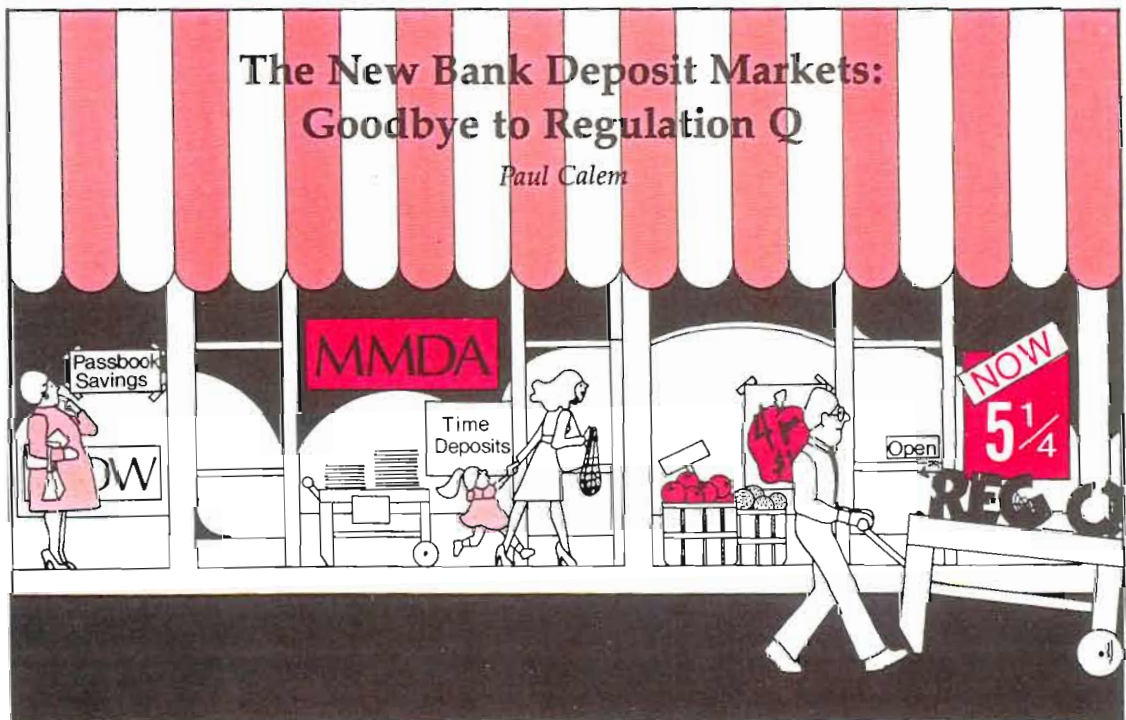
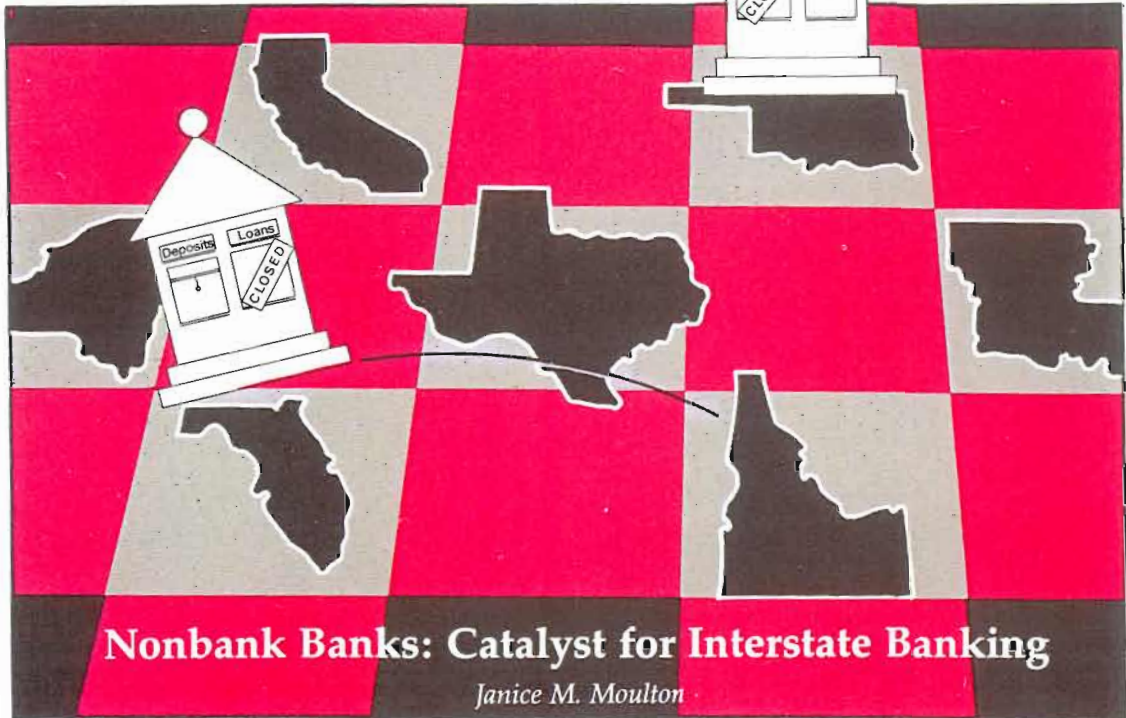


BUSINESS REVIEW

ISSN 0007-7011

Federal Reserve Bank of Philadelphia

NOVEMBER • DECEMBER 1985



BUSINESS REVIEW

**Federal Reserve Bank of Philadelphia
Ten Independence Mall
Philadelphia, Pennsylvania 19106**

NOVEMBER/DECEMBER 1985

NONBANK BANKS: CATALYST FOR INTERSTATE BANKING 3

Janice M. Moulton

The future of nonbank banks is being debated not only by financial institutions, but also by regulators and legislators at both the state and federal level. In the meantime, bank holding companies have used the nonbank bank "loophole" as a way to cross state lines. While the future of nonbank banks is uncertain, their legacy is clear. Nonbank banks have acted as a catalyst in a rapidly changing banking environment, helping to focus disparate forces on interstate banking issues and to hasten the dismantling of interstate banking restrictions.

THE NEW BANK DEPOSIT MARKETS: GOODBYE TO REGULATION Q . . 19

Paul Calem

As the last phase of removing Regulation Q's interest rate ceilings and minimum balance requirements approaches, banking deposit markets have taken on a new shape. As a result, consumers face a sometimes bewildering array of types of deposit accounts, with individual banking institutions offering their own versions of each type. While some consumers may be daunted by these choices, in fact the new environment can help improve their financial position. Since banks now have more flexibility in designing their deposit products, customers can seek out accounts that are closely tailored to their resources and needs. And, in doing so, customers give banks the incentive to design and price their products competitively.

The BUSINESS REVIEW is published by the Department of Research every other month. It is edited by Judith Farnbach. Artwork is directed by Ronald B. Williams, with the assistance of Dianne Hallowell. The views expressed herein are not necessarily those of this Bank or of the Federal Reserve System. The Review is available without charge.

Please send subscription orders and changes of address to the Department of Research at the above address or telephone (215) 574-6428. Editorial communications also should be sent to the Department of Research or telephone (215) 574-3805. Requests for additional copies should be sent to the Department of Public Services.

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twelve regional banks located around the nation as well as the Board of Governors in Washington. The Federal Reserve System was established by Congress in 1913 primarily to manage the nation's monetary affairs. Supporting functions include clearing checks, providing coin and currency to the banking system, acting as banker for the Federal government, supervising commercial banks, and enforcing consumer credit protection laws. In keeping with the Federal Reserve Act, the System is an agency of the Congress, independent administratively of the Executive Branch, and insulated from partisan political pressures. The Federal Reserve is self-supporting and regularly makes payments to the United States Treasury from its operating surpluses.

NONBANK BANKS: Catalyst For Interstate Banking

*Janice M. Moulton**

The recent emergence of nonbank banks has created considerable controversy. Nonbank banks are the subject of Congressional debate, court litigation, actions by state legislatures, debates among bankers, and discussion by federal and state bank regulators. Basically, a nonbank bank is an institution that, in order to avoid federal regulation under the Bank Holding Company Act, offers either demand deposits or

commercial loans but not both. Hence it is a bank and yet not a bank—a nonbank bank.¹ This in-between status has been exploited by bank holding companies, which want to use nonbank banks as vehicles to cross state lines, and by other organizations, like brokerage houses or retail chains, which want to open up their own banking-type subsidiaries. As a result, nonbank banks have prompted federal and state regulators

*Janice M. Moulton, Research Officer and Economist, heads the Banking Section of the Research Department of the Federal Reserve Bank of Philadelphia. Special thanks go to Edward Mahon, Assistant Counsel of the Philadelphia Fed, for his helpful discussions of legal issues and to Jim DiSalvo for expert research assistance.

¹Although this new entity was dubbed a nonbank bank, it can perform limited banking functions and more accurately might be called a limited purpose bank. To avoid confusion with many other kinds of limited purpose banks, however, such as credit card banks or trust companies, the term nonbank bank is used in this article.

to consider anew some fundamental questions about what a bank is, about the separation of banking and commerce, and about interstate banking.

Some of the activities that are occurring nationwide with nonbank banks can be illustrated by activity in the three states that make up the Third Federal Reserve District—Pennsylvania, New Jersey, and Delaware. Moreover, their experience with nonbank banks points up some of the complex economic and legal issues that are part of this development. Each of the three states takes a different stance on states' rights issues, such as the kinds of restrictions imposed on out-of-state institutions. And these differences help illuminate some of the factors states must consider when shaping legislation aimed at nonbank banks and interstate banking. Whatever the outcome of state and federal legislative and court actions on nonbank banks, they will leave a lasting legacy on the banking system because they are acting as a catalyst for interstate banking.

NONBANK BANKS: WHAT ARE THEY, WHO WANTS THEM, AND WHY?

Since deregulation began, many of the services that banks traditionally offered are now provided by other kinds of firms. Merrill Lynch has a Cash Management Account while Sears has Financial Centers right in their stores. Nonbanking firms have continued to push into the realm of traditional banking activities, but without coming under banking regulation, by taking advantage of an apparent loophole in the Federal Bank Holding Company Act (BHCA). According to the act, if a firm owns a bank, which is defined as "any institution... which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans," then the firm is a bank holding company and therefore subject to the regulations associated with the act.² So non-

banking firms have sought to avoid becoming bank holding companies by creating nonbank banks which offer either demand deposits or commercial loans, but not both. By eluding bank holding company status, these firms keep clear of the requirement to divest themselves of all business activities not permitted to bank holding companies under section 4(c)(8) of the BHCA, such as manufacturing or retailing. Thus nonbanking firms can own nonbank banks, which can be chartered by banking regulators, can be members of the Federal Reserve System, and can obtain FDIC insurance—in short, which are almost exactly like a bank—without coming under the regulations of the BHCA.³

Bank holding companies have perceived advantages to exploiting this loophole as well. While the bank holding company itself is subject to the act, any nonbank bank it might establish technically has been thought to be a Section 4 (nonbanking) subsidiary of the bank holding company under the BHCA. Because a nonbank bank has not been considered legally to be a bank subsidiary, bank holding companies could use them to get around some of the restrictions of the act. In particular, bank holding companies could sidestep the Douglas Amendment—Section 3(d) of the BHCA—which prohibits a bank holding company from acquiring a bank in another state unless that state specifically permits the acquisition. That is, bank holding companies could set up nonbank bank subsidiaries in other states without obtaining the states' permission, and engage to a limited degree in interstate banking.⁴

³Nonbank banks may be eligible to become members of the Federal Reserve System, provided they accept deposits that are eligible for FDIC insurance. Fed membership requires that a bank be any incorporated entity with a bank or trust company charter. The FDIC, to grant insurance, requires that the chartered financial institution be engaged in the business of receiving deposits.

⁴Section 3(d) of the BHCA covers the *bank* subsidiaries of the bank holding company while Section 4(c)(8) addresses the permissible activities of the *nonbanking* subsidiaries of the bank holding company, which can cross state lines.

²Section 2(c) BHCA of 1956 as amended in 1970, 12 U.S.C. 1841(c).

Nonbanking firms get the ball rolling... The first nonbank bank was approved by the Comptroller in 1980 when Gulf & Western Industries proposed to acquire Fidelity National Bank of Concord, California. At that time Fidelity was operating as a full service bank under a national bank charter. Since Gulf & Western is not a bank holding company, it could not acquire a nationally chartered bank under the BHCA without divesting itself of activities not permitted to bank holding companies. So it proposed instead that Fidelity sell its commercial loans and cease all commercial loan activities. Gulf & Western wanted to retain Fidelity's status as a fully-chartered national bank, however, and was required, under the Change in Bank Control Act, to notify the Comptroller of the change in ownership. The Comptroller then faced a difficult decision. He could actively disapprove the acquisition if he believed the nonbank bank really was a bank. Or he could allow the acquisition to proceed on the basis that the nonbank bank did not fit the literal definition of a bank and thus legally evaded the restrictions of the BHCA. He decided to allow the acquisition to proceed, thus creating the first nonbank bank of this type.

Over the next three years, the Comptroller approved a handful of acquisitions by organizations that were not bank holding companies. In 1982, Dreyfus, a large mutual fund, acquired a state-chartered bank in New Jersey, stripped off its commercial loans, and began operating it as a nonbank bank—a so-called “consumer bank” that retained demand deposits. J.C. Penney followed suit the next year with an acquisition of a nationally-chartered bank in Delaware, and it, too, sold off the commercial loan portfolio. But it was Dimension Financial Corp. that caused a sensation in 1983 when it filed with the Comptroller for new national bank charters to establish 31 nonbank banks in 25 states, including Pennsylvania.

At this point, it was evident that nonbanking organizations were eager to operate nonbank banks despite their limitations, in order to get an

entree into banking. Brokerage houses, insurance firms, retail chains, and others were offering their customers many banking services on a nationwide basis, and they wanted to expand their banking business—particularly by offering NOW accounts or other deposits. By April 1983, the Comptroller believed the implications of these applications for the structure of the financial industry were important enough to declare a moratorium on granting national charters to nonbanking companies to establish new nonbank bank subsidiaries. The express purpose of the moratorium was to give Congress time to examine the public policy issues of limited purpose bank charters and to establish a legislative framework for changes in state laws that affect geographic restrictions.⁵ A major public policy issue here is the distinction between banking and commerce, mandated in the Glass-Steagall Act over fifty years ago, which remains an important part of banking law. Federal Reserve Chairman Volcker, among others, has argued that banks should not be owned by nonbanking firms.⁶ Congress, however, was unable to come to grips with the nonbank bank loophole, largely because some legislators simply wanted to close the loophole while others wanted to consider nonbank banks in a broader framework for financial services deregulation. When Congress failed to act on this loophole, the Comptroller revoked the moratorium in early 1984.

... And bank holding companies pick up the ball and run. The usefulness of nonbank banks to bank holding companies soon became appar-

⁵Although the moratorium lasted throughout 1983, the Comptroller continued to process the applications for nonbank banks that had been filed previously.

⁶If a nonbanking firm engages in various businesses, in addition to owning a bank, the bank faces risks that it might be adversely impacted by risky activities in other parts of the organization. For example, a manufacturing firm that is suffering earnings losses may be tempted to drain funds from its bank subsidiary to shore up its failing production subsidiary. Thus, any legislation that attempts to fit nonbank banks into a bank definition also will have to address this question of ownership of banks by other institutions.

ent as well. With nonbank banks, bank holding companies could evade restrictions of the BHCA—in particular, the Douglas Amendment—and jump over the barriers to interstate banking.

The first bank holding company foray into nonbank banks came in 1983 when U.S. Trust Corporation, a bank holding company based in New York, received preliminary approval from the Comptroller to convert the charter of their trust subsidiary in Florida to that of a national bank, giving the subsidiary all national bank powers except the power to make commercial loans. Since the Federal Reserve is the primary regulator of bank holding companies, the Comptroller's approval was made subject to the Fed's approval.⁷ The Fed's Board concluded that this application did not violate Florida's prohibition on out-of-state bank holding companies establishing a *bank* subsidiary in the state. On March 23, 1984, the Fed reluctantly approved the application, and the Comptroller issued the national bank charter.⁸

Immediately after the U.S. Trust case was announced, Mellon Bank led several other large bank holding companies in filing many applications for nonbank banks in various cities through-

out the country. By the end of 1984, the Comptroller had pending over 300 applications by more than 50 bank holding companies.⁹ At that point, however, state actions in one court in Florida led to a preliminary injunction stopping the Comptroller from issuing any more charters to nonbank banks. And as a result, the Fed stopped processing such applications in early 1985. Furthermore, another Florida court overturned the Fed's ruling in the U.S. Trust case just a few months later.

The many applications by bank holding companies within the span of a few months reveals their desire to expand their markets across state lines. They gain several advantages by diversifying geographically into locations where they would not be permitted to operate full service banks. First, serving a new locale means the nonbank bank can lend to area businesses and consumers, which, by virtue of their type of industry or role in a regional economy, may have different loan characteristics from those who are already customers of the full service banking subsidiary. Such diversification means that the holding company may avoid putting too many of its loans "in the same basket." Thus when problem loans do appear in a particular industry or region of the country, such as the recent defaults on energy loans, the rest of the loan portfolio will help steady earnings. Second, a new location can yield different deposit customers and offer an opportunity to expand and diversify the deposit base. For example, even if a nonbank bank does not accept demand deposits, it still can take other deposits, such as NOW and Super-NOW accounts, Money Market Deposit

⁷The Fed approved the establishment of the limited purpose bank, which was technically a nonbanking subsidiary of a bank holding company, under Section 4(c)(8) of the BHCA. In May, 1985, the *U.S. Trust* decision was overturned by the U.S. Court of Appeals, Eleventh Circuit, *Florida Department of Banking vs. Federal Reserve Board*, No. 84-3269, 1985.

⁸In its order, the Federal Reserve Board strongly urged Congressional action to close the loophole. The order stated "If the nonbank concept, particularly as expanded by the interpretation of demand deposits adopted by the Tenth Circuit, becomes broadly generalized, a bank holding company, or commercial or industrial company, through exploitation of an unintended loophole, could operate 'banks' that offer NOW accounts and make commercial loans in every state, thus defeating congressional policies on commingling of banking or commerce, conflicts of interest, concentration of resources, and excessive risk, or with respect to limitations on interstate banking. Congressional action thus is urgently needed to ensure that the policies of the Act are maintained."

⁹Soon after the *U.S. Trust* case, with the number of applications mounting rapidly, the Comptroller declared another moratorium, this time on processing applications received after March 31, 1984. Again Congress did not act. After Congress adjourned in October, the Comptroller ended the moratorium and resumed processing the applications. Still another moratorium followed late in 1984 as the Comptroller sought to prepare a defense against state challenges in the courts.

Accounts, certificates of deposit, and so on. Third, building new customer relationships outside the states in which the holding company currently operates its banking subsidiary helps it to position itself better for the time when more states will permit entry of out-of-state full service banks. Given recent trends in deregulation, the chances of seeing full interstate banking within the next ten years appear much greater now than only a few years ago. Thus, perhaps the greatest advantage of setting up nonbank banks for bank holding companies is the ability to get a head start on the competition and to implement an interstate banking strategy early on.

**NONBANK BANK ACTIVITY
IN THE THIRD DISTRICT**

Pennsylvania, New Jersey, and Delaware illustrate some of the different types of activity that are occurring across the nation with nonbank banks. In the tri-state area today, 8 limited purpose banks are operating (excluding trusts), 4 have final approval but are not yet operating, 21 have preliminary approval, and 12 applications

are pending (see Table 1).¹⁰ Of those that have received some form of regulatory approval, 22 of the nonbank banks plan to keep their demand deposits while 11 plan to retain commercial loans.

Table 2 (p. 8) summarizes the activity of institutions that have applied (or been approved) to open nonbank banks in each of the three states. A glance at the list reveals action by several large bank holding companies, such as Citicorp, Chase, First Interstate, and Security Pacific, most of which want to locate in Pennsylvania. These money center and larger regional banks are actively seeking to expand into several states; such institutions account for the bulk of the applications that have come before the Comptroller. Few small or medium-sized bank holding

¹⁰Nationally, bank holding companies have only 5 nonbank banks that are currently operating, though 23 more have received final approval from all necessary authorities, and nearly 280 have preliminary approval. Other firms own about 40 nonbank banks that are currently operating, and have received final regulatory approval for 11 more.

**TABLE 1
NONBANK BANKS IN THE TRI-STATE AREA**

Nonbank Banks	PA	NJ	DE	Total
Operating	0	2	6	8
Final approval Charter granted by federal or state authorities but not yet operating.	0	4	0	4
Preliminary approval Approved by at least one regulator but needs approval from other regulators to receive charter.	13	7	1	21
Pending approval Application submitted but not approved by regulators.	4	5	3	12

TABLE 2
NONBANK BANK APPROVALS FOR THE TRI-STATE AREA

Headquarters location	Subsidiary location	Charter	Type	Status	Operation kept
PENNSYLVANIA					
Barclays American Corp. Charlotte, NC	Barclays Bank of Lancaster, N.A. Lancaster	Nat'l.	De Novo	Preliminary Approval	DD
	Barclays Bank of PA, N.A., Lower Burrell	Nat'l.	De Novo	Preliminary Approval	DD
Chase Manhattan Corp. New York, NY	Chase Manhattan Nat'l. Bank of PA Bala Cynwyd	Nat'l.	De Novo	Preliminary Approval	CL
Citicorp New York, NY	Citibank (PA), N.A. King of Prussia	Nat'l.	De Novo	Preliminary Approval	CL
First Interstate Bancorp. Los Angeles, CA	First Interstate Bank of Phila., N.A. Philadelphia	Nat'l.	De Novo	Preliminary Approval	CL
	First Interstate Bank of Pitt., N.A. Pittsburgh	Nat'l.	De Novo	Preliminary Approval	DD
First Maryland Bancorp. Baltimore, MD	First Omni Bank (PA) Allentown	Nat'l.	De Novo	Preliminary Approval	DD
First Nat'l. State Bancorp. Newark, NJ	First Nat'l. State Bank/Solebury Solebury Twp.	Nat'l.	De Novo	Preliminary Approval	DD
Hongkong & Shanghai Banking Corp. Hong Kong	Hongkong & Shanghai Nat'l. Bank (PA) Philadelphia	Nat'l.	De Novo	Preliminary Approval	DD
Irving Bank Corp. New York, NY	Irving Trust PA, N.A. Philadelphia	Nat'l.	De Novo	Preliminary Approval	CL
Marine Midland Banks, Inc. Buffalo, NY	Marine Midland Bank (PA), N.A. Pittsburgh	Nat'l.	De Novo	Preliminary Approval	DD
Midlantic Banks, Inc. Edison, NJ	Midlantic National Bank/PA King of Prussia	Nat'l.	De Novo	Preliminary Approval	CL
Security Pacific Corp. Los Angeles, CA	Security Pacific Nat'l. Bk. of PA Bala Cynwyd	Nat'l.	De Novo	Preliminary Approval	CL
NEW JERSEY					
Aetna Life & Casualty Hartford, CT	Liberty Bank & Trust Co. Gibbsboro	State	De Novo	Operating	DD
Bank of New York Co., Inc. New York, NY	Bank of New York (NJ), N.A. Livingston	Nat'l.	De Novo	Preliminary Approval	DD
Bear-Stearns & Co. New York, NY	Custodial Trust Co. Trenton	State	De Novo	Approved 2/7/84	DD

Headquarters location	Subsidiary location	Charter	Type	Status	Operation kept
Chase Manhattan Corp. New York, NY	Chase Manhattan Nat'l. Bank of NJ Hasbrouck Heights	Nat'l.	De Novo	Preliminary Approval	CL
Chemical NY Corp. New York, NY	Chemical Bank (NJ), N.A. Roseland	Nat'l.	De Novo	Preliminary Approval	DD
Citicorp New York, NY	Citibank (NJ), N.A. Whippany	Nat'l.	De Novo	Preliminary Approval	CL
Dreyfus Corp. New York, NY	Dreyfus Consumer Bank East Orange	State	Acquisition	Operating 8/21/82	DD
Fidelcor, Inc. Philadelphia, PA	Fidelity Bank (NJ), N.A. Cherry Hill	Nat'l.	De Novo	Preliminary Approval	DD
Irving Bank Corp. New York, NY	Irving Trust of NJ, N.A. Morristown	Nat'l.	De Novo	Preliminary Approval	CL
Marine Midland Bank, Inc. Buffalo, NY	Marine Midland Bk. (NJ), N.A. Morristown	Nat'l.	De Novo	Preliminary Approval	DD
Merrill Lynch, Pierce, Fenner & Smith New York, NY	Merrill Lynch Bank & Trust Plainsboro	State	Acquisition	Operating 1/3/84	CL
Paine Webber & Co. New York, NY	Paine Webber Bank & Trust Princeton	State	De Novo	Approved 9/20/84	DD
Thomson-McKinnon & Co. New York, NY	Thomson-McKinnon Bank East Hanover	State	De Novo	Approved 9/5/84	DD
DELAWARE					
E.F. Hutton Group, Inc. New York, NY	E.F. Hutton Bank Wilmington	State	Acquisition	Operating 10/13/84	CL
Commercial Credit Corp. Baltimore, MD	First National Bank of Wilmington Wilmington	Nat'l.	Acquisition	Operating 5/20/83	DD
J.C. Penney & Co. New York, NY	J.C. Penney Nat'l. Bank Harrington	Nat'l.	Acquisition	Operating 4/28/83	DD
Teachers Service Organization Willow Grove, PA	Colonial National Bank Wilmington	Nat'l.	Acquisition	Operating 1/25/82	DD
Horizon Bancorp Morristown, NJ	Horizon Bank of DE, N.A. Christiana	Nat'l.	De Novo	Preliminary Approval	DD
Sears, Roebuck & Co. Chicago, IL	Greenwood Trust Co. Greenwood	State	De Novo	Operating 1/14/85	DD

companies have filed applications for the tri-state area. In addition there are numerous non-banking organizations, such as brokerage houses, insurance firms, mutual funds, and retail chains, that have applied to set up nonbank banks, mainly in New Jersey and Delaware.

At the same time, institutions headquartered in Pennsylvania, New Jersey, and Delaware also have acted to establish nonbank banks outside their home state. Mellon Bank Corp., the largest

bank holding company in the tri-state area, has filed the most applications, but other, smaller regional bank holding companies and banks have filed as well (see Table 3). Altogether, some 7 bank holding companies in the tri-state area have received at least preliminary approval to locate nonbank banks outside their home state.

From these lists it is clear that bank holding companies are quite active in trying to establish a banking foothold in new markets via nonbank

TABLE 3
NONBANK BANK APPROVALS FOR TRI-STATE AREA HOLDING COMPANIES

Headquarters location	Subsidiary location	Charter	Type	Status	Operation kept
Fidelcor, Inc. Philadelphia, PA	Fidelity Bank (NJ), N.A. Cherry Hill, NJ	Nat'l.	De Novo	Preliminary Approval	DD
	Fidelity Bank (FL), N.A. Ft. Lauderdale, FL	Nat'l.	De Novo	Preliminary Approval	DD
Mellon Bank Corp. Pittsburgh, PA	Mellon Bank (FL) N.A. Boca Raton, FL	Nat'l.	Converted Trust	Preliminary Approval	DD
	Mellon Bank (CO), N.A. Arvada, CO	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (OH), N.A. Cleveland, OH	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (CA), N.A. Pomona, CA	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (IL), N.A. Oak Brook, IL	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (MD), N.A. Towson, MD	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (DC), N.A. Washington, DC	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (TX), N.A. Dallas, TX	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (VA), N.A. Springfield, VA	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (WA), N.A. Bellevue, WA	Nat'l.	De Novo	Preliminary Approval	DD
Mellon Bank (Miami), N.A. Miami, FL	Nat'l.	De Novo	Preliminary Approval	DD	

banks. The extent of the reach from the bank holding company headquarters—or its banking subsidiary—to the new market varies somewhat (Chart 1, p. 12). In general, it appears that most of the bank holding companies expanding into this area are coming from neighboring states—that is, they are headquartered or have their banking subsidiaries in contiguous states. Of course, this may not be the only region into which they want to expand their nonbank banks.

Moreover, for bank holding companies headquartered in the tri-state area, about a third of the nonbank banks are planned for locations near the parent company, while two-thirds are located in various areas around the country, with Florida on almost every local bank holding company's list.

Data from the tri-state area also indicate that bank holding companies are trying to locate nonbank banks in the same area as their non-

Headquarters location	Subsidiary location	Charter	Type	Status	Operation kept
Mellon Bank Corp. Pittsburgh, PA (continued)	Mellon Bank (NY), N.A. New York, NY	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (MA), N.A. Boston, MA	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (AZ), N.A. Phoenix, AZ	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (GA), N.A. Atlanta, GA	Nat'l.	De Novo	Preliminary Approval	DD
	Mellon Bank (LA), N.A. Metairie, LA	Nat'l.	De Novo	Preliminary Approval	DD
PNC Financial Corp. Pittsburgh, PA	Northeastern Trust Co. of FL, N.A. Vero Beach, FL	Nat'l.	Converted Trust	Preliminary Approval	DD
First Fidelity Bancorp. Newark, NJ	FNS Bank of NY New York, NY	State	De Novo	Approved 12/18/84	DD
	First National State Bank/Solebury Solebury Twp., PA	Nat'l.	De Novo	Preliminary Approval	DD
	First Fidelity Trust, N.A., FL Boca Raton, FL	Nat'l.	Converted Trust	Preliminary Approval	DD
Horizon Bancorp Morristown, NJ	Horizon Bank (DE), N.A. Christiana, DE	Nat'l.	De Novo	Preliminary Approval	DD
Midlantic Banks, Inc. Edison, NJ	Florida Coast Midlantic Trust Co. Lighthouse Point, FL	Nat'l.	Converted Trust	Preliminary Approval	DD
Wilmington Trust Co. Wilmington, DE	Wilmington Trust Co. of FL, N.A. Stuart, FL	Nat'l.	Converted Trust	Approved 5/9/84	DD

banking subsidiaries, such as consumer finance subsidiaries, or commercial loan offices (Chart 2). The likely reason for doing this is to try to mitigate the effects of the restrictions that nonbank banks face. Since nonbank banks must either give up demand deposits or commercial loans, they also give up the gains in efficiency available to full service banks that come from channeling deposits into commercial loans, from linking the pricing of certain loans and deposits, and from building a commercial relationship

with a firm on both sides of a balance sheet. Commercial relationships are cut short, for example, for a nonbank bank that gives up demand deposits, because it is unable to offer businesses a checking account. Moreover, nonbank banks face several restrictions from federal regulatory authorities (see FED EFFORTS TO CLOSE THE LOOPHOLE.) Therefore, bank holding companies try to reduce these inefficiencies by locating the nonbank bank where the holding company already has a presence

CHART 1
BANK HOLDING COMPANIES EXPAND THEIR MARKETS
Nonbank Banks Located Near Bank Subsidiaries

Location Relative to One of the Affiliate Bank Subsidiaries of the BHC:	Nonbank Banks in the Tri-State Area owned by BHCs Headquartered outside PA, NJ, and DE	Nonbank Banks owned by BHCs Headquartered in PA, NJ, and DE
In a contiguous state	19	7
In a state that is not contiguous	3	18

CHART 2
COMPLEMENTARY SUBSIDIARIES
OF BANK HOLDING COMPANIES:
Nonbank Banks Located Near Nonbanking 4(c) (8) Subsidiaries

Location Relative to the Nearest Nonbanking Subsidiaries of the BHC:	Nonbank Banks in the Tri-State Area owned by BHCs Headquartered outside PA, NJ, and DE	Nonbank Banks owned by BHCs Headquartered in PA, NJ, and DE
In the same state	13	16
In a contiguous state	7	4
In a state that is not contiguous	2	2

established by another subsidiary. Since bank holding companies generally are permitted to establish their *nonbanking* subsidiaries without regard to state lines, many already have an extensive network of offices outside their home state upon which to build. For example, a bank holding company could locate its nonbank bank in an area where it has a consumer finance subsidiary, because the customer relationships already established could be expanded to include a broader range of services offered by the nonbank bank.

In sum, bank holding companies view nonbank banks as a means of diversifying their deposit base and their loan portfolios by jumping over barriers that have prevented them from

crossing state lines. So far, most *operating* nonbank banks are owned by non-banking organizations. Bank holding companies started later, and their movement has been blocked at this point by court cases. One of the major issues is the position taken by the states where these nonbank banks would be located.

STATE BANKING AUTHORITIES' REACTIONS IN THE TRI-STATE AREA AND ELSEWHERE

State banking authorities want to control banking activities within their borders. Under the Douglas Amendment to the BHCA, states can permit an out-of-state bank holding company to acquire an in-state bank through enactment of

FED EFFORTS TO CLOSE THE LOOPHOLE

Although the Fed believed it had no legal alternative but to approve nonbank banks, the Board's approval of U.S. Trust and subsequent applications was subject to several conditions. The first was that the parent company would not operate the demand deposit-taking activities "in tandem with any other subsidiary or other financial institutions" while the second prohibited linking "in any way the demand deposit and commercial lending services."^a Both these conditions sought to isolate the deposit-taking or commercial loan activities of the nonbank banks from those of the bank subsidiary. The third condition prohibited the nonbank bank from engaging "in any transactions with affiliates without the Board's approval" except the payment of dividends to the parent company or a capital infusion by the parent company. Several bank holding companies with pending applications argued that the third condition was too restrictive and requested that the Board consider certain limited transactions between nonbank banks and other affiliates. In response, the Board held an open meeting in January, 1985 to discuss the possibility of approving various internal support services, such as data processing or accounting, as well as check clearing or trust services. Shortly thereafter, similar proposals to relax these back office restrictions were put out for public comment.

The other major way that the Fed has tried to close the loophole, besides urging action by Congress, has been to broaden the definition of a bank. After all, there are many different kinds of deposits that a bank may offer in addition to demand deposits, and many types of loans besides commercial loans; thus a nonbank bank can still offer a wide range of basic products. In a revision to Regulation Y, the Fed details its definition of both commercial loans and deposits for the purposes of the BHCA. In the commercial loan area, the Fed tried unsuccessfully to include purchased funds—such as federal funds, repurchase agreements, and Eurodollars—in a broader definition that would pull more institutions under the holding company umbrella. Similarly, the Fed sought to expand the definition of demand deposits to include NOW accounts. Neither of these expanded definitions was accepted at the federal district court level, and the Federal Reserve has appealed to the Supreme Court to rule on the definition of demand deposits and commercial loans under Regulation Y.

^aBoard of Governors of the Federal Reserve System, Open Meeting Agenda, January 9, 1985.

specific legislation.¹¹ But if a nonbank bank is not a bank under the BHCA, then these state laws do not address them and thus do not expressly permit or prohibit their establishment or acquisition. Federal regulators approved national charters for nonbank banks in the various states because they felt they had no alternative under the current definition of a bank under the federal BHCA. But in approving nonbank banks, these regulators have expressed a strong desire to see Congress enact legislation that explicitly either permits or prohibits them. Most state banking authorities agree that they would like to see Congress resolve the uncertainty by passing legislation bringing these nonbank banks under the federal BHCA. Such action would end what states perceive as a federal intrusion on their authority and would allow states, under the Douglas Amendment, to pass laws permitting bank holding companies to establish a nonbank bank, or not, as states choose.¹² But attempts to close the loophole in Congress have not succeeded because of the difficulty in separating this issue from others central to banking, such as expanded bank powers, interstate restrictions, and Glass-Steagall. In the meantime, however, these battles are being fought in the courts, which

¹¹In this regard, various states have passed laws inviting bank holding companies located in nearby states to enter; currently half the states have some sort of a regional or reciprocal interstate banking law. These regional pacts must address some important issues, such as how and when to go nationwide, before proceeding smoothly. Moreover, these regional agreements depend upon the sometimes slow-moving state legislatures, and many states have not acted to relax their borders at all. Congress also is considering several interstate banking bills which would permit states to enact regional or reciprocal banking laws. Several of the legal issues were resolved when the Supreme Court upheld the constitutionality of several New England states' regional banking laws in *Northeast Bancorp, Inc. vs. Board of Governors*, No. 84-363.

¹²However, ownership by a nonbanking organization may not be fully covered under these state laws and may require separate legislation. One important question is whether the parent company would be considered a bank holding company subject to restrictions under state law.

have gone a good distance toward stopping the nonbank bank movement. (See COURT CHALLENGES TO NONBANK BANKS.)

The lack of legislation at the federal level undoubtedly has encouraged state legislatures to pass their own laws to regain control of their borders. States view this nonbank bank issue as a states' rights issue, and they want the flexibility to address it in their own way. At present, several states—including Florida, New Jersey, Colorado, North Carolina, Virginia, Maryland, and Connecticut—have passed laws which in some ways restrict the chartering of nonbank banks within their borders. Several more state legislatures are considering similar laws, while others are reinterpreting their current banking laws to handle the nonbank bank issue. Often the thrust of these actions has been to revise the definition of a bank and to prohibit organizations from acquiring the entities that meet the revised definition. But there is no consensus among the states on how to proceed on this issue. That is illustrated well by the tri-state area. New Jersey, Pennsylvania, and Delaware have each attempted to address this nonbank bank issue in a different way.

New Jersey. Bankers in New Jersey have experienced statewide banking and multibank holding companies for over a decade. Since New York is so close, brokerage houses and banks based in New York find northern New Jersey a convenient location in which to expand their banking business. In fact, five of the first six applications for nonbank banks to receive final approval from New Jersey state authorities were all from brokerage and investment banking houses in New York (see Table 2, p. 8). Most of these planned to have their nonbank banks accept deposits. Bankers in New Jersey, however, have grown concerned about protecting the local deposit base and associated customer relationships from the threat of deposit-taking nonbank banks. Commercial loans were perceived to be less threatening, perhaps because the commercial loan market operates to a large extent outside the local market and banks in New York already

COURT CHALLENGES TO NONBANK BANKS

Independent Bankers Association of America, Community Bankers of Florida, Inc., Florida Bankers Association, Barnett Bank of Jacksonville, Barnett Bank of Martin County vs. C.T. Conover, U.S. District Court, Jacksonville, Florida, No. 84-1403, February 15, 1985.

These groups of banks are challenging the Comptroller's authority to issue national bank charters for nonbank banks on the ground that these entities are not eligible for such charters. The district court issued a preliminary ruling which prohibited the Comptroller from issuing final charters to nonbank banks, although preliminary approvals were still permitted. As a result, within a month, the Federal Reserve Board announced it would suspend processing of applications that were pending from bank holding companies, citing the court's decision, which, "unless reversed or limited, eliminates the ability of bank holding companies to open nationally-chartered nonbank banks."

The court considered several factors in its preliminary ruling. One major issue is whether associations that do not have powers both to accept demand deposits and to make commercial loans are engaged in the "business of banking" within the meaning of the National Bank Act. Here the court found that demand deposits and commercial loans are core activities in the banking business; both powers are essential for a financial institution to receive a national bank charter. Another important argument that the court found persuasive bears on the two exceptions Congress has made in the chartering of national bank associations. These exceptions are trust companies, which manage and invest their clients' funds, and bankers' banks, which coordinate and buy and sell various banking services for their member banks. Congress, recognizing that both of these associations did not engage in the business of accepting demand deposits and making commercial loans, authorized specific amendments to the National Bank Act which allowed the Comptroller to charter these so-called "limited charter institutions." By analogy, the court argued that the Comptroller should seek Congressional authority to charter nonbank banks. Finally, the court disagreed with the Comptroller's contention that he really was issuing full charters to nonbank banks, and that such associations voluntarily agree to limit the exercise of those powers. Instead, the court argued that when nonbank banks apply for final approval from the Comptroller, legally they have given up one of the two powers, resulting in substantially the same outcome as if the charters were limited.

Independent Bankers Association of America vs. Federal Reserve Board, U.S. District Court, Washington, D.C., No. 84-3201, February 27, 1985. This court ruled that the Comptroller does have legal authority to issue final charters for nonbank banks to Dimension Financial Corporation, a Denver subsidiary of Valley Federal Savings and Loan Association. Rather than address the National Bank Act issue, the court decided whether the BHCA applies to the Dimension charters. In this case, the court found that the Dimension charters for nonbank banks did not raise a substantive question under the BHCA, and therefore the proposal was not subject to Fed jurisdiction. Although this court ruled the Comptroller acted properly, the conflicting ruling of the Florida court appears to override it.

Florida Department of Banking and Finance and Florida Bankers Association vs. Federal Reserve Board, U.S. Court of Appeals, Eleventh Circuit, No. 84-3269, May 20, 1985. In this important ruling, the federal appeals court overturned the U.S. Trust case, in which the Fed approved, subject to several conditions, the conversion of a trust subsidiary into a nonbank bank that did not make commercial loans. The court relied upon Congressional intent, rather than a literal interpretation of the amendments to the BHCA, in its finding that a limited purpose bank is indeed a bank under the Douglas Amendment to the BHCA. Apparently, the ruling prohibits the Fed, and by extension the Comptroller, from approving such nonbank bank applications unless the state expressly permits such entities. In September, the U.S. Department of Justice filed a brief with the Supreme Court urging them to revise the appeals court ruling on U.S. Trust. The Solicitor General argued that Congress intended to include commercial loans as a necessary element in the two-part definition of a bank.

cover the New Jersey markets to some extent. Further, bank holding companies already are allowed to open commercial finance subsidiaries, which, to some degree, can be viewed as a substitute for a nonbank bank that retains commercial loans. Therefore, deposit-taking institutions were thought to pose a greater threat to home-state banks in New Jersey than commercial lending operations in terms of new competition.

In February, 1985, the Governor of New Jersey signed a one-year moratorium effectively prohibiting companies from establishing new deposit-taking nonbank banks.¹³ This bill broadens the definition of a bank to include any organization in New Jersey that accepts deposits that are insured by the Federal Deposit Insurance Corporation (FDIC), including NOW accounts. Under the legislation, a bank holding company is permitted to control a New Jersey bank if such a bank also fits the definition of a bank under the federal BHCA. The interpretation is that a nonbank bank which accepts demand deposits or NOW accounts (but does not make commercial loans) qualifies as a New Jersey bank but does not fit the federal BHCA definition; therefore it cannot be controlled by a bank holding company. Further, other companies which are not bank holding companies, such as Merrill Lynch, also are not permitted under this law to control a bank with FDIC-insured deposits. As mentioned, the law does not prohibit the establishment of a nonbank bank which keeps the commercial loan side but does not accept insured deposits. This type of nonbank bank does not meet the criterion for a New Jersey bank and thus is not addressed by the statute. Accordingly, both bank holding companies and other organizations can acquire nonbank banks that retain commercial loans.

The New Jersey law grandfathers any organization or bank holding company which, on January 1, 1985, controlled a bank or had received final approval from state or federal regulators to

control a bank. As a result, the nonbanking companies that have received approval from the New Jersey state banking commissioner to establish nonbank banks can continue to operate them, although no more deposit-taking banks will be allowed to enter. On January 1, 1986 the act expires. By that time, the backers of the bill expect that Congress will have acted to resolve some of the issues raised by nonbank banks.

Pennsylvania. Though more than 11 institutions have applied to establish nonbank banks in the state, Pennsylvania wants no part of them. Most banks still are busy coping with the 1982 Pennsylvania banking law, which allowed the formation of multibank holding companies and expanded branching privileges. A regional banking bill also is under serious consideration, and most parties believe that alternative is a better approach to out-of-state institutions. Rather than propose new legislation to prohibit nonbank banks, Pennsylvania's Department of Banking has chosen to interpret existing law. It contends that the 1982 law is sufficient for its purposes. That law defines an "institution" as "a national bank whose principal place of business is located in Pennsylvania" or as a Pennsylvania bank, or bank and trust company, which receives demand deposits.¹⁴ The Pennsylvania Department of Banking has interpreted the term "institution" to include nonbank banks. Further, only Pennsylvania bank holding companies are allowed to control such institutions, and to qualify, holding companies must conduct their business principally in Pennsylvania. This means they must hold the largest amount of deposits of their banking subsidiaries in Pennsylvania, effectively prohibiting an out-of-state bank holding company from controlling a nonbank bank. In-state bank holding companies, though allowed to control a nonbank bank, would have to count it as one of their four banking subsidiaries permitted under the 1982 Pennsylvania banking act. That option would not appear very attractive compared to

¹³New Jersey PL1985, Chapter 39, Statement, signed February 4, 1985.

¹⁴Purdon's Statutes, 7 P.S. 115a.

acquiring a full service bank subsidiary.

Several issues remain unresolved concerning Pennsylvania's interpretation of the current law. One issue is whether other financial organizations, such as Sears or American Express, are also excluded from controlling nonbank banks under this interpretation, since they do not qualify as a Pennsylvania bank holding company. A second issue is whether a commercial-loan nonbank bank is prohibited as well as one that accepts demand deposits. Since an institution is defined as a bank, or bank and trust company, that receives demand deposits, one possible interpretation, similar to the New Jersey law, is that nonbank banks that make commercial loans are not covered by the law, and thus are not prohibited. Another item of contention concerns whether NOW accounts would be included in the demand deposit definition, as the Department of Banking argues, or whether NOWs are a different entity, as a federal court recently found.¹⁵

Delaware. Delaware has a history of trying to attract out-of-state banks, and they have continued to build their financial service industry via legislation. Consistent with this strategy, Delaware has not prohibited nonbank banks that either accept demand deposits or make commercial loans; both types currently operate within the state. Of course, under the Financial Center Development Act passed in 1981, Delaware invited out-of-state banks to establish limited purpose subsidiaries in the state (such as credit card subsidiaries), provided they did not compete for local depositors and met certain capital and employment conditions.¹⁶ Other legislation followed that invited the formation of commercial credit banks within the state. Given this encouragement to out-of-state institutions to locate

special banking subsidiaries in Delaware, it's clear that the state looks favorably upon nonbank banks, particularly those that grant commercial loans. They have welcomed both bank holding companies and other institutions, such as Sears.

In sum, Pennsylvania, New Jersey, and Delaware represent different views on nonbank banks. Each state wants to address the issues of interstate banking and to experiment in its own fashion. Nonbank banks have prompted states to examine under what conditions they might permit out-of-state entry into banking, what kind of interstate banking they might allow, and how to make the transition.

SUMMARY

Are nonbank banks a passing fad or a lasting legacy? The Comptroller has approved over two hundred of them. Bank holding companies appear to view nonbank banks as an entree into other states where they cannot currently establish bank subsidiaries, and other financial institutions view them as a chance to enter banking via a banking-type subsidiary. Looking to the future, it's not likely that these entities will remain in their current form during the next five years. More likely, they are a transition vehicle to interstate banking and simply take advantage of the particular Bank Holding Company Act loophole that exists now. Congress is considering legislation to close the loophole and may include a provision to prohibit these nonbank banks retroactively, albeit with a grandfather clause for those established before some cut-off date. At the same time, state legislatures certainly are acting to exert their right to decide such issues. The courts, too, are playing a major role, as in the reversal of the U.S. Trust case; recent court rulings have rejected a literal interpretation of the bank definition under the BHCA. As a result, there is a reasonable chance that this limited purpose bank loophole will be closed soon; those nonbank banks currently operating will either be grandfathered or divested.

Even if nonbank banks do not survive in their present form, they still will have a lasting effect

¹⁵The Supreme Court has agreed to hear *Dimension vs. Federal Reserve Board* where the issue is the Federal Reserve's authority under Regulation Y to expand the definition of demand deposits to include NOW accounts.

¹⁶See Janice M. Moulton "Delaware Moves Toward Interstate Banking: A Look at the FCDA", this *Business Review*, (July/August 1983), pp. 17-25.