94

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94 Testifying before the Senate Committee on Banking, Mr. Volcker noted:
We, at the Board, in view of existing law and expressions of congressional intent, have indicated that we could not approve the acquisition of state chartered banks by bank holding companies with the apparent intent of undertaking, under relevant state law, widespread insurance activities, beyond the state in which the bank is chartered. This is one illustration of the urgent need for congressional direction in setting appropriate guidelines.