Safe and Sound under the US Banking Act

Joseph J. Norton
Southern Methodist University, Dedman School of Law

Recommended Citation

This document is brought to you for free and open access by the Faculty Scholarship at SMU Scholar. It has been accepted for inclusion in Faculty Journal Articles and Book Chapters by an authorized administrator of SMU Scholar. For more information, please visit http://digitalrepository.smu.edu.
must be deposited in a German clearing system and the warrants and related documentation must be governed by German law. However, exercise of the warrants through Euro-clear and/or Cedel, as is customary for warrants issued in the Euromarkets, should be permissible so long as the role of Euro-clear and/or Cedel is auxiliary and not, in effect, that of the principal warrant agent.

In the case of warrants exercisable into debt securities of German public sector borrowers, the Bundesbank or the issuer of the underlying securities has in the past imposed other conditions, for example, that such warrants must be covered by the deposit with a trustee of a sufficient amount of the underlying securities and that such warrants must not be issued in excess of a specified amount of the underlying securities. The rationale underlying such conditions is to ensure that such warrants are subject to substantially the same rules as options in regard to securities traded on German stock exchanges.

Euro-warrants that are linked to commodity or other indices may raise the same or similar German legal problems as do bonds that have such features.

**German issuers (domestic warrants).** There are no general restrictions on issuing domestic warrants.

Restrictions on domestic warrants for debt securities are similar to those for Euro-warrants. In the case of currency warrants, no Federal Ministry of Finance approval should be required because currency warrants should not be viewed as providing for the unconditional payment of a sum certain; they give instead the irrevocable right to conclude a purchase contract. However, this view is not entirely free from doubt. German issuers may therefore choose to place such warrants initially outside Germany. Initial placement outside Germany is also required by the German Currency Law when the issue price of the warrants is not denominated in Deutschmarks. Finally, an issue of currency or other commodity-type warrants should not be undertaken without a review of the stock exchange, gaming and other pertinent German laws and the circumstances of the individual issue.

## Safe and sound under the US Banking Act

**How does congress view deregulation? Joseph Norton, Professor of Law at Southern Methodist University, Dallas, Texas** reviews the new US Competitive Equality Banking Act

The Competitive Equality Banking Act 1987 (CEBA), which became US federal law on August 10, 1987, is a comprehensive (but non-deregulatory) financial act, which arose from the critical need to replenish the financial resources of the Federal Savings and Loan Insurance Corporation (FSLIC). CEBA covers a wide range of banking issues, some of which had been under consideration since the 1982 Banking Act. For example, CEBA bans the formation or acquisition of limited service banks or nonbank banks and creates a one year moratorium on bank expansion into real estate, insurance, and securities business. Notwithstanding its omnibus nature and complexities, CEBA cannot be viewed as part of the 1978, 1980, and 1982 series of deregulation legislation.

**Title I — Financial institutions competitive equality.** This Title aims to create more competitive equality among bank holding companies, banks, nonbanks, and thrift institutions.

A fundamental legal principle in American financial law has been the separation of banking and commerce. However, during the last few years, a loophole in the definition of a bank under the Bank Holding Company Act (BHCA) has been exploited to permit commercial companies to form or acquire limited service banks (so-called non-bank banks) that took deposits or made commercial loans (but not both), without restrictions of financial law. This growing practice raised significant policy concerns: erosion of the separation of banking and commerce, creation of new competitive inequalities, undermining bank supervision, and jeopardising of the payments system. This inequality was modified by amending the definition of bank under the BHCA to include an institution with FDIC insurance or an institution that accepts demand deposits and makes commercial loans. However, this equalisation process would still permit nonbank banks acquired on or before March 5, 1987 to continue to operate with restrictions (ie annual growth rate limited to seven percent, prohibit entry into new services, and prohibit nonbank banks from joint marketing within the corporate structure). Exemptions also exist for foreign banks, thrifts insured by FSLIC, bona fide trust companies, credit unions, credit card banks and industrial banks. On August 20, 1987, the Federal Reserve Board (FRB) approved a Statement of Guidance on complying with the grandfather non-bank bank provisions of CEBA.

By adding a new Section 23B to the Federal Reserve Act as the counterpart to Section 23A (restricting transactions between bank affiliate and the bank), this Title restricts transactions between banks and their affiliates. The terms of such transactions (including loans and purchases of assets) must be substantially the same as those for comparable transactions with nonaffiliated companies. FDIC-insured institutions are also precluded from holding themselves out as responsible for an affiliate's obligations. Moreover, specific rules are established respecting the purchase of securities as a fiduciary or principal from an affiliate or in situations in which an affiliate is a principal underwriter.

Title I modified several principles of the law of thrift
institutions. The National Housing Act (NHA) classifies thrift holding companies on the basis of the number of thrift institutions they control: a multiple company controls more than one institution, whereas a unitary company controls a single institution. NHA restricts the activities of a multiple thrift holding company but not of a unitary thrift holding company; thus a commercial company is free to own a single thrift institution. This special rule for unitary thrift holding companies dates from 1968, when the powers and activities of thrift institutions remained narrowly circumscribed. Thrifts did not, for example, make commercial loans or offer access to the payments system. Now, however, many thrift institutions are much like banks, and the ownership of such institutions by a commercial company raises essentially the same concerns as nonbank banks.

QTL test

The closing of the nonbank loophole, unless accompanied by appropriate restrictions on thrift institutions would merely transform the nonbank bank problem into a nonthrift thrift problem. Congress thought that would be undesirable and would undercut the reason for a separate thrift industry: the commitment of thrift institutions to residential mortgage lending. Therefore, the Act provides that the unitary thrift holding company exemption is not available to a holding company formed after March 5, 1987, unless the company's subsidiary thrift institution meets a 'qualifies as thrift lender' or QTL test, under which a thrift must devote at least 60 per cent of its assets to housing related activities. A holding company formed before March 5, 1987 will not be subject to those restrictions, similar to those applicable to nonbank banks.

Under the grandfather restrictions, the company must not obtain control of a bank or an additional insured thrift, or engage in an activity of a financial nature in which it did not engage at March 5, 1987, and which is not permissible for savings and loan holding companies that do not meet the QTL test. The subsidiary thrift must continue to meet the thrift asset test in the Internal Revenue Code; not increase the number of locations from which it does business; and not permit an overdraft on behalf of an affiliate or overdraw its own account at a Federal Reserve Bank or on behalf of an affiliate, unless the overdraft results from an inadvertent computer error or accounting error that is beyond the control of the thrift and the affiliate.

This title also creates a new incentive for thrift institutions to service the demand for housing needs. A qualified thrift is an institution that maintains 60 per cent of its assets in housing related investments. Thrift institutions generally are given until January 1, 1988 to satisfy the QTL Test.

Section 104(d) of this Title addresses two issues: first, inter-affiliate transactions and second, joint marketing activities. The Act provides that prohibitions on inter-affiliate transactions currently applicable to savings and loan holding companies, 12 CFR §584.3, does not apply to transactions between a subsidiary thrift institution and affiliates engaged in activities permissible for a bank holding company under Section 4(c)(8) of the BHCA.

The other portion of this section prohibits diversified savings and loan holding companies and their subsidiary thrift institutions from engaging in joint marketing activities for market products of an affiliate that are not permissible for a bank holding company under Section 4(c)(8) of the BHCA. This is similar to the joint marketing restrictions applied to nonbank banks. Joint marketing activities engaged in as of March 5, 1987 will be grandfathered.

The NHA generally prohibits the FSLIC from approving an acquisition if it would result in a multiple savings and loan holding company controlling insured institutions in more than one state. The NHA continued an exception to this prohibition in the case of emergency acquisitions. This section of the Act adds two exceptions to the prohibition. First, the FSLIC may approve such an interstate acquisition if at March 5, 1987, the acquiring company controlled an insured institution with a home or branch office in the state of the institution to be acquired. Second, the FSLIC may approve such an acquisition if the laws of the state where the institution to be acquired is located specifically permit one of its state chartered institutions located in the state where the acquiring entity is located. This exception parallels the Douglas amendment prohibition on interstate banking contained in the BHCA.

This Section 104(h) provides that the FSLIC may not waive compliance with the nonbanking activities restriction of the NHA if the thrift subsidiary acquired by a unitary savings and loan holding company under the emergency thrift acquisition provision, Section 4-8(m), fails to meet the QTL test. Under Section 105 of this Title, a thrift institution will not be eligible for advances from a Federal Home Loan Bank unless it meets the QTL Test.

Institutions that are subsidiaries of bank holding companies are subject to anti-tying provisions of the BHCA which prohibits such banks from insisting that a customer who seeks a loan or other service from a bank purchase some additional product or service from the bank's parent or affiliate. The anti-tying restrictions are extended to thrift institutions that are subsidiaries of savings and loan holding companies, and to grandfathered nonbanking firms that own a FDIC insured bank (and other affiliates and banks), trust companies, credit card companies, industrial banks, Edge Act companies and their parents and affiliates. The insider loan restrictions under federal bank laws are also now extended to the above relationships.

Equalising competition

Section 106 of the Title applies Section 20 and 32 of the Glass-Steagall Act (which pertains to underwriting and distribution of securities) to FDIC-insured non-FRS member banks and to insured thrift institutions until March 1, 1988. The Section does not affect affiliations or officer, director or employee relationships established before March 5, 1987. Also exempt are acquisitions by securities firms of failing thrifts with over US$500m in assets, and thrift acquisitions by firms engaged in the underwriting of certain prescribed types of securities.

Finally under the Title national banks are permitted to enter into net leases up to 10 per cent of their assets. This section makes the competition between national banks and federal thrifts more equal with respect to this activity.
Title II — Moratorium on certain nonbanking activities. This title imposes a moratorium on certain securities, insurance, and real estate activities from March 6, 1987 (retroactive application) to March 1, 1988. However, during this period, the bank regulators may continue to process new power applications, provided such activities do not commence before March 1, 1988. This Title also sets out limitations on insurance activities of state banks acquired by a bank holding company during this period. The various bank regulators' interpretation of what are new activities will shape how restrictive (or conversely, how flexible) the moratorium will be. The moratorium assumes that before March 1, 1988 (when the moratorium will lapse unless extended by law) Congress will act on the issue of new powers. However, many banking law commentators see this as unlikely.

Bridge banks

Title III — FSLIC recapitalisation. This Title creates a financing corporation with authority to sell long-term bonds equal to US$10.825m over the next three years. It also clarifies the FSLIC's power to collect exit fees from thrift institutions that withdraw from membership. The new formula permits the FSLIC to collect a fee equal to twice a thrift institution's regular annual assessment plus twice its special assessment. Thrift institutions that entered into withdrawal agreements on or before March 31, 1987 are grandfathered from the new formula. No withdrawals from the FSLIC will be permitted for one year from the date that CEBA became law.

Title IV — Thrift industry recovery provisions. The Title addresses a wide variety of issues related to the Federal Home Loan Bank Board's (FHLBB) supervision and regulation of thrift institutions. Congress began by mandating that Generally Accepted Accounting Principles (GAAP), as modified by bank regulators, must be utilised for reporting purposes by 1988.

Title V — Emergency acquisitions. This Title grants the FDIC the power to sell troubled institutions with assets of US$500m or more across state lines. It also grants the FDIC the power to establish a bridge bank to take over troubled or failed banks until a buyer can be located. Title I of the 1982 Garn St Germain Banking Act (granting the FDIC and FSLIC flexibility in dealing with troubled banks) is made permanent. The FHLBB net worth certificates programme is extended until October 13, 1991. Finally, federal financial institution regulators are exempted from budgetary restrictions mandated by the Gramm-Rudman Act.

Title VI — Expedited funds. This Title requires the cheque processing system to be improved to increase the availability of funds to financial institution customers. The Title creates a temporary (September 1, 1988 to August 31, 1990) and permanent schedule which requires a depository institution to make local funds available within one business day and non-local funds available within no more than four business days. Depository institutions must disclose their funds availability policy to their customers. The Board of Governors of the Federal Reserve System is given the authority to adopt regulations to implement this Title. The Title provides that state funds availability statutes enacted by September 1, 1989 control funds availability only to the extent that any state statute provides for a short payment period.

The FRB may use administrative enforcement powers to enforce compliance. Individual and class action civil liability claims may be brought to recompense for statutory damage.

Title VII — Credit union amendments. This Title reinstates the conservatorship power of the NCUA, states that share accounts are equity for a credit union, and eliminates the requirement for faithful performance bonds for credit union officers and employees.

Title VIII — Loan loss amortisation for agricultural banks. The Federal Deposit Insurance Act is amended to permit agricultural banks to write down their loan losses over seven years rather than deduct a loss from capital as soon as the loss is recognised.

Title IX — Full faith and credit back deposits insurance. Under this Title Congress reaffirms that federally insured deposits are backed by the full faith and credit of the United States.

Title X — Payment of government cheques. This Title creates a system for the order by payment of Treasury cheques and commissions a study to determine the extent to which individuals who receive Treasury cheques have difficulty in cashing them.

Title XI — Payment of certain interest required. This Title directs the FDIC to pay interest on non-negotiable 'yellow certificates', that were issued by Golden Pacific National Bank of New York (a failed national bank).

Title XII — Miscellaneous provisions. This Title requires that adjustable rate mortgages include a maximum rate of interest applicable to loans on one-to-four family dwellings. It also directs the General Accounting Office (GAO) to study the history of investment in high yield non-investment grade bonds made by financial institutions. The Title clarifies that nothing in the Federal Reserve Act should be interpreted as exempting or prohibiting the FRB or any Federal Reserve Bank from paying presentment fees to private payment providers. The GAO is directed to study competitive issues in the payments mechanism. The FHLBB is directed to study the direct investment activities of thrift institutions.

Balancing Act

CEBA does not constitute a continuation of the 1978, 1980 and 1982 series of bank deregulation legislation. On the contrary, CEBA reflects US Congress uncertainty over several years in trying to balance deregulation of bank powers and geographic expansion with growing concerns over the safety and soundness of the US banking and thrift systems (resulting from the continuing increase in the failure of such institutions). In fact, CEBA may be viewed as a retreat from deregulation (e.g. the prohibition of non-bank banks) or at least as a temporary preservation of the status quo (e.g. the moratorium on new powers). Whether the next US Congress can develop a consensus on bank deregulation issues remains to be seen. The usual time scale for new legislation and the 1988 presidential elections make any major deregulatory banking legislation in 1988 appear unlikely. Marketplace realities (at home and abroad) and the attitude of the bank and thrift regulators will probably continue to provide the greatest impetus in this area.