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Hal S. Scott, Deregulation and Access to the Payment System, 23 Harv. J. on Legis. 331 (1986)
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POLICY ESSAY

DEREGULATION AND ACCESS TO THE PAYMENT SYSTEM

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The market for financial services in the United States has long been characterized by a series of federally-imposed geographic restrictions and service-market divisions. Congress enacted these restrictions to prevent both banks and their holding companies from engaging in certain business activities and to restrict their ability to expand across state lines. Because such restrictions have substantial anti-competitive effects, and are not necessary to protect the safety and soundness of depository institutions themselves, this Policy Essay proposes the repeal of current regulations of the activities of bank holding companies. At the same time, the payment system—the various arrangements for transferring value, other than cash, between two parties—must be protected from the unacceptable risks of deregulation by prohibiting unregulated depository institution affiliates from processing payments through commonly owned depository institutions.

I. COMPETITION AND UNIVERSAL BANKING

Eliminating all legally imposed market divisions would be appropriate if the only goal was to increase competition. We would replace our system of specialized financial institutions with a universal banking system in which all banks have unlimited powers and are regulated for safety and soundness.[1] One could even eliminate all licensing and regulation and adopt a free banking system such as that in 19th century Scotland.[2]

Adoption of a universal banking system would require the repeal of all legally imposed geographic market divisions that currently prevent full interstate and intrastate banking. This

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[1] The quintessential example of a universal banking system is that of the Federal Republic of Germany. *See* S. CROSSICK & M. LINDSEY, EUROPEAN BANKING LAW: AN ANALYSIS OF COMMUNITY AND MEMBER STATE LEGISLATION 31–34 (1983).

[2] *See generally* M. FRY, BANKING DEREGULATION: THE SCOTTISH EXAMPLE (1985).

repeal could be accomplished by a federal law (a reverse Douglas Amendment[3]) prohibiting states from erecting intrastate or interstate market barriers. In addition, product market divisions would be abolished, not only as between depository institutions—the market division between thrifts and banks[4] would disappear—but also as between depository institutions and other financial institutions such as securities firms and insurance companies. Ultimately, even the divisions between financial institutions and all other private firms would be eliminated. In sum, we would dismantle much of the Bank Holding Company Act,[5] all of the Glass-Steagall Act,[6] and remove other existing restrictions on the powers of national and state banks.[7]

II. The Impact of Universal Banking on the Safety and Soundness of Financial Institutions

A strong competition policy would have two important consequences. First, states would be less able to structure their own state markets. Although reduced state protectionism may be desirable, we may still wish to avoid delivering such a blow to the dual banking system—the system of overlapping federal

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[3] The Douglas Amendment to the Bank Holding Company Act prevents the Federal Reserve Board from permitting the acquisition of an out-of-state bank by a bank holding company "unless the acquisition . . . is specifically authorized by the statute laws of the State in which such bank is located, by language to that effect and not merely by implication." 12 U.S.C. § 1842(d) (1982). In Northeast Bancorp, Inc. v. Board of Governors of the Fed. Reserve Sys., 105 S. Ct. 2545 (1985), the Supreme Court held that this provision permits states to admit into their markets, if they so desire, only the bank holding companies of some states while simultaneously excluding those of other states.

[4] Savings and loan associations, saving banks and credit unions are commonly referred to as thrifts. When subjected to federal regulation (either because of federal chartering or federal insurance) thrifts have traditionally been the object of portfolio restrictions and powers limitations that are different from those imposed on commercial banks. Nevertheless, the passage of the Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12 & 15 U.S.C.), began a welcome movement toward the elimination of regulatory inconsistencies and barriers between thrifts and commercial banks. Thus, for example, thrifts may now offer noninterest-bearing demand deposit accounts to parties with whom they have certain business relationships, and may make commercial loans up to 10% of their assets and nonresidential real property loans up to 40% of their assets. Moreover, the Act allowed both thrifts and commercial banks to offer money market deposit accounts.

[5] 12 U.S.C. §§ 1841–1850 (1982).

[6] Banking Act of 1933, 12 U.S.C. §§ 24, 377–378 (1982).

[7] *See, e.g.*, 12 U.S.C. §§ 24 (Seventh), 335 (1982) (restricting banks' ability to underwrite and deal in securities).

and state regulation of banking[8]—and the values of federalism which underlie it.

More important, an unwavering commitment to competition could have significant adverse consequences for the safety and soundness of our financial institutions. A universal banking system might well entail more risky business activity. It will certainly entail more competition. Both conditions could increase bank failures and thereby raise costs to the de jure and de facto insurers, the Federal Deposit Insurance Corporation (FDIC)[9] and the Federal Reserve Board (the Fed),[10] and ultimately to the public. Deposit insurance reform[11] might impose greater

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[8] The interaction of federal and state authority in the banking regulation field is very complex, but at least two points should be emphasized. The first is that banks are regulated at two levels. The primary level of regulation is that of the state or federal chartering authority. A secondary level of exclusively federal regulation exists for Federal Deposit Insurance Corporation (FDIC) insured state-chartered banks and for state-chartered banks which are members of the Federal Reserve system. The Federal Reserve Board regulates state banks that are members of the Federal Reserve System and the FDIC regulates all other federally insured banks. The second point is that banks can *choose* the administrative structure under which they will operate, either when they seek their initial charters, or subsequently by deciding to change one charter for another or by abandoning Federal Reserve membership or FDIC insurance. This ability to choose regulatory masters sometimes has been said to produce competition in laxity among regulators. *See* K. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 5–13 (1977).

[9] The FDIC is an independent agency of the federal government. It insures deposits placed in qualifying depository institutions up to a maximum of $100,000 per depositor acting in the same capacity and in the same right. 12 U.S.C. §§ 1728, 1821(a), 1813(m) (1982). The FDIC is also empowered to facilitate the merger of a weak or failing bank into a sound one. By using this authority—commonly referred to as a purchase and assumption—the FDIC can acquire the bad assets of a failing bank for cash, thus enabling the acquiring bank to obtain sound assets equal to the liabilities it assumes. *See* 12 U.S.C. § 1823 (1982). When the FDIC resorts to this power to aid a failing bank, all depositors are effectively protected in *full amount* of their deposits. *See generally* C. GOLEMBE & D. HOLLAND, FEDERAL REGULATION OF BANKING, 1983–1984, at 41–59 (1983). The FDIC attempts to handle most bank failures by merging the failing institution into a healthy one. *See* FDIC, 1984 ANNUAL REPORT 6 (1985).

[10] The Federal Reserve functions in practice as the lender of last resort, extending emergency credit assistance to institutions facing liquidity crises. Federal Reserve assistance of this type is extended through the discount window and must be fully secured by United States government securities, or by collateral satisfactory to the lending Reserve Bank. *See* 12 U.S.C. §§ 347, 347(b) (1982); 12 C.F.R. § 201.4(b) (1984). *See generally* Parthemos & Varvel, *The Discount Window* in FEDERAL RESERVE BANK OF RICHMOND, INSTRUMENTS OF THE MONEY MARKET 59, 63–65 (5th ed. 1981) (discussing borrowing from the discount window).

[11] Pursuant to the Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469, the three federal deposit insurance agencies—the FDIC, the Federal Savings and Loan Insurance Corporation (FSLIC), and the National Credit Union Insurance Corporation (FCUIC)—have completed studies of the current system of bank deposit insurance, its impact on the structure and operations of depository institutions, and the feasibility of implementing specified changes including risk-based premiums. *See* Wall, *Deposit Insurance Reform: The Insuring Agencies' Proposals*,

discipline, but the basic problem would remain significant. Completing the deregulation of bank liabilities is another potential solution. Having disposed of price controls on liabilities by phasing out Regulation Q,[12] we could go on to eliminate government guarantees of liabilities—federal deposit insurance and Federal Reserve lender of last resort facilities.

A system without government guarantees could well lead, however, to financial panics and runs on banks even in a strong economy. The recent Ohio thrift experience[13] could be replicated on a nationwide basis. The public has become dependent on government guarantees, and there is virtually no political chance of their removal. Whether they are necessary for a strong financial system in the long run is a question that deserves further study elsewhere.

Because government guarantees of liabilities will be with us for some time, we must find a way to increase competition for financial services without imposing unacceptable risks on the public guarantors; the matter cannot be left only to private shareholders and creditors. This Policy Essay proceeds to examine this issue for product markets, leaving discussion of geographic markets to another day.

FED. RESERVE BANK ATLANTA ECON. REV., Jan. 1984, at 43, 44–46. The FDIC has recently proposed that risky banks should pay higher premiums than non-risky banks. Currently all FDIC insured banks pay a premium of one twelfth of one percent on domestic deposits. 12 U.S.C. § 1817(b)(1). The FDIC proposes an increase in this assessment of up to two twelfths of one percent for risky banks. This approach would provide a significant financial incentive for banks to avoid excessive risk taking and to correct their problems promptly. Statement of William Seidman, Chairman, FDIC, before the Senate Comm. on Banking, Housing, and Urban Affairs, 99th Congress, 2d Sess., March 13, 1986; *reprinted in* Am. Banker, March 20, 1986, at 1, col. 1, 19, col. 1.

[12] Regulation Q is issued under the authority of § 19 of the Federal Reserve Act, 12 U.S.C. § 371 (1982), and § 7 of the International Banking Act of 1978, 12 U.S.C. § 3105 (1982). It governs the payment of interest on deposits held by member banks and by United States branches and agencies of foreign banks with worldwide consolidated assets in excess of $1 billion. 12 C.F.R. pt. 217 (1984). Similar regulations govern the payment of interest by other depository institutions. *Cf.* 12 C.F.R. pt. 329 (1984) (payment of interest by insured banks); 12 C.F.R. pt. 526 (1984) (payment of interest by savings and loan associations). The Depository Institutions Deregulation Act of 1980, Pub. L. No. 96-221 tit. II, §§ 204–205, 94 Stat. 142, 143, *codified at* 12 U.S.C. §§ 3503–3504 (1982), provides for the orderly phaseout of interest rate ceilings over a six-year period, which concludes this year.

[13] *See generally One Ohio S&L Fully Resumes Its Operations*, Wall St. J., Mar. 22, 1985, at 4, col. 1; *Rescue of Ohio's Ailing S&Ls Expected to Cost State More than $200 Million*, Wall St. J., Apr. 22, 1985, at 8, col. 1; *See also Maryland Panic Subsides After Caps Imposed*, Am. Banker, May 16, 1985, at 1, col. 4.

III. A BLUEPRINT FOR REFORM

A. *Regulate Depository Institutions*

We need to place limits on risk-taking within banks or any other institutions that take deposits and therefore enjoy either de jure or de facto insurance. The successful operation of these limits requires effective supervision and examination of such deposit-taking institutions. Although it is wrong to assume that certain activities are inherently riskier than others[14]—underwriting IBM stock is less risky than lending to Mexico—it may be difficult for regulators to judge the riskiness of activities that are unfamiliar to them. This is particularly true given the difficulties regulatory agencies have had judging the riskiness of such traditional bank activities as commercial lending. In the immediate future, therefore, we should limit bank activities to areas approved by regulators; over time these areas may evolve and expand. These limits should also apply to state banks because federal insurers are at risk for most state bank failures.

B. *Subsidiaries of Depository Institutions Should Be Regulated Like Their Parents*

Limitations on bank activities should also apply to activities of all direct or indirect subsidiaries[15] of banks because parent banks are directly at risk for the failure of their subsidiaries. Under present law, national bank activities are properly controlled: national banks cannot do anything more in an operating subsidiary than they can do in the bank.[16] Some states, however,

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[14] *See* Note, *Restrictions of Bank Underwriting of Corporate Securities: A Proposal For More Permissive Regulation*, 97 HARV. L. REV. 720, 727 (1984) (criticizing underwriting restrictions for "assuming that underwriting is uniquely and uncontrollably risky").

[15] As defined in Appendix A.

[16] 12 C.F.R. § 5.34(d)(2) ("Unless otherwise provided by statute or regulation, all provisions of Federal banking laws and regulations applicable to the operations of the parent bank shall be equally applicable to the operations of its operating subsidiaries."). These operating subsidiaries are creatures of the regulatory process, not of statute, and their existence is based on the common sense notion that national banks should be able to exercise their powers through a separately incorporated entity subject to the Comptroller of the Currency's supervision if they find it convenient or expedient to do so. *See* Glidden, *The Regulation of National Banks' Subsidiaries*, 40 BUS. LAW. 1299, 1303–04 (1985). In addition to these operating subsidiaries, national banks may establish statutory subsidiaries—subsidiaries established pursuant to specific authorization in some federal statute—and so-called DPC subsidiaries, or subsidiaries established to manage property acquired through foreclosure or in satisfaction of debts previously contracted. *Id.* at 1300, 1305.

allow more expansive activities in bank subsidiaries than they do in banks.[17] Although the Fed arguably has the power under existing law to stop bank subsidiaries of bank holding companies from taking advantage of this state authority,[18] this power is in fact far from clear. Further, the Fed lacks the authority to stop state non-member banks that are not in holding companies from availing themselves of these state law opportunities. In any event, the issue should be dealt with in legislation adopting the national bank standard for state banks.

C. *Affiliates of Depository Institutions Should Not Be Regulated*

We must also decide whether to place limits on risk taking by bank affiliates. I oppose any such regulation because banks are insulated from their affiliates' risk and because it would allow for unequal treatment of firms in essentially identical situations unless the present bank definition loophole is closed.

1. Banks Are Insulated from Affiliate Risk

Federal Reserve Board Chairman Volcker believes that we must control affiliate risk because the poor performance or failure of an affiliate can have a negative impact on the related bank.[19] Advocates of this view claim that this result could come about for two reasons: (1) affiliate losses could negatively affect holding company capital, thus impairing the ability of the hold-

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[17] *See, e.g.*, MASS. GEN. LAWS ANN. ch. 167F, § 3(4) (West 1984) (authorizing banks to invest up to four percent of their deposits in any corporation).

[18] The Bank Holding Company Act, 12 U.S.C. §§ 1841–1850 (1982), prohibits a bank holding company from acquiring or retaining direct or indirect ownership or control of more than five percent of the shares of a company, as defined. *Id.* § 1842(a)(3). The Federal Reserve Board has taken the position that the Act prohibits "a holding company subsidiary *bank* as well as the holding company itself from owning more than 5% of the voting shares of any company engaged in impermissible nonbank activities." 50 Fed. Reg. 4519, 4521 n.3 (1985) (emphasis in original).

[19] *See Problems, Options, and Issues Currently Facing the Financial Services Industry and the Agencies That Regulate and Supervise These Entities, Part I: Hearings on S. 1532, S. 1609, and S. 1682 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 51, 61 (1983) (statement of Paul Volcker, Chairman, Board of Governors, Federal Reserve System); *Financial Institutions Restructuring and Services Act of 1981, Part II: Hearings on S. 1686, S. 1703, S. 1720, and S. 1721 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 97th Cong., 1st Sess. 429, 432 (1981) (same).

ing company to serve as a source of strength for the bank[20] and (2) the public could lose confidence in a bank as a result of the failure of its affiliate.[21] I am not persuaded.

If the normal principle of limited liability for corporations applies, and if supervisors regulate *bank* capital,[22] bank capital will be unaffected by holding company losses.[23] If bank capital strength is desirable, it should be regulated at the bank rather than the holding company level.

The fear that the public would lose confidence in a bank because of the failure of its affiliate is based on a belief that people will act irrationally. Insured depositors have nothing to lose from a bank failure, let alone an affiliate failure. Only a loss in confidence about the adequacy of FDIC insurance would trigger panic withdrawals. As for uninsured depositors, most of whom are sophisticated banks or commercial enterprises, they presumably understand that the solvency of a bank is not affected by the failure of an affiliate. Our experience, albeit quite limited, suggests that the market can differentiate between a bank and an affiliate in difficulty.[24] Our regulatory policy should not be based on the assumption that large sophisticated depositors will behave irrationally.

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[20] *Cf. Competitive Equity in the Financial Services Industry, Part III: Hearings on S. 2181 and S. 2134 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 2d. Sess. 1112 (1984) (statement of Prof. Robert A. Eisenbeis).

[21] *See* Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 789, 833–34 (1979) (noting the "alleged danger . . . that the public may confuse the name and identity of a risky affiliate with that of the intermediary itself, with the result that a loss of confidence in the risky business will be transferred to the intermediary," but disputing "how serious the danger is.").

[22] Banks must presently maintain primary capital at six percent of assets. *Minimum Capital Ratios Increased to Set Uniform Capital Requirements for Commercial Banks*, [1984–1985 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 86,188 (Mar. 19, 1985) (Joint release of the Comptroller of Currency and the FDIC announcing the adoption of a uniform capital requirement of six percent for all national and FDIC-insured state nonmember banks); *FRB Adopts Revised Capital Adequacy Guidelines for BHCs and State Member Banks*, [1984–1985 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 86,221 (Apr. 24, 1985) (requiring state member banks and bank holding companies also to maintain a minimum capital requirement of six percent).

There are new regulatory proposals for risk-based capital requirements. *See, e.g., FRB Proposes Supplemental Capital Standards to Measure Bank Risk Exposure*, [Current Binder] FED. BANKING L. REP. (CCH) ¶ 86,505 (Jan. 31, 1986) (Fed's proposal would supplement existing capital standards by assigning assets and certain off-balance sheet items to one of four broad risk categories, which would then be weighted according to their relative risk.).

[23] *See* Note, *The Demise of the Bank/Nonbank Distinction: An Argument for Deregulating the Activities of Bank Holding Companies*, 98 HARV. L. REV. 650, 661–62 (1985) (discussing the unlikelihood of veil-piercing in the banking context).

[24] *See* J.P. Morgan & Co., Inc., Rethinking Glass-Steagall: The Case for Allowing Bank Holding Company Subsidiaries to Underwrite and Deal in Corporate Securities 20 n.15 (Dec. 1984) (on file at HARV. J. ON LEGIS.).

The July 1984 decision of the FDIC and the Fed to rescue Continental Illinois Corporation (the holding company) rather than Continental Illinois National Bank lends no support to those who maintain that banks and affiliates cannot be kept separate. The argument that a holding company has to be rescued to maintain confidence in the bank has already been discussed. The legal rationale for rescuing the holding company was that it was a condition of default on outstanding holding company notes for the holding company to give anyone a stock interest in a holding company subsidiary[25]—which would have occurred if FDIC had taken stock in the bank. The covenants may have entitled the note holders to claim a default against the holding company, which conceivably could have been enforced to enjoin the issuance of stock or to subordinate any issued stock.[26] If the existence of restrictive covenants will require other holding company rescues, legislation should be enacted to require the retirement of existing holding company debt with restrictive covenants or the cancellation of covenants as applied to a stock interest of the FDIC, to prohibit any new holding company debt with such covenants, and to prohibit any future holding company rescues by the regulatory agencies.[27]

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[25] *See* FDIC, 1984 ANNUAL REPORT 4 (1985) (noting that the FDIC "would have preferred placing the new capital directly in the bank rather than using the holding company as a conduit," but that the holding company "had outstanding indenture agreements which precluded this option"); *Anatomy of Failure—Continental Illinois: How Bad Judgments and Big Egos Did it In*, Wall St. J., July 30, 1984, at 1, col. 1 (describing the Treasury's opposition to the holding company rescue).

[26] The Treasury Department's legal department argued that there was no authority for a holding company rescue, Memorandum from Margery Waxman, Acting General Counsel of the Treasury to Secretary Regan (July 25, 1984) (on file at HARV. J. ON LEGIS.), but the Department of Justice, Memorandum from Theodore B. Olsen, Assistant Attorney General, Office of Legal Counsel, to Secretary Regan (July 24, 1984) (on file at HARV. J. ON LEGIS.), the Federal Reserve Board, Memorandum from Michael Bradfield, General Counsel of the Board of Governors of the Federal Reserve System (July 25, 1984) (on file at HARV. J. ON LEGIS.), and the FDIC, Memorandum from Margaret L. Eggington, Acting General Counsel of FDIC to the Board of Directors of the FDIC (July 25, 1984) (on file at HARV. J. ON LEGIS.) took an opposite position, relying on 12 U.S.C. § 1823(c)(2)(A) (1982) which provides:

> In order to facilitate a merger or consolidation of an insured bank . . . with an insured institution or the sale of assets of such insured bank and the assumption of such insured bank's liabilities by an insured institution, or the acquisition of the stock of such insured bank, the Corporation is authorized, in its sole discretion and upon such terms and conditions as the Board of Directors may prescribe—. . .
>
> (ii) to make loans or contributions to, or deposits in, *or purchase the securities of*, such insured institution or *the company which controls* or will acquire control of *such insured institution* . . . . (emphasis added).

[27] One could argue that the covenants should not have prevented the FDIC from taking a stock interest. The bondholders, upon declaring a default, should be regarded as in

2. The Bank Definition Loophole Will Not Be Closed

Even if we accepted the Volcker view—that we need to control affiliate risk in order to protect the bank—we apparently

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no better position than shareholders of the bank. Shareholders of a failed bank cannot object to the FDIC taking stock. 12 U.S.C. § 1823(c)(1) (1982); Zinman v. Fed. Deposit Ins. Corp., 567 F. Supp. 243, 250 (E.D.Pa. 1983).

H.R. 15, introduced by Congressman Wylie (R-Oh.), 99th Cong., 1st Sess., 1985, attempted to deal with this problem by amending the Bank Holding Company Act to provide:

> [N]o provision of any contract to which a bank holding company is a party shall be enforceable in any court (1) if that provision prohibits the bank holding company from selling shares of a subsidiary bank, or prohibits it from permitting a subsidiary bank from selling its own shares to an entity other than the holding company, when such a sale takes place in conjunction with or as part of assistance provided by the [FDIC] . . . , or (2) if compliance by any bank subsidiary of such holding company with a directive or order of the appropriate banking agency would cause such holding company to be or to become in default of such provision . . . .

Although a step in the right direction, this solution is insufficient in three respects. First, it is prospective only, and would do nothing about existing restrictive covenants. Second, it applies only to bank holding companies. It therefore leaves non-regulated holding companies free to use such covenants. This is a serious deficiency because unlike bank holding companies, whose major assets are banks, non-regulated holding companies' major assets are in the holding company. Thus, rescue of a non-regulated holding company, such as Sears or American Express, in order to rescue a captive bank would be even less supportable, and considerably more costly, than rescuing a bank holding company. Third, the proposal does not *preclude* the regulatory agencies from rescuing a holding company.

There should be limited concern with the prospect of a constitutional challenge to the requirement that existing bonds or debentures with restrictive covenants be retired, or the restrictive covenants be cancelled as applied to a FDIC stock interest. The Supreme Court has held that the government may execute laws that adversely affect recognized economic values without that action constituting a taking requiring compensation under the Fifth Amendment if the government has reasonably concluded that important public goals would be served by the law. *See* Penn Central Trans. Co. v. New York City, 438 U.S. 104, 123–28 (1977); Pension Benefit Guaranty Corp. v. R. A. Gray & Co., 104 S. Ct. 2709, 2717–18 (1984). Although there could be no valid contract clause claim under Article I, Section 10 of the U.S. Constitution, since that clause only applies to actions by a state rather than the federal government, it is instructive that this clause would be very unlikely to invalidate a covenant prohibition, if passed by a state, under the Supreme Court's case law. *See, e.g.*, Exxon Corp. v. Eagerton, 462 U.S. 176, 187–94 (1982). Indeed, in *Pension Benefit Guaranty Corp.*, 104 S. Ct. at 2720, the Court stated: "we have contrasted the limitations imposed on States by the Contract Clause with the less searching standards imposed on economic legislation by the Due Process Clause."

Finally, it is difficult to see how bondholders would be worse off as a result of a law prohibiting covenants restricting the FDIC's ability to take a stock interest in the bank of a holding company subsidiary. If the FDIC were not to inject capital in a failed bank as a result of the restrictive covenant, the failed bank could be liquidated and the holding company's stock interest in the bank would be worthless. Bondholders should not be entitled to assume that the FDIC will necessarily invest in the holding company if it is precluded from investing in the bank. *Cf. Zinman*, 567 F. Supp. at 251 (rejection of challenge by shareholders of First Pennsylvania Corp. to a FDIC rescue of its failed bank subidiary, First Pennsylvania National Bank, N. A., in which the FDIC made a $325 million term loan to the bank and took warrants in holding company stock to prevent holding company shareholders from receiving a windfall from the rescue).

lack the political will to undertake the comprehensive regulation of affiliates that is necessary to control affiliate risk. This inability is evident in our continuing failure to close the loophole in the definition of "bank" in the Bank Holding Company Act,[28] which permits *unregulated* holding companies, such as Chrysler, National Steel, and Sears,[29] to own national and state-chartered banks. Despite much congressional attention, it is extremely unlikely that this loopohole will be completely closed.

H.R. 20, as reported by the House Banking Committee[30] and now pending in the House Rules Committee, purports to close the loophole, but it permanently grandfathers a substantial number of unregulated holding companies.[31] The bill also prospectively allows unregulated holding companies to own state chartered banks that are eligible for but not insured by the FDIC.[32] Moreover, companies that own only one thrift would be regulated under more lenient standards than bank holding companies.[33]

Furthermore, the Supreme Court's recent decision in *Board of Governors of the Federal Reserve System v. Dimension Finance Corporation*[34] made it clear that the inadequacies of the Bank Holding Company Act cannot be overcome through the administrative process, however ingenious the theory underlying such an attempt may be. In *Dimension*, the Court rebuffed the Federal Reserve's attempt to expand the definition of commercial loans to cover virtually all short-term money market assets and to include NOW accounts within its definition of demand deposits.[35] "If the Bank Holding Company [Act] falls

[28] The Bank Holding Company Act defines as a bank within its coverage an institution that "(1) accepts deposits that the depositor has a legal right to withdraw on demand, *and* (2) engages in the business of making commercial loans." 12 U.S.C. § 1841(c) (1982) (emphasis added). Because the statutory coverage is only triggered when *both* prongs of the definition are met, it is possible for a holding company to own an institution (commonly referred to as a non-bank bank) which is considered a bank for most regulatory purposes and still remain unregulated. Note, *supra* note 23, at 653–55.

[29] *See, e.g., Sears Takes Step Toward National Consumer Banks*, Wall St. J., Oct. 23, 1984, at 3, col. 1; Note, *supra* note 23, at 655 n.27. *See also Cross-Industry Ownership of US Commercial Banks*, Am. Banker, Sept. 5, 1984, at 24, col. 1 (listing pending and planned acquisitions).

[30] H.R. REP. No. 175, 99th Cong., 1st Sess. 1–7 (1985).

[31] *Id.* at 3, 12 (grandfathered institutions would not be subject to section 4 of the Bank Holding Company Act unless they acquire an additional bank or changed ownership).

[32] *Id.* at 7, 16–17.

[33] *Id.* at 4–6, 14–16 (the thrift must be a qualified institution; that is, it must have 65% of its assets in residential mortgages and related investments for three out of every four calendar quarters).

[34] 106 S. Ct. 681 (1986).

[35] The Court invalidated the Fed's recent amendments to Regulation Y, 12 C.F.R. §225.2(a)(1)(A)–(B) (1985).

short of providing safeguards desirable or necessary to protect the public interest," the Court concluded, "that is a problem for Congress, and not the Board or the courts, to address."[36]

Rather than a problem, however, the non-bank bank development is a step in the right direction because the better policy is to allow any activity at the holding company level. Banks are not actually at risk for poor performance or failure by affiliates—a fact presumably well understood by large, sophisticated, and partially-uninsured investors. In light of this absence of risk, the competitive burdens imposed by holding company regulation are truly unjustifiable. Consequently, instead of lamenting the non-bank bank loophole, we should seek to extend the benefits of deregulation to bank holding companies. Under this approach, *all* firms owning banks would be unregulated holding companies in the sense that they could pursue any activities they wanted through the holding company. Chrysler could buy Citicorp or Citicorp could buy Chrysler. This change would establish an even playing field. The only firms that would object would be those that do not want one.

Even if complete holding company deregulation is not feasible, maximum activity deregulation is still desirable. At the least, Congress should give holding companies increased powers to engage in securities and insurance activities, and broaden the general authorization for holding company activities. Congress should also replace the existing standard of "closely related to banking" with a broader financial services test.[37]

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[36] *Dimension*, 106 S. Ct. at 689.

[37] *Cf. Sen. Garn's Proposed "Financial Services Competitive Equity Act" (S. 2181)*, WASH. FIN. REP. (BNA) No. 41, at 816, 818–25 (Nov. 28, 1983). In addition to permitting the establishment by the holding company of depository institution securities affiliates, *see* S. 2181, 98th Cong., 1st Sess., §§ 104(a)(2), 104(e)(3) (1983), S. 2181 would have modified the closely related to banking standard of 12 U.S.C. § 1843(a)(8) by expanding it to activities determined by the Board by regulation to be of a financial nature. *See*, S. 2181, § 104(d). Moreover, S. 2181 would have amended 12 U.S.C. § 1843(c)(8) expressly to permit bank holding company ownership of shares in companies engaged in insurance, underwriting, and brokerage and in certain real estate investments. *Id.* The main provisions of S. 2181 were subsequently incorporated in another bill, S. 2851, which was reported out of Committee on June 27, 1984. S. REP. NO. 560, 98th Cong., 2d Sess. 24 (1984). During mark-up, however, the bill was amended to eliminate the reference to activites of a financial nature and the closely related test, with an admonition to the Board to consider technological innovations in interpreting this standard. *See id.* In this form the bill passed the Senate (89 to 5) on Sept. 13, 1984. 130 CONG. REC. S11,162, S11,164 (daily ed. Sept. 13, 1984). The bill passed by the Senate did retain the orginal bill's concept creating depository institution securities affiliates that could be owned by bank holding companies. The activities of these affiliates, however, were restricted by the Senate committee mainly to the underwriting of certain governmental obligations, the rendering of investment advice to investment companies (except closed-

D. *Banks Should Not Be Permitted to Process Payments for Unregulated Affiliates*

The success of this approach, allowing the combination of regulated banks and unregulated holding companies, depends on maintaining the separate identity of the two entities.[38] Generally, maintaining this separation will require observing the principle of arms-length dealing.[39] In some areas, however, it may be better to prevent any dealings between the two entities because of the difficulty of enforcing the principle and the risks that may arise from our failure to do so. The focus should now be on defining those areas. Payment processing is clearly one.

1. Access to the Payment System

An important reason why unregulated holding companies acquire non-bank banks is to obtain direct access to the payment system through their own banks rather than through third-party banks. The payments volume of many firms is substantial enough to realize cost savings by bringing the payment function in-house.[40]

Prior to 1980, access to the payment system was restricted to members of the Federal Reserve System.[41] Since the enactment

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end companies), the underwriting of and dealing in promissory notes secured by real-estate mortgages, and the underwriting, sale, or dealing in commercial paper. *See id.* at S11,165.

[38] *See* Note, *supra* note 23, at 661–64; *cf.* Clark, *supra* note 21, at 791 (describing goals of separation regulation).

[39] Section 23A of the Federal Reserve Act, 12 U.S.C. § 371c (1982), prevents a member bank from engaging in a covered transaction—a loan or extension of credit, purchase of securities issued by an affiliate, and the issuance of guarantees, among others—with any one affiliate if the aggregate amount of covered transactions of the member bank and its subsidiaries will exceed ten percent of the member bank's capital, and any covered transaction with all affiliates if the aggregate amount exceeds twenty percent. *See also* 12 U.S.C. § 1828(j) (1982) (applying similar standards to nonmember insured banks).

[40]

> [H]eavy users of the payment system could operate more efficiently if they could directly participate in the payment system, rather than purchase collection and clearing services from banks. Retailers, finance companies, mortgage bankers, and non-bank issuers of credit and debit cards are constantly receiving payments from the public that must be collected through the payment system. Securities firms, insurance companies and mutual funds are constantly transferring funds to customers, annuitants or shareholders by check or wire.

SEARS, ROEBUCK AND CO., FINANCIAL SERVICES, CONSUMERS AND THE SEPARATION OF BANKING AND COMMERCE, at 3 (1985) (on file at HARV. J. ON LEGIS.) [hereinafter cited as SEARS].

[41] Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 105(d), 94 Stat. 132, 140, *codified at* 12 U.S.C. 248(o) (expanding access from member banks to depository institutions).

of the Depository Institutions Deregulation and Monetary Control Act of 1980,[42] all "depository institutions" such as banks have been allowed to hold clearing accounts with and to buy payment services from the Federal Reserve Banks.[43] A depository institution is defined as: (1) any bank insured by or eligible for FDIC insurance; (2) any mutual or other state savings bank; (3) any credit union insured by or eligible for insurance by the National Credit Union Insurance Board; (4) any institution which is a member of the Federal Home Loan Bank system; and (5) any institution insured by or eligible for insurance by the Federal Savings and Loan Insurance Corporation.[44]

The most important payment service offered by the Fed is FedWire,[45] an electronic communication and settlement system provided by the twelve Federal Reserve Banks. Its volume is growing at a twenty percent annual rate[46] and it currently handles over $435 billion in transactions daily, with an average transaction size of $2.4 million.[47] Private payment systems also move large dollar volumes. The largest is the Clearing House Interbank Payment System (CHIPS), a system established and maintained by the New York Clearing House Association. CHIPS handles more than $300 billion per day[48] on behalf of over 130 participant banks and provides same-day settlement through the New York Federal Reserve Bank.[49] The average transaction on CHIPS is $3.1 million.[50]

2. General Risk to the Payment System

The stability of our financial system depends on the ability of banks to settle their positions in both FedWire and CHIPS transactions.

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[42] Pub. L. No. 96-221, 94 Stat. 132, *codified at* various sections of 12 U.S.C.

[43] 12 U.S.C. § 248(o) (1982).

[44] 12 U.S.C. § 461(b)(1)(A) (1982).

[45] *See* Scott, *Corporate Wire Transfers and the Uniform New Payments Code*, 83 COLUM. L. REV. 1664, 1669–70 (1983).

[46] ASSOCIATION OF RESERVE CITY BANKERS, RISKS IN THE ELECTRONIC PAYMENTS SYSTEMS: REPORT OF THE RISK TASK FORCE, 11 (1983) (on file at HARV. J. ON LEGIS.)[hereinafter cited as RISKS IN THE ELECTRONICS PAYMENTS SYSTEM.].

[47] Federal Reserve Board, Reduction of Payments System Risk: A Manual for Depository Institutions, at A-3 (1985) (typescript) (on file at HARV. J. ON LEGIS.) [hereinafter cited as Depository Institutions Manual].

[48] *Id.*

[49] The figures have been updated from those supplied in the sources cited in notes 46–48, *supra*, based on a conversation with the Federal Reserve Board staff, Mar. 28, 1986 (figures not yet published).

[50] *Id.*

When using FedWire, banks commonly overdraw collected balances in their clearing accounts during the day when they transfer funds to other parties.[51] The Fed allows these daylight overdrafts because the speed of financial transactions would be greatly slowed if banks were only allowed to make transfers against collected balances. A transfer by the Fed to a receiving bank is final[52] in that the Fed cannot take the money back even if the sending bank fails to cover an overdraft. This finality allows the receiving bank to give good funds to the beneficiary of the payment immediately, which in turn allows further transactions to proceed unconditionally.

If, however, the sending bank cannot cover its Fed position, because of insolvency or lack of liquidity, the Fed is at risk and becomes a creditor of the failed bank. If the Fed responded to this situation by making an overnight secured loan at the discount window, and the institution failed at some later time, the Fed would have a prior claim to the assets securing the loan.[53] This priority would leave fewer assets and value for the FDIC which, in a liquidation, pays off the insured deposits and becomes a general creditor of the failed institution.[54]

Participants in the CHIPS system make transfers to each other during the day that are settled at the end of the day.[55] At any time during the day, a bank may be in a net debit position with any other bank. For example, if Bank *A* has sent $100 million to Bank *B* and received $60 million from Bank *B*, Bank *A* has a net debit position of $40 million with Bank *B*—on net Bank *A* owes Bank *B* $40 million. Banks may also have a net debit position with all other banks. For example, Bank *A* which has sent $500 million to and received $260 million from all other

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[51] Scott, *supra* note 45, at 1670; McDonough, *Daylight Overdrafts: One Perspective*, BANKERS MAG., Sept.-Oct. 1984, at 74, 76. Daylight overdrafts on FedWire currently are, on average, $110–$120 billion per day. Depository Institutions Manual, *supra* note 47, at A-5.

[52] 12 C.F.R. § 210.36(a) (1985) (Regulation J, pt. B).

[53] Federal Reserve lending is *secured* by "the deposit or pledge of bonds, notes, certificates of indebtedness, or Treasury bills of the United States," 12 U.S.C. § 347 (1982), or by notes "secured to the satisfaction" of the Federal Reserve Bank in question, 12 C.F.R. § 201.4(b).

[54] *See* 12 U.S.C. §§ 1821(f)–(g) (1982) (payment of insured deposits subject to subrogation). In fact, the Federal Reserve, as a *secured* creditor, assumes limited risk on its discount window loans. Rather, the FDIC is the agency most at risk and may thus be said to be the true lender of last resort. W. Isaac, *Statement on Deposit Insurance and Supervisory Reform Presented to the Senate Comm. on Banking, Housing and Urban Affairs*, July 23, 1985, at A-7 (Chairman, Federal Deposit Insurance Corp.) (on file at HARV. J. ON LEGIS.).

[55] *See* Scott, *supra* note 45, at 1672–73.

banks has a net debit position of $240 million with all other banks. At the end of the day, settlement of net debit system positions must occur through a transfer of funds to the New York Fed which in turn distributes these funds to banks with a net credit system position, i.e. banks which on net are owed money by all other banks.

An unwind occurs when the bank cannot settle its position at the end of the day.[56] A new settlement calculation is made that excludes all transactions involving the failed bank. The deleted transactions must be settled independently between the particular banks involved. Returning to our first example, if Bank *A* failed to settle, Bank *B*, which is a net creditor of Bank *A* for $40 million, would attempt to recover that amount from *A*. This task may, however, be impossible if Bank *A* has become insolvent. Because CHIPS payments are usually posted conditionally during the day (unlike FedWire) Bank *B* might also try to recover funds from the beneficiaries of the payments received from *A*. The beneficiaries, however, may have already drawn down their accounts and may be unable to make a refund. If Bank *B* is left with a $40 million loss as a result of Bank *A*'s failure to settle, it may in turn be unable to settle its own newly calculated net debit system position; a chain reaction of failures could ensue. Although the New York Fed has no obligation to cover the net debit system position of a bank unable to settle, it may nevertheless do so anyway by extending a secured loan. Such a credit extension may be necessary to avoid the chain reaction effect and the financial panic that might follow from an unwind. Again, if at some later time the bank failed, the Fed would have a prior claim to the assets securing its loan thus leaving fewer assets and less value for the FDIC.

Although there has never been a significant settlement failure, this does not mean it cannot happen. One might compare settlement failure to a nuclear power plant accident. There is a very low probability that either will occur, but each could cause catastrophic damage. In both cases the risk could result from the activities of any firm in the respective industries. The fact that we have never had a serious nuclear accident should not lead us to believe we can safely leave nuclear power unregu-

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[56] RISKS IN THE ELECTRONIC PAYMENTS SYSTEM, *supra* note 47, at 18–19; Rules Governing the Clearing House Interbank Payments System para. 13(b) (as last amended in 1981) (on file at HARV. J. ON LEGIS.).

lated. The same holds true for settlement failure and financial institutions. We should not wait for the payment system analog of Three Mile Island. Any increase in payment system risk should be forcefully resisted.

A financial safety net provided by the Federal Reserve System must be viewed as a cornerstone of the payment system. The finality of a FedWire transfer without regard to settlement by the sending bank and the expectation of Fed action to cover positions in CHIPS allow our payment system to serve the needs of commerce. Because it is the Fed—and ultimately the American public—which bears the risk of a settlement failure, it is essential that the Fed be able to ensure that all users of the system remain solvent. This goal is generally accomplished through bank regulation.

Limitation of payment system risk has been a major concern of the banking industry and the Federal Reserve Board for the last few years.[57] In fact, the Fed and the banking industry have developed a system for limiting intra-day overdrafts as between individual banks (bilateral net credit limits) and between an individual bank and all other banks, a bank's net debit position (net debit caps).[58] Beginning on March 27, 1986, all banks within a private large dollar network must establish bilateral net credit limits for their dealings with other participants in that network. At the same time, each bank must adopt a net debit cap to be applied to its aggregate position at a given moment in time on all systems combined, including FedWire. The maximum net debit cap across all systems cannot be greater than three times the bank's capital and must be approved by the bank's Board of Directors.[59]

These limits are designed to encourage banks to control and monitor the risks to which their own customers expose them. If banks allow their customers to overdraft accounts on a daily basis, in the expectation that open positions will be covered before the bank must pay on FedWire or CHIPS transactions,

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[57] *See* 49 Fed. Reg. 13,186 (1984) (Federal Reserve's request for comments on proposed risk reduction policy); ASSOCIATION OF RESERVE CITY BANKERS, THE FINAL REPORT OF THE RISK CONTROL TASK FORCE (Oct. 1984) (on file at HARV. J. ON LEGIS.); ASSOCIATION OF RESERVE CITY BANKERS, REPORT ON THE PAYMENTS SYSTEM 42–46 (1982) (on file at HARV. J. ON LEGIS.).

[58] Federal Reserve Board, Overview of the Federal Reserve System's Policy Statement Regarding Reducing Risks on Large-Dollar Electronic Funds Transfer System in DEPOSITORY INSTITUTIONS MANUAL, *supra* note 47, at C-4 to C-8.

[59] *Id.* at C-9, C-10.

and the customers fail to cover, the banks may be unable to settle with other banks. Despite their own risk for defaulted overdrafts, which should be regarded as loans subject to normal credit reviews, banks often lack the management and operational controls to control this risk. Sophisticated and expensive communication and computer systems are required to keep real-time track of customers' constantly changing account balances. Although the caps are not legally binding they will be monitored by the Fed on an ex post basis.[60] Banks that exceed their limits will be counseled by the Fed and ultimately may be restricted in their use of FedWire.[61]

3. Additional Risks Which Unregulated Affiliates Can Impose on the Payment System

Risk to the payment system is greatly affected by the type of institutions that have access to the system. The number and type of such institutions has greatly increased since 1980. Although all institutions with *direct* access are regulated, better controls are needed over the risks to which the payments system is exposed as a result of bank processing of affiliate transactions.

When banks process affiliate payments, the normal economic incentive of a bank to avoid risk does not operate. Holding companies maximize profit and risk at the holding company and not at the bank level. If a holding company wants an overdraft facility from its bank it will get one. This fact puts the bank and, in turn, the payment system at risk for the solvency and liquidity of holding company affiliates.[62] Regulation of overdraft credit facilities between banks and affiliates would be impossible on a case-by-case basis. Credit guidelines would be difficult to formulate and enforce and would be subject to creative avoid-

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[60] *Id.* at C-7 to C-10.

[61] *Id.* at C-9 to C-10, C-14 to C-15.

[62] Although unregulated holding companies stress the savings they could realize by bringing the payments function in-house, and assert that these savings will be passed on to their customers in the form of lower prices, these apparent gains would be more than offset by the costs to the Fed, the FDIC, and ultimately the public from a riskier payment system. Indeed, the very premise for the formation of some captive banks is the avoidance of risk restraints imposed by independent banks. *See infra* note 71; *see also* Letter from Rep. St Germain (D-RI), Chairman of the House Banking Comm. to Rep. Dingell (D-Mich.), Chairman of the House Energy and Commerce Comm. *reprinted in* X BANK LETTER 9 (Mar. 17, 1986) (Even if consumers intially benefit from lower costs, they would eventually have to pay for "the mistakes and misdeeds of owners of such banks.").

ance. The Fed's inability to distinguish between affiliate-created overdrafts from other overdrafts also prevents separate regulation of FedWire or CHIPS overdrafts created by affiliate transactions.

Although the Fed arguably has the power under the Federal Reserve Act or the Bank Holding Company Act to prevent unregulated companies from processing payments through affiliated banks, this authority is far from clear.[63] In any event, the matter should not be left to administrative discretion but should be specifically dealt with by statute.

E. *Controls on Processing Affiliate Payments*

This Policy Essay has argued that all bank affiliate activity should be deregulated but it has also acknowledged that this outcome is unlikely. For the foreseeable future, bank holding companies will be subject to significant regulatory controls such as capital requirements,[64] supervision and examination,[65] and activity limitations.[66] Although such controls may be generally undesirable, they do serve to protect the payment system.[67]

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[63] Under the Bank Holding Company Act, for example, "[t]he Board is authorized to issue such regulations and orders as may be necessary to enable it to administer and carry out the purposes of the Act *and prevent evasions thereof*." 12 U.S.C. § 1844(b) (1982) (emphasis added). The Board could argue that it is an evasion of the Act's purpose of regulating bank holding companies for banks to process payments for their unregulated affiliates. It is doubtful, however, that this argument would have much force in light of Board of Governors of the Fed. Reserve Sys. v. Dimension Fin. Corp., 106 S. Ct. 681 (1986) (striking down the Fed's broadened definition of bank).

[64] *FRB Adopts Revised Capital Adequacy Guidelines for BHCs and State Member Banks*, [1984–1985 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 86,221 (Apr. 24, 1985).

[65] 12 U.S.C. § 1844 (1982).

[66] 12 U.S.C. §§ 1843, 1844(e) (1982).

[67] This proposed statute would prohibit unregulated holding companies from processing any payments for its affiliate, by prohibiting the holding company from having any payment transactions with its captive bank. This Policy Essay has focused on the risks in the wire transfer systems, but there are also similar risks in the check and automated clearing house (ACH) payment systems.

With respect to checks, the holding company might get withdrawable funds from its affiliate sooner than from an independent bank, *see* the Chrysler discussion in note 71, *infra*, or the bank might not return bad holding company checks to payees, who might continue to supply goods and services to the holding company unaware of the impending holding company failure.

In an ACH credit transaction, credit transfers are sent by corporations in payment of payroll, dividend, interest, and pension obligations. Increasingly, ACH transactions are also used by corporations to pay suppliers. Payroll transfers can serve as an illustration. Employers can make direct payroll deposits to the accounts of employees by providing their bank (OB) with information, by delivering a computer tape or by direct wire communication, indicating the payroll data, *e.g.*, name of employees and banks holding

Activity limitations reduce the range of risks to which a captive depository institution may be exposed by processing payments for its parent. This risk is also controlled by examination, monitoring, and control of capital adequacy, of the riskiness of particular assets and liabilities, and of holding companies' operating procedures. Transactions between holding companies and their depository institutions are also examined, monitored, and controlled.[68] The presence of such regulation, *in the short term*, means that it is unnecessary to adopt more direct controls on the ability of banks to process payments for their bank holding company affiliates.

Nonetheless, given the existence of truly unregulated holding companies that can own banks through the non-bank bank device, there will be many instances in which the risk inherent in the ability of banks to process payments for affiliates will remain largely unchecked. The answer to this problem is not to impose regulation on these companies, but to find a way to insulate the payment system.

This result can be achieved by restricting an unregulated holding company from using an affiliated depository institution to process its payments. A specific proposal to this effect is set out in the Appendix. Such unregulated holding companies, and their non-bank affiliates, would be free to access the payment system indirectly through independent depository institutions. Moreover, the unregulated holding companies' own depository institutions would be free to offer the full range of payment services to their unaffiliated customers. In addition, employees of the holding company should be free to do all of their banking, including payments, through the affiliated institution. Thus, for example, while Sears would have to make its corporate pay-

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the employees' accounts (RBs). The OB debits its customer, the employer, for the entire payroll and credits any employees with accounts at the OB. It then sends the remaining data on to the Fed. The Fed credits the various RBs.

If the OB fails to settle with the Fed for the amount of the payroll, either the Fed or the RBs may be at risk. If the OB were to fail before the Fed gave final credit to the RBs, the Fed could refuse to post the items to the RBs and return the items to the OB. If the RBs had already given their customers credits, which is typically the case since they receive information about these credits in advance of the settlement date, the RBs would be at risk. If, on the other hand, the Fed learns of OB's failure after the RBs have been given final credits, the Fed is at risk.

The general point is that a captive OB which puts ACH credits through for its failing parent could create substantial risk to other participants in the payment system.

[68] *See* Board of Governors of the Federal Reserve System, Policy for Frequency and Scope of Examinations of State Member Banks and Inspections of Bank Holding Companies, Oct. 7, 1985; *reprinted in* Am. Banker, Oct. 10, 1985, at 4, col. 1.

ments through an independent institution, its affiliated thrift institution, Sears Savings Bank, could continue to process payments for all of the bank's independent customers and all of Sears' employees. In the long term, this restriction on holding company payments through affiliated depository institutions would apply to all holding companies. The same restrictions should apply to bank holding companies when they become unregulated.

As an alternative solution to the payment risk problem, one could prohibit unregulated holding companies from incurring any overdrafts on FedWire, and perhaps in any other system to which they had access. This proposal, however, has some serious drawbacks. First, as an operational matter, Reserve Banks do not have systems that can monitor and enforce a no-overdraft policy on an on-line basis.[69] Although many unregulated companies could be trusted to observe such a policy, others could not, particularly in times of financial stress. Second, a no-overdraft policy seems overly restrictive, because there is no reason to prevent some level of overdrafts created by the activities of independent customers, *e.g.*, third party depositors of the nonbank bank.

Even if a no-overdraft policy could be enforced and companies were willing to incur the funding costs (the costs incurred in borrowing money during the day to support funds transfer), there are two other major concerns. First, there will be a potentially enormous increase in the demand for Fed accounts and ultimately the cost of making funds transfers. Currently there

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[69] Currently three Reserve banks, New York, Atlanta, and San Francisco, employ the so-called New York Monitor system which allows these Reserve Banks to monitor funds accounts on-line. It is anticipated that the remaining nine Reserve Banks will have this capability in 1987. Although the New York Monitor allows on-line monitoring, the system does not have the capability to monitor all reserve accounts simultaneously. Instead, it monitors a random sample of accounts. Further, the monitoring system only compares the amount of the requested transfer with the balance in the account. It cannot differentiate between collected and uncollected balances. Thus, if a non-regulated holding company were to deposit a $10 million check with its captive bank (Bank *A*), drawn on its account at another bank (Bank *B*), and Bank *A* deposited the check with the Fed, the Fed monitoring system would only see a $10 million deposit in the funds account. The monitoring system would allow transfers against that balance, even though the check credit was actually provisional, and could be reversed if Bank *B* later failed to pay the check. Although a system could be designed to deal with both of these problems, allowing monitoring of all accounts simultaneously and only permitting transfers against final entries, the cost of these enhancements would be substantial. This potential cost raises the issue of whether all banks should pay for the costs of system enhancements designed to protect the Fed from the risks imposed by the banks owned by unregulated holding companies.

are approximately 8,000 reserve accounts.[70] If companies and individuals could avoid the expense of dealing with an independent bank by obtaining a Fed account through the incorporation of what amounted to a paper bank, a bank whose only purpose was to obtain a Fed account, the number of Fed accounts would increase dramatically.[71] Not only would the Fed lack the processing and communication capacity to handle such a system, the vast expansion of transfer combinations might also greatly increase the cost of funds transfers in general, if the Fed's system were required to handle a transaction volume which exceeded the optimum level. The payment system is better off by operating at two levels, the Fed with banks and banks with customers.

Of course, one could argue that the Fed's limited capacity should not necessarily be allocated to banks. In theory, the law could require the Fed to auction off those accounts to the highest

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[70] Although there are over 40,000 depository institutions which are entitled to hold accounts, about 32,000 institutions are either exempt from reserve requirements because their deposits are less than $2 million, 12 U.S.C. § 461(b)(11)(A)(i) (1982), or hold reserves through pass-through accounts with correspondent banks, *id.* § 461(c)(1)(B), and thus choose not to hold reserve accounts but instead make their payments through correspondent banks.

[71] There are two noteworthy examples of paper banks. First, in 1981, Chrysler Corp., during its financial difficulties, incorporated a state chartered bank, Automotive Financial Services, Inc. (AFS), whose sole purpose was to present to the Fed dealer drafts that had been deposited with it by its parent Chrysler. Dealer drafts are drafts drawn by Chrysler on its dealers, directing the dealers' banks to pay Chrysler for cars shipped to the dealers. Given Chrysler's financial difficulties, if an independent bank would take the drafts at all, it would only do so on a collection basis, *i.e.*, only credit Chrysler after the drafts were paid, or by purchase at a substantial discount. AFS, on the other hand, offered Chrysler a means of getting immediate credit without discounting. If the Fed had given AFS immediate credit on the drafts, with no conditions, it would have absorbed the entire risk of a potential dishonor of the drafts. In fact the Fed required AFS to hold clearing balances which could be debited in the event that the dealer drafts were dishonored. Nevertheless, Chrysler, through AFS, got better terms from the Fed than it would have received from a private bank.

The second noteworthy paper bank is Custodial Trust Co. (CTC), the captive of the investment bank, Bear, Stearns & Co. Bear, Stearns is a primary dealer in United States government securities which are transferred through the Fed's book-entry account system. Only depository institutions can hold such accounts. Clearing banks buy and sell book-entry securities on behalf of non-bank dealers and they impose transaction charges for this service. The banks allow the dealers to purchase securities by overdrafting their accounts as long as the banks hold the securities to secure the overdrafts. The banks will also demand that sufficient balances be maintained to cover the banks' market risk on the securities. The banks in turn overdraft their accounts at the Fed. By operating its own bank, Bear, Stearns brought the clearing bank function in-house in order to avoid the transaction charges and balance requirements. This device would not work if the captive bank, CTC, were prohibited from overdrafting its Fed account. Bear, Stearns would then be better off clearing through a bank which had the right to overdraft during the day than incurring the intra-day financing to support CTC's book-entry activities.

bidders. This would allow commercial firms to compete with banks for accounts. The actual result, however, would resemble the current situation because banks would have more payment volume than all but a very few commercial companies or individuals. It is probably simpler to keep the situation the way it is. Furthermore, the Fed accounts are not only used for payments—they also serve as reserve accounts. Because many banks which take reservable liabilities will need to have such accounts in any event, whatever their payment volume, this serves as an additional reason for allocating the accounts to them.

Although this analysis suggests that only "real" banks[72] should be able to have Fed accounts, it would still, absent additional considerations, permit unregulated holding companies that owned real banks, such as Sears-Sears Savings Bank or American Express-Boston Safe, to use their real banks to make payments on a no-overdraft basis. Any other commercial company that is willing to acquire or start up a real bank would be able to do so as well.

The second concern, however, goes to the point that unregulated holding companies should not be allowed to make payments even through their real banks.[73] Although a no-overdraft policy can protect the Fed from the direct financial risk resulting from a bank's overdrafts, protecting the bank against failure is just as important. If an unregulated holding company can overdraft its bank account, the bank may be exposed to failure because of the holding company's activities, and the Fed or

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[72] Real banks could be defined as banks that actively seek to make loans and take deposits from independent customers.

[73] The normal 15% of capital lending limit, applicable to unsecured credit extensions to a single borrower, *see* 12 U.S.C. § 84 (1982) (lending limit provision), does not apply to daylight overdrafts of national banks. *See* 12 C.F.R. § 32.105 (1985) (Office of the Comptroller of the Currency (OCC) interpretation stating lending limits not applicable to daylight overdrafts). Although some states might apply lending limits to overdrafts on state banks, and although the OCC interpretation could be repealed, it would be exceedingly difficult to enforce the application of lending limits to overdrafts that might occur for only a matter of seconds. Indeed, this is probably the reason that such overdrafts were exempted from the lending limits by the OCC. There is no ruling from the Fed as to whether the § 23A limits on loans to affiliates (*see supra* note 39) would apply to daylight overdrafts. Furthermore, these affiliate prohibitions do not apply to thrifts or non-insured banks, both of which have payment system access. *But cf.* Reg. O, 12 C.F.R. pt. 215 (1984), regulating insider loans, including those to officers, directors, and principal shareholders such as holding companies. This regulation exempts overdrafts to principal shareholders, other than officers or directors, from otherwise applicable lending limits. *Id.* § 215.4(d) and note 4. This exemption seems to be required by 12 U.S.C. § 375(b)(4) (1982).

FDIC, which will have no knowledge or expertise about these activities, will be at risk as public guarantors. Although the Fed may be able to enforce a no-overdraft policy at the Fed/bank level through controls on its own system, it has no way to enforce the policy at the holding company/bank level.

Existing laws imposing lending limits on loans by depository institutions to affiliates cannot be relied upon to prevent an unregulated holding company from overdrafting an affiliate.[74] First, daylight overdrafts are not regarded as loans by the OCC. Second, the limitations on loans to affiliates only apply to insured banks, and are not applicable to non-insured banks or thrifts, both of which can be used to obtain payment system access. Third, lending limits would be very difficult to apply effectively to overdrafts because of the difficulty in monitoring.[75] Finally, normal lending limits are enforced on an ex post basis through the examination process. Obviously this technique would not be effective in protecting a captive bank from extending overdraft facilities to its parent when the parent is in trouble.[76]

Thus, unregulated holding companies should be prohibited from making any payments through their own banks. Instead, they should be forced to deal at arms-length with banks that will exercise their independent judgment in deciding upon the appropriate levels of overdrafts during the day.

IV. CONCLUSION

We are at a crossroads in the reform of our financial system. We must make basic choices. My view is that we should limit bank activities to those that regulators can understand and evaluate, but that we should deregulate the activities of bank holding company affiliates. Rather than condemn the expansion of un-

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[74] *Id.*

[75] A banker's problems in monitoring the daylight overdraft activity of its customers would be similar to the problems of the Fed in monitoring overdrafts by banks. *See supra* note 69.

[76] Sears has contended that such a credit extension "is highly unlikely to occur with any frequency in light of the severe penalties to which bank officers and employees are subject if they violate prudent banking standards . . .," citing 12 U.S.C. § 504 which provides for a civil penalty of up to $1000 per day for each day lending limits are violated. SEARS, *supra* note 40, at 8–9. With respect to an intra-day overdraft which is uncovered at the time of a bank failure this penalty could only result in a $1000 fine; hardly a sufficient deterrent.

regulated holding companies into the banking field, and try to turn back the clock, we should accept this development and try to bring bank holding companies to a parity with unregulated holding companies.

On the other hand, unregulated companies should not be able to impose the risk of their failure on affiliated banks. This concern requires us to maintain the separateness of the holding company and the bank. In particular, it requires us to prohibit unregulated companies from processing payments through affiliated banks. If, however, we do not succeed in completely deregulating holding company activity, regulated bank holding companies should be allowed, *in the short term*, to process payments through their affiliated banks.

Regulated bank holding companies, unlike unregulated holding companies, are regulated for risk through examination, monitoring, and control of capital adequacy, types of permissible activites, and operating procedures. Although it is undoubtedly true that *some* regulated holding companies are more risky than *some* unregulated holding companies, this is generally not the case.[77] Furthermore, the Fed is in the position, through information obtained from its regulation of bank holding companies to make assessments about the solvency of a particular regulated bank holding company. However, it has no such information, on a continual basis, about unregulated companies. If a regulated bank holding company is experiencing difficulties, the Fed will probably know this in advance of the holding company's failure and could prevent the holding company from making payments through its bank. Unregulated holding companies may fail suddenly, leaving the bank exposed. Finally, the overdraft

[77] In the 1981–1983 period, the general business failure rate was 86 per 10,000, as compared with the failure rate of 46 per 10,000 for a composite of FDIC insured commercial and mutual savings banks, and FSLIC insured savings and loan associations. The FDIC data include as a failing bank liquidations and any situation requiring federal assistance to a bank, whereas the FSLIC data only include liquidations and federally assisted mergers. These failure rates are based on U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 1986, 521 (Table 883) (1986) and on information provided by telephone by James Moreno, Assistant Director, Div. of Research and Statistical Planning, FDIC, and Doug Green, Communications Office, Federal Home Loan Bank Board. Between 1960 and 1975 the business failure rate was an average of 47.6 per 10,000 while the failure rate of banks insured by the FDIC was 4 per 10,000. *See* Clark, *The Soundness of Financial Intermediaries*, 86 YALE L. J. 1, 13 n.48 (1976). The failure rate for depository institution holding companies should be considerably lower than the rate for depository institutions because many banks or thrifts which fail are not owned by holding companies and it is very unlikely at present that a holding company whose major asset is a depository institution will fail without such institution also failing.

risk to a bank from an unregulated company is likely to be more substantial than the risk from a regulated bank holding company because the payment volume of an unregulated holding company is likely to represent a higher percentage of its captive bank's total payment volume. This reflects the fact that the major assets of unregulated holding companies will be in the holding company rather than the bank.[78]

Deregulation of the holding company requires the maintenance of corporate separateness between the unregulated holding company and the regulated bank. Because this is exceedingly difficult in the case of payments, the best approach is to prohibit the unregulated holding company from using its captive depository institution to make its payments.

APPENDIX

STATUTE PROHIBITING PAYMENT ARRANGEMENTS BETWEEN UNREGULATED HOLDING COMPANIES AND THEIR SUBSIDIARY BANKS

(1) No depository institution controlled by an unregulated holding company may hold any demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties for, or process payments for or on behalf of, such holding company or any of such holding company's affiliates.

(2) For purposes of this section, the following definitions apply:

(a) the term 'depository institution' means any 'depository institution' as defined in Section 19(b) of the Federal Reserve Act (12 U.S.C. § 461(b));

(b) the term 'unregulated holding company' means any holding company which is not

(i) a 'bank holding company' within the meaning of Section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. § 1841); or

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[78] This difference also means, as discussed in note 27, *supra*, that a holding company rescue of an unregulated bank holding company, necessitated by restrictive bank covenants, would be generally more expensive than for the rescue of a regulated bank holding company.

(ii) a savings and loan holding company engaged only in activities permissible for a multiple savings and loan holding company under Section 408(c) of the National Housing Act (12 U.S.C. § 1730a(c));

(c) the term 'process payments' means any use of depository institution, Federal Reserve Bank, Federal Home Loan Bank Board or other similar accounts for the purpose of receiving or sending payments from one party to another party;

(d) the term 'holding company' means any company that directly or indirectly controls a depository institution and the term 'affiliate' means any subsidiary of such company. The terms control, subsidiary and company have the same meaning as in Section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. § 1841).