Nonbank Banks: A Legitimate Financial Intermediary Emerges From The Bank Holding Company Act Loophole

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Nonbank Banks: A Legitimate Financial Intermediary Emerges From The Bank Holding Company Act Loophole.

Nonbank banks represent the financial institutions' recent attempt to avoid the regulations of the Bank Holding Company Act. The evolution of the nonbank bank illustrates the vitality of financial markets and technological change. While banking regulatory statutes have remained static, the dynamics of technology and electronic banking have allowed financial institutions to transcend the state's traditional borders. When static federal regulations began to choke profits, financial institutions sought alternatives to traditional banking. The financial institutions stretched the fabric of banking regulations to their extreme, and the nonbank bank emerged through a loophole in the Bank Holding Company Act. This article explores the development and impact of nonbank banking.

I. INTRODUCTION

Financial institutions are at the core of the capitalist free-enterprise system.1 Through the United States financial system flows the money that builds our cities, creates our wealth and provides for the American way of life.2 The entire system is regulated3 and con-

1. For WESTLAW® research select the ALLFEDS or NTP database and use this search query:

Nonbank & “Bank Holding Company Act” or B.H.C.A.

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This article examines the case law regarding nonbank banks. Although the term “nonbank banks” seems to be a redundant anomaly, the Federal Reserve defines the terms “nonbank” and “nonbank banks” differently. For the Federal Reserve, a “nonbank bank” is a depository institution, and as such must hold reserves with the Federal Reserve. In contrast, the term “nonbanks” is given a broad general definition by the Federal Reserve and may include nondepository institutions which are not required to hold reserves with the Federal Reserve. This article adopts the definitions used by the Federal Reserve. Thus, the term “nonbank banks” as used in this article refers to depository institutions, unsupervised by the Federal Reserve under the Bank Holding Company Act, yet required to hold Federal Reserves.

2. Banks create the “money” that exists in the economy by acting on the incentives of the Federal Reserve’s actions. Economists express these actions as a mathematical equation called the multiplier effect. The multiplier effect is easy to illustrate: if a bank is required to hold 10% reserves and a customer deposits $100, then the bank will retain $10 and attempt to loan out the remaining $90. When the loaned money is deposited in another bank, $9 will be retained for reserves and the remaining $81 will be loaned out. This scenario repeats itself until the funds are exhausted through a series of banks throughout the economy. The Federal Reserve Bank is the agency which acts as the central controller of the United States banking system. See generally L. AUERNHEIMER & R. EKELUND JR., THE ESSENTIALS OF MONEY AND BANKING (1982).

3. For the average Sam Saver, the control that the Federal Reserve Board has is
trolled by a dual tiered system of state and federal laws which frequently overlap. These laws represent the efforts of legislators to provide stability and safety to an important economic sector.

Today the nonbank bank represents a new form of institution in the financial system. A nonbank bank is a financial institution which does not engage in commercial lending but maintains only nondemand deposits. Since the nonbank bank is technically not a bank, it is not subject to the usual morass of federal and state legislation. Through careful structuring, relevant case law, and a loophole in the Bank Holding Company Act, the nonbank bank has become the major vehicle for large banks and retailers to expand into the financial institution arena. Unlike banks, nonbank banks have the

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not noticed until it has affected the overall economy. Most citizens behave like a Sam Saver and deposit their money in what they believe to be a bank. Yet, the financial institution where Sam Saver deposits his money may not be a bank at all. See generally infra note 8.

4. The Federal Reserve Board is the agency which implements the fiscal policy of the United States. It has the fiscal tools necessary to expand or to contract the economy. The Board controls the economy through four basic sets of controls. The first is the general regulating power that is granted through the Bank Holding Company Act of 1956, 12 U.S.C. § 1841 (1982). The three remaining controls are reserve requirements, federal funds rates, and the discount window. These items are most threatened by the increasing number of nonregulated nonbank banks. See L. AUERNHEIMER & R. EKELUND, JR., supra note 1, at 231, 242-46. If the economy is growing too slowly, the Federal Reserve Board may drop the discount rate to increase investment spending and employment. See Fed Lowers Loan Rate; Prime Drops, L.A. Times, Mar. 8, 1986, at 1, col. 5.

5. The dual tiered system of banking evolved from the natural division of power through federalism. Today, the system is composed of the federal system of regulations and the fifty state systems of regulations. The federal regulatory framework consists of essentially three administrative regulatory agencies: the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation. CONGRESSIONAL RESEARCH SERVICE, THE LIBRARY OF CONGRESS, 98TH CONG., 1ST SESS., FORMATION AND POSERS OF NATIONAL BANKING ASSOCIATIONS — A LEGAL PRIMER 1-10 (Comm. Print 1983).

6. The federal regulators include the Federal Reserve Board, the Comptroller of the Currency, and the federal insurance agencies. Id.

7. Id.


10. Id.
12. The identities of the large United States nonbank banks are surprising and sometimes unconnected with the thought of banking. The nation's largest retailer con-
ability to develop a nationwide interstate network.

This article will examine the development and merging concepts of nonbank banks, nonbanks, and interstate nonbank banking. The discussion will initially focus on the historical growth and control of the financial system. Secondly, actual federal and state legislation and corresponding case law, which prompted the evolution of the nonbank bank, will be discussed. Finally, there will be a review of the impact of the nonbank bank on the future of interstate banking.

II. THE STRUCTURE OF THE U.S. NONBANK BANKING SYSTEM

A. The Framework of Regulations

The failure of banks during the era of the Great Depression prompted the legislators to break up large banks which engaged in securities underwriting, insurance, and banking.\(^ {13} \) At the time the laws were proposed, the general citizenry of the United States lacked confidence in the existing financial system and was reluctant to process transactions through it.\(^ {14} \) By breaking up conglomerate financial

glomerate, Sears, Roebuck & Co., is often cited as the most aggressive newcomer to nonbank banking. Sears is developing its “Discover Card” to be a major competitor to Visa and Mastercard. With this card, customers can access automated teller machines at 5,428 locations and 800 retail stores nationwide. The card will connect customers with the Sears Financial Network, allowing them access to savings and money market deposit accounts, certificates of deposit, and IRA’s. J.C. Penney Co. also operates limited service banks. See Cahan & Ellis, Nonbanks: Who’s Getting The Bucks – and Who’s Not, Bus. Wk., Feb. 10, 1986, at 57. These types of nonbanks are usually referred to as consumer lenders. The group includes the insurance-brokerage giants such as Prudential/Bache/PruCapital, American Express, and Merrill Lynch. The consumer lending of the auto companies, such as Ford Motor and General Motors, is also considered nonbanking. In addition, the list includes the big names associated with lending and banking like BankAmerica Corporation, Citicorp, First Interstate Bancorp, Security Pacific Corporation, Beneficial Corporation, Wells Fargo & Co., and Crocker National Corporation. K. COOPER & D. FRASER, BANKING DEREGULATION AND THE NEW COMPETITION IN FINANCIAL SERVICES 199 (1980).

Nonbanks that are categorized as consumer lenders may see their profits shrink on credit card operations due to the new tax code. Under the new code, consumer interest is no longer deductible. See Tax Reform Act of 1986 Pub. L. No. 99-514, § 511(b), 1986 U.S. CODE CONG. & ADMIN. NEWS Pamphlet 9A, 162 (100 Stat.) (to be codified at I.R.C. § 163) (disallows deductions for nonbusiness interest expense). Yet, traditional equity loans, usually made by a bank, retain their deductibility. See id. § 511(b)(b)(D). Thus, consumers may have a tax incentive to use equity loans, instead of nonbank consumer credit cards.


14. The depositors of large banks often created the collapse of their own institutions by causing a “run” on the banks’ reserves. In the 1930’s, the banks were still
institutions and creating the Federal Reserve Banking System, Congress restored the public's confidence in the financial system.\textsuperscript{15}

1. The Douglas Amendment

The Douglas Amendment\textsuperscript{16} to the Bank Holding Company Act grants individual states the power to control interstate banking.\textsuperscript{17} The amendment removes the Federal Reserve Board's power to approve any acquisitions by a bank holding company or a bank in one state or banks in another state,\textsuperscript{18} unless certain conditions are met. The Act confers upon the states the power to grant interstate banking by providing for it in specific statutory language. The amendment, however, still retains a dual tiered system of federal and state regulation. Thus, if the states specifically provide for interstate banking, the Federal Reserve Board must still approve any interstate acquisitions under the Bank Holding Company Act.\textsuperscript{19}

In \textit{Huston v. Board of Governors of the Federal Reserve System},\textsuperscript{20} the Eighth Circuit interpreted the Federal Reserve Board's authority and responsibility when the Douglas Amendment interacts with state law. The \textit{Huston} case concerned the acquisition of nonvoting shares in Iowa bank holding companies by out-of-state bank holding companies.\textsuperscript{21} The Board concluded that the two transactions did not need Board approval because only nonvoting shares were involved. Huston, the superintendent of banking for the State of Iowa, appealed the decision as a violation of both the Douglas Amendment and Iowa

\textsuperscript{15} As the United States left the gold standard, the economy boomed and almost all sectors of the economy prospered. The resurgence in the economy made many citizens feel more secure, although the banks were only slightly safer. \textit{Id}.

\textsuperscript{16} \textit{Id.} at 277.
The court determined that there were three basic levels of protection provided by the Bank Holding Company Act to prevent undue control and concentration through interstate banking acquisitions. First, section three of the Act gave the Board wide supervisory discretion to control the indirect and direct acquisitions of banks by bank holding companies. Thus, if a bank or holding company wanted to be acquired or controlled, the Board gave its approval as required. Second, Board approval was also required for stock acquisitions by bank holding companies if more than five percent of the outstanding stock was obtained after the acquisition. The Board was given the power to determine whether a bank holding company "exercises a 'controlling influence over the management or policies of [another] bank or company.'" The third level of protection granted by the Douglas Amendment was the state power to "check undue concentrations of banking resources." Thus, the Act provided two federal checks and one state check against banking concentration.

The Eighth Circuit disagreed with the superintendent's claims and described the Board's duties under the Douglas Amendment. First, the court determined that every application for an interstate acquisition need not be approved by the Board. The court rejected the superintendent's claim that the Douglas Amendment required the Board to give mandatory review to all acquisitions by holding companies. Instead, the court adopted a limited view of the Board's role under the Amendment. The court interpreted the Douglas Amendment as pertaining only to mandatory Board approvals under the Bank Holding Company Act. In Huston, the Board was not required to grant approval since the Douglas Amendment did not apply.

Second, the court determined that mandatory review by the Board was conditioned on "direct or indirect ownership or control of the corporation whose shares were being purchased." The superintendent argued that the statute was to be read broadly so as to re-
dent argued that since the acquisition application before the Board involved the same company acquiring a nonvoting interest, the Board should review the application. However, in this case, there was no evidence that the companies purchasing nonvoting shares could exercise any substantial degree of control. Without proof of the requisite element of control, the Board was not required to act under section three of the Act. Thus, absent mandatory review by the Board, the Douglas Amendment could not apply. While acknowledging that there may be dangers involved in “nonvoting equity investments,” the court found that the Board had acted properly. Finally, since the Douglas Amendment did not apply, the Board was not required to test the transactions under state law.

Third, the court determined that the Board was only required to grant limited hearings in reviewing interstate bank transactions. The superintendent argued that the Board was required to grant formal evidentiary hearings. However, the court found that under the Act, the Board was required to grant formal evidentiary hearings only when material facts were in dispute. Thus, since there were no material facts in dispute in this case, the Board properly refused the superintendent’s request for a hearing.

a. Interstate Financial Acquisitions

In Northeast Bancorp, Inc. v. Board of Governors of the Federal Reserve System, the United States Supreme Court interpreted the powers and limitations of the Douglas Amendment. Northeast concerned state legislation which attempted to limit interstate bank acquisitions to one geographic area. Massachusetts and Connecticut provided for the interstate acquisitions of out-of-state bank holding companies. The holding companies could acquire an out-of-state holding company only if the particular state had a reciprocal statute.

In this case, the states wanted to keep interstate banking limited to bank holding companies with their principal place of business in the northeastern section of the United States. They claimed that the

quire Board review of applications, regardless of control. However, the court applied a much narrower view. It determined that to prompt mandatory review, the holding company would have to create a subsidiary in the company whose shares were being acquired. Id. at 281.

31. Id. at 282.
32. Id. at 283.
33. Id.
34. Huston, 758 F.2d at 284.
36. See infra notes 143-46.
37. A reciprocal state statute allows interstate acquisitions only if the state where the purchasing bank has its principal place of business allows the same type of interstate purchases.
Douglas Amendment allowed the restrictive state legislation. Northeast Bancorp, however, claimed that the acquisitions permitted under these statutes were prohibited by the Bank Holding Company Act and violated the compact, commerce, and equal protection clauses of the United States Constitution. 38

The Court found that state reciprocal interstate banking statutes did not violate the commerce clause. 39 Since Congress had spoken on the issue of interstate commerce, there were no dormant commerce clause issues in Northeast. The Court admitted that if the states had acted alone to prevent out-of-state acquisitions, such actions would have violated the commerce clause. The Court noted, however, that Congress can validate a commerce clause violation. Hence, when Congress legislates in such a manner, "state actions which it plainly authorizes are invulnerable to constitutional attack under the Commerce Clause." 40 Thus, the interstate banking statutes did not violate the commerce clause.

The Court also rejected Northeast's claim that the statutes violated the compact clause. 41 The Justices explained that the compact clause was intended to prevent the states from obtaining too much political power. The inherent problem in such compacts is that they raise the possibility of the states "encroach[ing] upon or interfer[ing] with the just supremacy of the United States." 42 The Court proceeded to describe several "indicia" which would show that an unlawful compact existed. Since the Court found no such "indicia," the statutes did not enhance the political power of the New England states and there was no violation of the compact clause. 43

The Court also failed to find a violation of the equal protection clause. 44 The Court based its decision on the rationale that the states were "not favoring local corporations at the expense of out of state corporations." 45 Rather, since banking has traditionally been regarded as a local concern, the Court distinguished out-of-state corporations domiciled in New England from other out-of-state corporations. In this case, the states were attempting to legislate for two important purposes: increasing the number of banking institu-

39. Id. at 2553-54.
40. Id. at 2554.
41. Id. (referring to U.S. Const., art. 1, § 10, cl. 3).
42. Northeast, 105 S. Ct. at 2554.
43. Id. at 2554-55.
44. Id. at 2555-56.
45. Id. at 2555.
tions to spur competition, and retaining local control over banking.\textsuperscript{46} Since the states were protecting a legitimate state interest of local banking, the Court found no equal protection violation.\textsuperscript{47}

2. The Bank Holding Company Act

The Federal Reserve Board is the major administrative unit which creates and implements the regulations necessary to put the Bank Holding Company Act into effect. The Board, in its regulatory function, attempts to determine Congress' intent regarding the shape of the banking industry. Historically, the Board has seen itself as the protector of the “public interest” and caretaker of the entire United States financial system. Pursuing its role as protector, the Board has aggressively attempted to create regulations which effectively control the banking industry. However, the Board has often exceeded congressional intent regarding its regulatory function, only to have the lower courts overrule its attempts.

The case of \textit{Western Bancshares, Inc. v. Board of Governors of the Federal Reserve System}\textsuperscript{48} serves as a prime example of the Board's aggressive regulatory efforts. In \textit{Western}, the Board attempted to regulate the price a bank holding company paid to gain control of a bank.\textsuperscript{49} The investing group in \textit{Western} used a strategy whereby they first purchased the controlling interest in the bank from the majority stockholders at a high price. After the investors gained a controlling interest, they then purchased the remaining minority interests at a price two-thirds less than the price at which the majority interests had been acquired. The Board found that this type of undisclosed transaction violated policy. Therefore, it denied the bank holding company's acquisition and directed the company to divest itself of the bank.\textsuperscript{50}

The Tenth Circuit rejected the Board's interpretation of its regulatory powers under the Bank Holding Company Act.\textsuperscript{51} The court found that the Board's action did not further the needs of the community, or prevent monopolies, overcompetition, or restraint of trade. Under the Act, these were the only standards Congress pre-

\textsuperscript{46} Id. at 2555-56.
\textsuperscript{47} Id. at 2556.
\textsuperscript{48} 480 F.2d 749 (10th Cir. 1973).
\textsuperscript{49} Id. at 751.
\textsuperscript{50} The investor bank holding company purchased 77\% of the bank's shares at $521.51 per share and 6\% at $400 per share. The remaining 17\% was purchased at $160-$164 per share. Id. at 750-51. This action violated the Board's policy of extending offers to "all stockholders of the same class on an equal basis." Id. at 751.
\textsuperscript{51} The Board contended that section 1842(c)(2) gave the Board broad powers to regulate for the "public interest." Under this "public interest," the Board believed that it had the power to regulate the acquisition prices, a position backed by the American Bankers Association. Id. at 752.
scribed for the Board to apply. The court found that the Board had interpreted its powers too broadly; the Act did not specifically give the Board the power to protect minority shareholders. Thus, since the Board lacked any statutory authority, either express or implied, the court set aside the Board's order.

III. THE PROSPERING CONCEPT OF NONBANK BANKING

A. Financial Institutions Exploit the Bank Holding Company Act Loophole

The Board attempted to apply these same aggressive regulatory practices to nonbank banking. In Wilshire Oil Company of Texas v. Board of Governors of the Federal Reserve System, the Board sought to prevent Wilshire from changing a bank into a nonbank bank. Wilshire had operated as an oil company and owned a subsidiary bank, the Trust Company of New Jersey. Thus, Wilshire was considered a one bank holding company subject to the Bank Holding Company Act. In 1970, Congress amended the Act and gave such one-bank holding companies ten years to divest their nonbanking subsidiaries or their banking operations. Under the amended version of the Act, Wilshire had to divest the oil and gas business or cease to be a bank holding company. Instead, Wilshire attempted to change its bank to a nonbank bank. The trust company operated by taking demand deposits and making commercial loans. In order to become a nonbank bank, Wilshire attempted to change its demand deposits to negotiable order of withdrawal (NOW) accounts. Under the 1970 amendments, if the trust company offered NOW accounts to its customers, it would be considered a nonbank bank exempt from regulation by the Board.

The trust company sent a letter to every customer reserving “the

52. Id. at 753. See also The Bank Holding Company Act, 12 U.S.C. § 1841(c) (1982).
53. Western, 480 F.2d at 753.
54. Id. at 752, 754.
56. The Wilshire Oil Company owned 90% of the Trust Company of New Jersey. Id. at 732-33 n.2.
57. Id. at 732-33. Originally, the Act regulated only holding companies that controlled more than one bank.
58. Id. at 733. Wilshire made its attempted restructuring of the bank on November 20, 1980. The 10 year divestment period of the Act expired on December 31, 1980. The change to NOW accounts seemed like a last minute effort to evade the Act. Id. at 733-34.
59. Id. at 736.
right to require 14 days notice prior to withdrawal from its transac-
tional accounts." However, the letter also stated that the trust com-
pany had no intention of exercising the prior notice requirement.
The only other change the Trust made was a description change on
its forms; no other changes were made in the company's deposit or
commercial loan activities. The Board ordered Wilshire to divest
the banking or oil business and did not agree that the trust company
was a nonbank bank. Wilshire argued that this was an over-expansion
of the Board's regulatory power.

The court distinguished the “transactional accounts” the trust com-
pany was offering from the traditional NOW accounts. The court
found the two accounts distinguishable since the transactional ac-
counts paid no interest. Utilizing this difference, the court con-
cluded that this type of account was not excludable under the Act.
Furthermore, relying on legislative history and congressional intent,
the court concluded that the trust company was to be included in
Congress’ definition of a “bank” under the Act.

Although the court held that the accounts were demand deposits,
the more important aspect of the decision involved the company’s at-
ttempt to evade the Act. The Board has the express regulatory power
to prevent evasions of the Act. The court believed this power au-
thorized the Board “to look behind the form of TCNJ’s activities to
their substance . . . .” Since Wilshire was attempting to change its
contract with its transactional accounts, the court found no harm in
allowing the Board to “penetrate the form of the contract to the un-
derlying substance of the transaction.” The Third Circuit was con-
cerned with the abuses the Act was designed to prevent, and allowed
the Board to regulate Wilshire to prevent evasion of the Act’s pro-
visions.

Under the Wilshire rationale, it appeared that a nonbank bank
would always be subject to regulation by the Board. In First Bancor-

60. Id. at 733-34.
61. Id. at 734. Wilshire argued that this provision prevented its customers from
having a legal right to withdraw. If there is no legal right to withdraw, the accounts
would not be demand deposits. Id. at 735.
62. Id. at 734.
63. Id. at 736-37.
64. Id.
65. Id. at 737-38. The Federal Deposit Insurance Corporation’s general counsel
also concluded that the accounts were demand deposits. Id. at 737 n.10.
66. 12 U.S.C. § 1844(b) (1982). “The board is authorized to issue such regulations
and orders as may be necessary . . . and prevent evasions thereof.” Id.
67. Wilshire, 668 F.2d at 739.
68. Id. at 739-40 (quoting First Nat'l Bank in Plant City v. Dickinson, 396 U.S. 122,
137 (1969)).
69. Wilshire, 668 F.2d at 732, 740.
poration v. Board of Governors of the Federal Reserve System,\(^7\) the Board directly attacked the nonbank bank structure. The Board sought to extend the Wilshire ruling to all NOW accounts offered by nonbank banks. In First Bancorporation, Bancorporation applied for and was granted approval by the Board to acquire and operate an industrial loan corporation. Two years later the industrial loan corporation began offering NOW accounts.

1. Evading the definition of “bank” in the Bank Holding Company Act

The facts of First Bancorporation are similar to the Wilshire case. Like Wilshire, First Bancorporation changed the company’s structure to provide NOW accounts to customers. First Bancorporation, however, is distinguishable. As an industrial loan company, First Bancorporation was never considered a “bank” merely by changing demand deposits to NOW accounts. Thus, in an attempt to become a “bank,” First Bancorporation tried to acquire a second industrial loan company. The corporation planned to again offer NOW accounts through the newly acquired loan company. The Board determined that the second acquisition would be considered a “bank” under the Bank Holding Company Act and, therefore, would be ineligible for acquisition as a nonbank bank entity under “the Act.”\(^7\) The Board would grant the approval only if First Bancorporation did not offer NOW accounts through the new acquisition or if the new acquisition ceased its commercial lending. In either case, the Board insisted that the NOW accounts of both the first and second acquisitions be subject to reserve and interest regulations. Although First Bancorporation never purchased the second company, the Board insisted that its new policy announcement would no longer allow industrial loan companies to offer NOW accounts and commercial loans. Under the Board’s new policy, if both services were offered by an industrial loan company, the loan company would be considered a “bank.” The Board officially adopted the new policy and informed First Bancorporation, as well as other companies, that a nonbank bank would be considered a “bank.”

The Tenth Circuit resoundingly rejected the Board’s attempt to regulate industrial loan companies. The court found the NOW accounts were not demand deposits since Utah law required industrial

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\(^7\) 728 F.2d 434 (10th Cir. 1984).

\(^7\) Id. at 435. See also 12 U.S.C. § 1842(d) (1982).
loan companies to "reserve the legal right to demand notice prior to withdrawal." Since prior notice was reserved, thereby preventing customers from legally demanding "immediate payment," the accounts were not demand deposits. The court determined that there were substantive differences between NOW accounts and demand deposits; NOW accounts, as opposed to demand accounts, can pay interest, are limited to certain depositors, and cannot be subject to a legal right of withdrawal.

Additionally, the court found that the legislative history did not support the Board's interpretation. The court agreed that the Board had determined, in both 1963 and 1965, that NOW accounts were subject to reserve and interest regulations. However, the court pointed out that the Act was amended in 1966 after the Board's interpretation. The court ruled that NOW accounts offered by nonbank banks were not subject to reserve and interest regulations under the Bank Holding Company Act.

Finally, the court further struck down the Board's method of implementing the policy. The court noted that the broad "public interest" language of the Bank Holding Company Act did not allow the Board to make use of adjudicative orders as a "vehicle" to change general policy. Although acknowledging the importance of reserve and interest regulations, the court concluded that "the Board abused its discretion by improperly attempting to propose legislative policy by adjudicative order." Thus, according to the Tenth Circuit, nonbank banks were allowed to offer both commercial loans and NOW accounts, neither of which would be subject to regulation by the Board.

*Wilshire* and *First Bancorporation* illustrate the development of the nonbank bank, and the regulatory framework which nonbank banks seek to escape. The nonbank bank emerged from the Bank Holding Company Act's restrictions on bank financial activities. Congress initially created the Bank Holding Company Act to control the growth of banking and bank holding companies. The Act was created to "restrain the undue concentration of commercial banking resources and to prevent possible abuses related to the control of commercial credit." S. Rep. No. 1084, 91st Cong., 2d Sess. 24, reprinted in 1970 U.S. CODE & AD. NEWS 5519, 5541.

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72. *First Bancorporation*, 728 F.2d at 436.
73. *Id.* at 438.
which have control over banks.\textsuperscript{75} The Board’s scope of power ema-
nates from the Act’s definition, including the 1966 and 1970 amend-
ments, of the word “bank.”\textsuperscript{76}

B. The Legal Mechanics of Nonbank Banking

Relevant case law clearly indicates that nonbank banks evolved
from the complex set of interwoven regulatory laws that were
adopted from 1927 to 1956. These laws were enacted in an attempt to
control and stabilize the United States financial system. From the de-
pression of the 1930’s to the present day, the key legislation has at-
ttempted to separate financial activities into securities underwriting,
insurance, and banking.

The First Bancorporation case illustrates that nonbanks are finan-
cial institutions that place themselves outside the regulation of the
Federal Reserve Board\textsuperscript{77} by avoiding the definition of “banks” found
in section 2(c) of the Bank Holding Company Act of 1956.\textsuperscript{78} By
avoiding the definition of “bank,” the nonbank financial institution
can offer its customers financial services that banks are not allowed
to offer.\textsuperscript{79} In 1970, section 2(c) was amended\textsuperscript{80} to include a financial
institution in the definition of a bank if the institution “1) accepts de-
posits that the depositor has a legal right to withdraw on demand,
and 2) engages in the business of making commercial loans . . . .”\textsuperscript{81}
Additionally, it should be noted that nonbanks fall into two distinct
categories: 1) institutions that offer demand deposits but do not make
commercial loans, and 2) institutions that make commercial loans but
do not offer demand deposits.\textsuperscript{82}

The controversy surrounding the nonbank bank evolved through

\textsuperscript{75} The Act gives the Board the power to regulate “any company which has con-
\textsuperscript{76} The 1956 Act defined “bank” as “any national banking association or any State
bank, savings bank, or trust company . . . .” Pub. L. No. 84-511, 70 Stat. 133 (1956). In
1966 Congress amended the definition to include institutions that accepted “deposits
that the depositor has a legal right to withdrawal on demand.” \textit{Dimension}, 106 S. Ct.
at 685.
\textsuperscript{77} \textit{See generally First Bancorporation}, 728 F.2d at 434.
\textsuperscript{78} Id.
\textsuperscript{79} \textit{Dimension}, 106 S. Ct. at 683.
\textsuperscript{81} Bank Holding Company Act, 12 U.S.C. \$ 1841(c) (1982).
\textsuperscript{82} Lobell, \textit{supra} note 8, at 1196. The incentive to operate nonbank banks arises
since it allows financial institutions to offer a complete set of financial services. Depos-
iting cash, buying and selling securities, giving investment advice, and providing cash
management and trust services can simultaneously be offered by nonbank banks.
Banks, in contrast, cannot offer these services as one complete, financial package. \textit{Id}. 
the congressional and Federal Reserve Board definitions of "legal right to withdraw on demand" and "commercial loans." Since these words were consistently given a specific definition, the financial institutions were able to structure transactions outside the standard definitional parameters. The nonbank bank financial institutions began to operate in nondemand deposits, obtaining funds through federal funds and money market certificates.

In response to the narrow definition of deposits, these financial institutions developed NOW accounts. At first glance, the NOW account appears to operate like a checking account: a customer may deposit funds in an account, the nonbank bank may pay interest on such account, and the customer may negotiate withdrawals from the account with "checks." However, unlike demand deposits, non-banks banks place restrictions on the accounts by reserving the possibility of prior notice before allowing withdrawal. This prior notice provision prevents the account from coming within the definition of "demand" deposit in section 2(c) of the Bank Holding Company Act. Additionally, nonbank banks began trading in commercial instruments such as federal funds, certificates of deposit, and commercial loans.

84. *Id.* at 686-87. These are the key words that define a bank.
85. *Id.* at 688-89. The specific intent of Congress' giving a narrow definition is evident in the congressional reports. A senate report explained that a bank is an "institute that accepts deposits payable on demand (checking accounts) .... " S. REP. No. 1179, 89th Cong., 2d Sess. 7 (1966). The report explained that the definition was designed to determine "whether an institution is a commercial bank so as to exclude institutions like industrial banks and nondeposit trust companies." *Id.*
86. NOW is the acronym for Negotiable Order of Withdrawal. Originally, NOW accounts were developed in the northeastern states. Congressional action through the Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. §§ 1464(c), 1832(a), 3501-03 (1982), allowed NOW accounts to be offered through all depository financial institutions. See *K. Cooper & D. Fraser*, supra note 12, at 105-25.
87. See generally infra notes 112-17. In *First Bancorporation v. Board of Governors of Fed. Reserve*, 728 F.2d 434 (10th Cir. 1984), the Board attempted to classify NOW accounts as checking accounts. The Tenth Circuit rejected the Board's broad interpretation. *Id.*
88. See *K. Cooper & D. Fraser*, supra note 12, at 105-25.
90. Federal funds are "commercial bank excess reserves .... ordinarily held in the Federal Reserve Banks, which are borrowed and lent in a very short-term market." L. AUERNHEIMER & R. EKELUND, JR., supra note 1, at 284. The federal funds market represents the trading that occurs between banks with their excess reserves. Banks that are members of the Federal Reserve System are required to hold a certain percentage of their assets as reserves in the Federal Reserve Banks. These are the emergency reserves of the banks. The banks lend their excess reserves (federal funds) to banks that need more reserves. The excess reserve banks charge interest and earn income on their idle funds. Banks in need of funds can meet their reserve requirements with the federal funds they have borrowed overnight. This lending of federal funds increases the earnings of banks with excess funds and allows the banks with shortages to take remedial measures (such as liquidating assets to increase their reserves) to meet the Federal Reserve requirements. Small banks consistently have the excess funds to
cial paper,\textsuperscript{92} and bankers' acceptances;\textsuperscript{93} these are not traditionally considered commercial loans.

Since state nonbank banks could use various sources of funds and profits without coming under the definition of "commercial loan" in the Bank Holding Company Act, a careful structuring of its financial operations would allow a nonbank to avoid federal regulations. From the inception of the Bank Holding Company Act in 1956 until 1984, the Federal Reserve Board remained consistent in its interpretation of the definition of "demand deposit" and "commercial loan."\textsuperscript{94} However, in 1984, through an amendment to "Regulation Y," the Board attempted to bring nonbank banks under its regulations.\textsuperscript{95} The

\textsuperscript{91} Certificates of deposits are negotiable certificates which pay interest rates as a function of the length and size of the certificate as well as the reputation of the issuing bank. Certificates, in general, are an effort to attract more corporate deposits. The certificate itself represents a receipt for the time deposit at the bank. R. Johnson & R. Melicher, Financial Management 161 (5th ed. 1982).

\textsuperscript{92} Commercial paper is a short term debt instrument of large corporations which are held by banks. These debt instruments are highly liquid and are often held as secondary reserves by banks. The corporations sell these notes to financial institutions to obtain short term working capital. L. Auernheimer & R. Ekelund, Jr., supra note 1, at 285.

\textsuperscript{93} Bankers' acceptances are similar to commercial paper. They are short term notes issued by businesses to the banks for funding. The bank "accepts" the note which acts as a guarantee of the note. The business agrees to pay the holder a fixed amount at the maturity date on the note. If the business defaults on the payment, the bank that has "accepted" the note must pay the holder in full. Id.

\textsuperscript{94} The NOW account did not become a major deposit form until the late 1970's. The Federal Depository and Institutions Act of 1980 made NOW accounts an official form of savings account. See Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. §§ 1464(c), 1832(a), 3501-03 (1982); see also supra note 86. The Board advised Boston Safe Deposit & Trust Co. that purchasing "money market instruments" such as certificates of deposit, commercial paper & bank acceptances were not commercial loans under the Act. Letter from Michael A. Greenspan, Assistant Secretary, Board of Governors to Lee J. Aubrey, Vice President, Federal Reserve Bank of Boston at 2 (May 18, 1972), cited in Dimension, 106 S. Ct. at 687.


\textsuperscript{95} The Board feared the acquisition of nonbank banks by large corporate insurance, security, and commercial organizations. Dimension, 106 S. Ct. at 685 n.3. The Board believed nonbank banks were dangerous to the national banking system in
terms "demand deposit" and "commercial loan" were redefined by the Board so as to gain regulatory control over nonbank banks. The Board expanded its definitions under Regulation Y to include NOW accounts, federal funds, and money market certificates. The amendment defined "demand deposit" as a deposit which is "as a matter of practice payable on demand." This definition places NOW accounts and nonbank banks offering such accounts under the Board's control. In addition, the Board amended its definition of "commercial loan" to include "the purchase of retail installment loans or commercial paper, certificates of deposit, bankers' acceptances and similar money market instruments." While traditionally these items had not been considered commercial loans, the definitional change sought to reverse the prior stance. Congress was well aware of the changes occurring in the financial markets and elected not to expand the scope of the Bank Holding Company Act. However, the Board believed that the new definitions were necessary to carry out the Act's basic purposes of insuring an impartial credit system, preventing conflicts of interest, and avoid-

three respects. First, by avoiding federal regulations, nonbank banks had a competitive advantage over banks. Second, nonbanks were allowing banking operations to become closer to commercial operations. Third, the interstate banking laws were being circumvented by the interstate acquisitions of nonbank banks. See Regulation Y, 49 Fed. Reg. 794, 835-36 (1984).

96. *Dimension*, 106 S. Ct. at 685.
98. *Dimension*, 106 S. Ct. at 685. Most depository institutions seldom exercise their absolute right to require prior notice of withdrawal. The literal interpretation of "demand deposit" in the Bank Holding Company Act includes a "legal right" to withdraw on demand. This amended definition attempted to close this loophole.
100. The amended version of Regulation Y was first proposed in 1983. 48 Fed. Reg. 23,520 (1983) (codified at 12 C.F.R. § 225) (proposed May 25, 1983). The summary of the proposal explains the changes as an attempt to simplify and reduce the applications for nonbanking activities. The section which changes the definitions of "demand deposit" and "commercial loan" reads in pertinent part:

(A) "Demand deposits" means any deposit with transactional capability that, as a matter of practice is payable on demand, and that is withdrawable by check, draft, negotiable order of withdrawal, or other similar instrument;

(B) "Commercial loans" means any loan other than a loan to an individual for personal, family, household, or charitable purposes, and includes the purchase of retail instrument loans or commercial paper, certificates of deposit, bankers acceptances, and similar money market instruments, the extension of broker call loans, the sale of federal funds, and the deposit of interest-bearing funds.

102. See generally supra note 97.
ing the concentration of control. The Board realized that nonbank banks were becoming the “functional” equivalent of banks without regulatory control. Since the Act gave the Board the regulatory power to implement regulations, controlling nonbank banks seemed to be a logical regulatory extension.

1. The Dimension decision legitimizes nonbank banking

In Board of Governors of the Federal Reserve System v. Dimension Financial Corporation, the United States Supreme Court resolved the issue of amended Regulation Y’s effect on nonbank banking. The Dimension Corporation unveiled plans to acquire thirty-one national banks in twenty-five states. The banks would operate as nonbank banks by taking demand deposits and not making commercial loans. Under this umbrella of control, the Dimension Financial Corporation would effectively become an interstate nonbanking system. The Federal Reserve Board would be powerless to regulate the thirty-one nonbank banks since they would not be “banks” under the Bank Holding Company Act.

The Federal Reserve Board rejected the Dimension Financial Corporation’s applications. Under the amended form of Regulation Y, the Board determined that the Dimension applications were not nonbank banks but were instead banks. Since the amended regulation defines “demand deposit” as a deposit that is “as a matter of practice payable on demand,” the deposits of the Dimension nonbanks would be deemed deposits under section 2 of the Bank Holding Company Act. The corporation also intended to engage in money market transactions which, under the amended regulation, would be

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104. 49 Fed. Reg. at 841.
105. See generally supra note 94.
108. If a bank attempted the same type of corporate structure, it would run afoul of the purposes of the Bank Holding Company Act. See supra note 38. In addition, a bank would have to gain approval to bypass the McFadden Act and the Douglas Amendment.
110. Dimension first appealed to the United States Court of Appeals. See Dimension Fin. Corp. v. Board of Governors of Fed. Reserve System, 744 F.2d 1402 (10th Cir. 1984) (the Tenth Circuit rejected the Federal Reserve Board’s attempt to control nonbank banks through amended Regulation Y).
111. See supra text accompanying notes 16-27 & notes 38-44.
112. The banks which Dimension was seeking to acquire were only offering NOW accounts to their customers.
considered commercial loans. Thus, under amended Regulation Y, Dimension's transactions would meet both criteria of section 2(c) of the Bank Holding Company Act. The ultimate result would be a classification of the corporation's acquisitions as banks, a determination which would subject Dimension to the Board's regulation.

In Dimension, the United States Supreme Court rejected the Board's attempt to regulate nonbank banks by amending Regulation Y. The Court's rationale rested on the legislative intent behind the Bank Holding Company Act, the abrupt change in the Board's policy, and the plain purpose of the Act. The Court noted that Congress had changed the definition of "bank" in section 2(c) of the Act twice in recent years but never intended to include nonbank banks in the definition. In addition, the Court also soundly rejected the Board's new definition of "demand deposit" and "commercial loan." Finally, since Dimension's applications were not to be considered "banks," the Court determined that the Board was powerless to regulate the proposed nonbank banks.

The Court explained that the Act gave the Board broad powers "over bank holding companies 'to restrain the undue concentration of commercial banking resources and to prevent possible abuses related to the control of commercial credit.'" Under the Act, nonbank banks were neither banks nor bank holding companies, and therefore, they were not subject to regulation by the Board. The Court also rejected the Board's contentions that the legislation was intended to regulate institutions that were "functionally equivalent" to banks. While the Court admitted that "there is much to be said for regulating financial institutions that are the functional equivalent of

113. Dimension, 106 S. Ct. at 683-84.
114. Id. at 687.
115. Id. at 684. The Board's attempt to reclassify NOW accounts as demand deposits was rejected by the Tenth Circuit in First Bancorporation v. Board of Governors, 728 F.2d 434 (10th Cir. 1984) (Utah law prevents industrial loan companies from accepting demand deposits; NOW accounts are not demand deposits under section 2(c) of the Bank Holding Company Act).
117. The Board's policy could not overturn the congressional intent. Id. at 689.
118. Id.
119. Id. at 685. See also First Bancorporation, 728 F.2d at 436-37.
120. Dimension, 106 S. Ct. at 686-87. The Board was attempting to regulate "commercial loan substitutes." Thus, credit extensions through nonconventional methods would be deemed "commercial loans." Id. at 686. The Court found that "[t]he term "commercial loan" is used in the financial community to describe the direct loan from a bank to a business customer for the purpose of providing funds needed by the customer in its business." Id. (emphasis added). Characteristic of such a loan is a close borrower-lender relationship. Id.
banks.” It explained that this problem must be resolved by Congress, and not the courts. Congress defined with specificity certain transactions that constitute banking subject to regulation. The statute may be imperfect, but the Board has no power to correct flaws that it perceives in the statute it is empowered to administer. Its rulemaking power is limited to adopting regulations to carry into effect the will of Congress as expressed in the statute. If the Bank Holding Company Act falls short of providing safeguards desirable or necessary to protect the public interest, that is a problem for Congress, and not the Board or the courts, to address.

The message of the Court was simple: if regulatory changes were to be made, Congress would have to make the changes by amending the statute.

IV. THE IMPACT OF NONBANK BANKING

As a result of the Dimension decision, nonbank banking is certain to proliferate. Congress must now address the impact that nonbank banks will have on the financial sector. The Dimension decision thrusts upon Congress concerns regarding the effect of nonbanks on established commercial banks, the safety of the financial system, the role of the Federal Reserve, and monetary policy. In the future, it must be decided what long range benefits nonbank banks will provide for the average American and the overall economy. Congress must then draft legislation to allow the financial system to provide both safety and financial innovations.

A. The Effect of Nonbank Banks Upon Established Commercial Banks

From 1978 to 1982, the financial system of the United States suffered from slow growth and high interest rates. For banks, the period represented a time for introspection and reevaluation into the future direction of banking: banks were burdened with outstanding loans that yielded low income through low interest rates. Simultaneously, the banks were faced with paying a high rate of interest to

123. Id. at 688. Congress could have easily amended the Act to use the “functional equivalency” test.

124. Id. at 689.

125. Comprehensive Reform in The Financial Services Industry: Hearings Before the Committee on Banking, Housing, and Urban Affairs, 99th Cong., 1st Sess. 123 (1985) (testimony of Paul Volcker, Chairman of the Federal Reserve Board) [hereinafter cited as Hearings]. Most of the problems resulted from financial institutions loaning out funds based on projections of inflation. During this period of disinflation, the banks were strained by their inaccurate economic forecasts. For a list of bank failures of 1984 and the first half of 1985, see id. at 179-89.
tract deposits. The result was often slow growth and a low return on the bank's investments. By contrast, nonbank banks were growing rapidly and expanding while banks were experiencing slow growth. During this period, nonbanks expanded in all areas.

Overall comparisons of nonbank banks with commercial banks have been compiled and statistically analyzed by the Federal Reserve System. The statistics show that nonbank banks grew at a rate comparable to commercial banks in both market percentage and profitability. The Federal Reserve Board classifies nonbanks as retailers, industrial based companies, diversified financial firms,

126. Id. at 158 (Chairman Volcker's written answers to the committee's written questions concerning the asset quality problems).
127. Id.
128. Id.
129. Id. The Federal Reserve Board of Chicago's research department has consistently produced statistical compilations of banks and nonbanks. The compilations compare the two groups of financial institutions using data prepared by the Federal Reserve System. See Pavel & Rosenblum, Banks and Nonbanks: The Horse Race Continues, ECON. PERSP., May-June 1985, at 3 (an analysis of 1981, 1983, and some 1984 statistics on banks and nonbanks) (hereinafter cited as The Horse Race). The authors indicate that banks are showing "an amazing degree of resiliency" in the changing marketplace. Id. at 15; see also Rosenblum, Siegel & Pavel, Banks and Nonbanks: A Run for the Money, ECON. PERSP. May-June 1983, at 2 (reprint) (the article presents an analysis of bank and nonbank statistics from 1972 and 1981 and contains a table summary of change concerning banks and nonbanks from 1980 to 1982 in chronological order) (hereinafter cited as A Run for the Money); Di Clemente, What is a Bank?, ECON. PERSP., Jan.-Feb. 1983, at 20, 24-26 (an analysis of the Federal Reserve Board's changing views on the definition of bank under the Bank Holding Company Act. The article presents a concise view of the Board's changing definition in table form). Pavel & Rosenblum, Financial Darwinism: Nonbanks-and Banks-are Surviving (SM-85-5) (Federal Reserve Bank of Chicago Staff Memoranda) (extensive in-depth analysis of nonbank and bank statistical information); Kaufman, Mote & Rosenblum, Consequences of Deregulation for Commercial Banking (SM-84-3) (Federal Reserve Bank of Chicago Staff Memoranda) (an analysis of the effect of deregulation, including its effect on banks and nonbanks). Sears Corporation has published a series of white papers on nonbank banking. See generally Foreman, Financial Services for All (n.d.) (explains the development of the nonbank bank); Greenspan, Risk, Safety and Bank Delegation (n.d.) (encourages deregulation of banking with some capital control on large banks); Janklow, Competition and Consumer Needs (n.d.) (an overview of deregulated banking written by the Governor of South Dakota); Morton, Financial Services Deregulation: A Necessity for the Insurance Industry (n.d.) (supports continued deregulation of the financial sector as viewed by the President of John Hancock Insurance Co.); Wriston, Insights, Consequences and Competition (n.d.) (general overview of deregulation and the ability of electronic banking to transcend the state border lines).
130. See The Horse Race, supra note 129, at 4-5.
131. Retailer nonbank banks include Sears, J.C. Penney and Montgomery Ward. Id. at 5.
132. Industrial nonbank banks include the following: General Motors Acceptance Corp., Ford Motor Credit Co., Chrysler Financial Corp., IBM Credit Corp., General Electric Credit, Westinghouse Credit, Borg-Warner Acceptance Corp., Gulf & Western, Control Data, Greyhound, Dana Corp., Armco Corp., National Intergroup, and ITT Corp. Id.
and insurance-based companies. Each of these groups experienced growth during the 1978-83 period. Although the data was limited and restrictive, it showed a clear trend: nonbank banks grew but their growth was cyclical in nature. When the economy was bad for commercial banks, nonbank banks grew. As the economy improved, however, commercial banks seemed to "catch up" with the nonbank banks.

The question is how long can commercial banks play "catch up" with the nonbanks? Since nonbanks are not subject to reserve requirements and other regulations by the Federal Reserve, they can utilize all of their excess cash to increase their return on equity. This ability to earn higher rates of return encourages the growth of nonbanks; increased profitability will attract more investors who are willing to develop more nonbanks.

Commercial banks and other financial institutions threatened by nonbank banks should look to state legislatures, not Congress, to improve market conditions since the states hold one of the key pivotal regulatory powers for decreasing the threat of nonbank banks: the

134. The insurance company nonbank banks include the following: Prudential, Equitable Life Assurance, Aetna Life & Casualty, American General Corp. and The Travelers. Id.
135. Id. With this increase in growth came an increase in profits as well. The thirty top nonbank banks earned $8 billion in profits in 1983. Id.
136. Although the banks have suffered somewhat in terms of profitability, they have "fared quite well against their nonbank competitors in the competitive environment of deregulation." Id. at 15.
137. Douglas Amendment, 12 U.S.C. § 1842(d) (1982). The technological change of electronic banking allowed banks to set up remote banking facilities. The ability to set up facilities at alternative sites, beyond a bank's "brick and mortar" main office, caused competitive turmoil between state and national banks at the state level.

Branch banking inside a state's borders is defined by the McFadden Act. 12 U.S.C. § 36, ch. 191, 44 Stat. 1224 (1927) (current version at 12 U.S.C. § 36 (1982)). See Securities Indus. v. Comptroller of the Currency, 765 F.2d 1196 (D.C. Cir. 1985) (upholding the district court's finding that discount brokerage houses operated by banks are branch offices) cert. denied, 106 S. Ct. 790 (1986); Independent Bankers Ass'n v. Marine Midland Bank, 757 F.2d 453 (2d Cir. 1985) (definition of branch bank under the McFadden Act does not include a national bank's shared use of an automatic teller machine (ATM) so long as the national bank does not own or rent the ATM); American Fidelity Bank & Trust Co. v. Heimann, 683 F.2d 999 (6th Cir. 1982) (the state banking supervisor's interpretation of "branch" within the meaning of that state's branching statute is not binding on the comptroller of the currency in the evaluation of national bank branch applications); Mutschler v. Peoples Nat'l Bank of Wash., 607 F.2d 274 (9th Cir. 1979) (the comptroller does not have a plenary power to define branch bank without regard to state law); State Bank of Fargo v. Merchants Nat'l Bank & Trust, 593 F.2d 341 (8th Cir. 1979) (where state banks, savings and loans and credit unions are using ATM's, the comptroller may approve ATM "branches" for national banks); Dakota Nat'l Bank & Trust Co. v. First Nat'l Bank, 554 F.2d 345 (8th
states can affect the growth of nonbank banking by utilizing the Douglas Amendment\textsuperscript{138} to increase interstate banking.

One of the reasons that nonbank banking has grown so rapidly is its ability to operate nationwide by avoiding the interstate regulatory restrictions on banks and bank holding companies.\textsuperscript{139} Technological change transcended states' borders and made nationwide instantaneous banking a reality. States, however, have continually attempted to prevent the development of interstate banking.\textsuperscript{140} By not allowing banks to grow with technological change, states have encouraged financial innovators to seek alternatives and substitutes to strictly regulated banking.\textsuperscript{141}

To date, twenty-one states have enacted legislation to provide for some type of interstate banking.\textsuperscript{142} There are four categories of interstate banking legislation: regional/reciprocal,\textsuperscript{143} national/reciprocal,\textsuperscript{144} national/regional,\textsuperscript{145} and national/reciprocal.\textsuperscript{146}

\textsuperscript{138} The amendment first incorporates the federal structure and then incorporates the state legislation.

\textsuperscript{139} See supra notes 75-95 and accompanying text.

\textsuperscript{140} Id.

\textsuperscript{141} See infra note 165.

\textsuperscript{142} Id.

\textsuperscript{143} The regional/reciprocal interstate banking states and their respective statutes include the following: Connecticut: see CONN. GEN. STAT. ANN. § 36-552 (West Supp. 1985) (defines the regional “New England” banks); id. § 36-553 (allows interstate bank holding company acquisitions); see id. § 36-554 (allows interstate bank acquisitions); Florida: see FLA. STAT. ANN. § 658.295 (West Supp. 1986); Georgia: see GA. CODE ANN. § 7-1-620(10)(11) (Supp. 1985) (defines the “Southern Regional” banks); id. § 7-1-621 (allows the regional interstate acquisitions); Idaho: see IDAHO CODE § 26-2602 (Supp. 1985) (defines the purpose of the interstate acquisition section); id. § 26-2605(b)(i) (defines the regional area of states); id. § 26-2605(c) (requires reciprocity); Indiana: see IND. CODE ANN. § 28-2-15-15 (Burns Supp. 1986) (defines “regional bank”); id. § 28-2-15-17 (grants the interstate acquisition rights); id. 28-2-15-17(e)(1),(2) (describes the reciprocity requirements); Maryland: see MD. FIN. INST. CODE ANN. § 5-903 (Supp. 1985) (allows interstate acquisitions; defines reciprocity requirements); Massachusetts: see MASS. GEN. LAWS ANN. ch. 167A, § 2 (West Supp. 1986); North Carolina: see N.C. GEN. STAT. § 53-210(12) (Supp. 1985) (defines “Regional” Bank); id. § 53-211(a) (allows interstate acquisitions); id. § 53-211(a)(2) (defines the reciprocity requirements); Oregon: see OR. REV. STAT. § 715.065 (Supp. 1985) (allows interstate acquisitions); id. § 715.070 (places limitations on acquiring out-of-state companies); South Carolina: see S.C. CODE ANN. § 34-24-20(12) (Law. Co-op. Supp. 1984) (defines “Southern Region States”); id. § 34-24-50(b)(2) (requires reciprocity); Tennessee: see TENN. CODE ANN. § 45-12-102(12) (Supp. 1985) (defines “regional” bank); id. § 45-12-103 (allows interstate acquisitions); id. § 45-12-103(2) (requires reciprocity); Utah: see UTAH CODE ANN.
cal, pure national, and trigger statutes. Each of these categories have one common attribute: they operate through the Douglas Amendment and allow banks to operate, own or branch into states other than the bank's principal place of business. The statutes differ only by the degree to which they allow interstate banking. Some statutes are drafted to allow unrestricted interstate banking while others are drafted narrowly to allow interstate banking only in specific instances. These statutes are one of the best weapons against the spread of nonbank banking. By removing the restrictions on banking, the statutes remove some of the incentives to create nonbank banks.

The new concept of true interstate banking heralds the concerns and problems associated with the concentration of banking. Thus,

§ 7-1-102 (1983) (expresses the intent of the legislation); id. § 7-1-103 (defines the “reciprocal” states); id. § 7-1-702 (allows acquisitions between the “reciprocal” states); Virginia: see VA. CODE § 6.1-194.97 (Supp. 1985) (allows interstate acquisitions between the regional states); id. § 6.1-194.97(1) (requires reciprocity).

144. There is only one national/reciprocal interstate banking state — New York; see N.Y. BANKING LAW § 142-b, §§ (a)(i), (ii) (McKinney Supp. 1986) (this section which is conditioned on reciprocity, allows for in-state acquisitions by out-of-state banks).

145. The pure national interstate banking states include the following: Alaska; Arizona (see ARIZ. REV. STAT. ANN. § 6-324 (Supp. 1985)); Maine (see ME. REV. STAT. ANN., tit. 9-B, § 1013 (Supp. 1985)); South Dakota (see S.D. CODIFIED LAWS ANN. § 51-16-40 (Supp. 1985)(provides for the acquisition of in-state bank holding companies by out-of-state holding companies); id. § 51-16-41 (limits the acquiring bank holding company to one bank office); Washington (see WASH. REV. CODE ANN. §§ 30.04, 230(2) (Supp. 1986) (allows for the acquisitions of in-state banks by out-of-state banks)).

146. There are two states with trigger statutes: Kentucky: see KY. REV. STAT. § 287.900 (Supp. 1984) (subsection (a) defines “bank”; subsection (d)(6)(a) refers to the regional requirements limiting acquisitions to contiguous states; and section (d)(6)(b) is the trigger section of the statute); and Rhode Island: see R.I. GEN. LAWS § 19-30-2 (Supp. 1985) (authorizing interstate bank acquisitions); id. § 19-30-4 (authorizing interstate mutual bank acquisitions).

147. The most specific requirement is that of reciprocity. However, those states with regional statutes allow only banks within a certain region to operate in their particular state.

148. From the current statistical evidence of the Federal Reserve Board, the trend is that “banks will improve their chances of competing successfully against their nonbank competitors as geographic and product restrictions are relaxed.” See The Horse Race, supra note 129, at 16. The Federal Reserve Board recognized that by regulating banks too closely, the banks will “respond to market demands and competitive pressures by developing and exploiting loopholes in the law.” Hearings, supra note 125, at 150 (written testimony of Paul Volcker, Chairman of the Federal Reserve Board).

149. Hearings, supra note 125, at 177 (testimony of William M. Isaac, Chairman of the Federal Deposit Insurance Corporation (FDIC)). The FDIC favors the view of limiting the concentration of banking by amending the antitrust laws. The FDIC does not favor the merging of large financial institutions. Since the FDIC is concerned with the insurance of the financial system, the risk of loss is less if there are a greater number
there must be a balancing between the interstate character of banking and allowing larger banks to obtain a larger market share (concentration). The interstate statutes which fall into the categories of regional/reciprocal, national/reciprocal, and trigger statutes all attempt to limit concentration.150 These categories limit interstate banking or concentration in three ways: 1) by defining a specific geographical area, and allowing states in that area to conduct interstate banking; 2) by imposing a time limit; or 3) by invoking a trigger statute. Although these elaborate statutory schemes are in place, effects of concentration on the United States financial system are unknown.151 Even the Federal Reserve System has published studies which are contradictory in predicting the effects of concentrated banking.152

B. The Safety of the Financial System

Congress and state legislatures must also be concerned with the effect of nonbank banking on the safety of the United States financial system. Again, nonbanks exist because bypassing the federal insurance reserve requirements allows nonbanks to earn higher profit margins. When a bank obtains a deposit from a customer, only a fraction of that deposit can be lent out by the bank.153 The bank must retain portions of the deposit for federal reserve requirements154 and federal deposit insurance reserves. Nonbanks are not subject to the reserve requirements and, thus, can utilize all of their funds to increase profits. Policy makers must carefully analyze the effect that bypassing reserves will have on the security and insurance portions of the United States financial system.155 Although the legal
framework for nonbanking should be nonregulatory in nature, the public at large must not bear the burden of failed nonbank banks and banks alone. The changes occurring in the financial market demand a careful balancing of financial safety and freedom of financial innovation.

During 1978 to 1986, the United States financial system suffered tremendous losses through bank failures.156 These failures occurred despite the entangled web of federal and state regulatory "protections." Yet, such losses often go unnoticed since the public is buffered from the adverse effects by federal insurance.157 The effect nonbanking will have on this "safety net" of financial insurance is still uncertain.

In congressional hearings, the Chairman of the Federal Reserve Board and the head of the Federal Deposit Insurance Corporation expressed the opinion that nonbank banks are detrimental to the overall safety of the United States financial system.158 The concerns expressed centered around the uncertainty that nonbank banks create and the possibilities for abuse which exist in a nonuniform regulatory system.159 However, the only example of abuse cited was that suffered by the Ohio banking system.160 In fact, testimony indicated that it was the federal banking regulations, catalyzed by unsound

157. *Id.* at 190. Chairman Volcker feared the "gaping loophole" of nonbanks. The Chairman was also concerned that nonbanks are "bit[ing] off pieces of the banking business." The Chairman believed that by letting nonbank banks exist, the result was a "weakening [of] the fabric of banking." *Id.* (testimony of the Chairman of the Federal Reserve Board). The FDIC would propose legislation that would define a bank as any institution "that calls itself a bank and takes deposits from the public . . ." *Id.* at 192. The concerns of the FDIC chairman are that nonbank banks may hold themselves out as banks and fail. If the deposits were uninsured, the public would lose their life savings. *Id.* But see *id.* at 191 (Chairman Issac of the FDIC testifies that nonbanks have been allowed to be insured since 1969).
158. The possible abuses of nonbank banking occur because the public usually believes that the nonbank bank is a bank and subject to all of the safeguards of federal insurance. This is the concern of uncertainty. Financial institutions in Ohio, Tennessee, Nebraska and Iowa had operated as "banks." In reality they were not banks. When they failed, they took the life savings of many people.

Ohio's problem was unique since the Ohio banks operated on a state based banking insurance. The state system could not repay all the losses sustained by the banks; thus, the savers lost their money. Such uninsured failures damage the public's confidence in the banking system. *Id.* at 167. Since a bank can be composed under a variety of forms, (insured and noninsured) this lack of uniformity misleads the public. Large banks are also subject to failure. Continental Illinois almost failed but was restructured without the use of FDIC funds. *Id.* at 166.

159. *Id.*
160. *Id.* at 167.
banking management, which contributed to the failure of many banks during 1984-85. Indeed, the Federal Deposit Insurance Corporation has recently taken steps to reduce the reserve requirements for agricultural banks to allow the banks a better chance to survive the agricultural crisis. This action enforces the view that the federal regulators are somewhat to blame for bank failures.

While the federal regulators address the problems created by the lack of uniformity in the financial system, they fail to address the beneficial economic effects of nonbank banking. For example, some of the largest nondepository nonbank growth has occurred in captive finance nonbanks like the General Motors Acceptance Corporation. By cutting out the middleman banker, the automobile manufacturers are able to offer the public lower financing at times when banks are not interested in loaning funds for autos. This intermediary role creates a beneficial effect for the economy as a whole and allows people to purchase autos they otherwise could not obtain. Similarly, why should a person be forced to go to a separate real estate agent, insurance agent, and stock broker, if he can make all of the transactions through a retail financial network? The questions of consumer choice and consumer convenience overlap the question of safety. These safety and consumer issues cannot be isolated without examining the entire effect of nonbanking on the United States economy.

C. The Role of the Federal Reserve and Monetary Policy

The impact of nonbank banking must include an analysis of its effect on the federal regulators themselves. Most notably, what effect, if any, has the development of nonbank banking had on the Federal Reserve, and its ability to carry out monetary policy? For the Federal Reserve, the growth of nonbank banks has been a setback in its ability to dominate and control the United States financial system and economy. As case law has demonstrated, the courts do not see the Federal Reserve as having any power to regulate nonbank banks by changing the definition of Regulation Y to bring the nonbanks under the Bank Holding Company Act’s provisions. If the Federal Reserve Board cannot bring nonbank banks under the Bank Holding Company Act, then the Federal Reserve Board cannot regulate nonbank banks. As the Wilshire case illustrates, the only

161. Id. at 166.
162. The regulators in the federal government are the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corporation.
163. See supra note 8.
164. Id.
165. See U.S. Trust Corp. v. Board of Governors of The Fed. Reserve System, 106 S. Ct. 875 (1986) (the Eleventh Circuit’s decision was vacated and remanded to be consistent with the Dimension decision).
time the Board may act is when a nonbank is attempting to evade the Bank Holding Company Act. 166

A more important question is whether nonbanks have affected the Federal Reserve Board’s ability to carry out effective monetary policy. 167 Have the nonbank banks limited the Board’s ability to use the discount rate, reserve requirements, and open market operations? Currently the Federal Reserve System has not implemented any study to determine if nonbank banks have affected its monetary policy in any way. 168 The following scenario, however, illustrates how the monetary policy may be effected.

If nonbank banks provide credit that follows a path bypassing banks entirely, then the Board’s monetary control may be hampered. For instance, if the Board attempts to reduce inflation, it will often increase the discount rate. 169 This attempt to slow inflation will usually not show results for approximately four months and may affect the economy for several years. 170 The Board monitors its monetary policies by examining the effects of its actions on the artificial statis-

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166. The courts have never overturned the Federal Reserve’s power to prevent evasions of the Bank Holding Company Act.

167. Monetary Policy — This is where law and economic theories necessarily mesh. It is critical that the policy makers carefully draft competent legislation in this area to prevent unexpected economic consequences.

168. There is the possibility that funds may temporarily avoid the banking system and therefore affect the Federal Reserve Board’s ability to accurately measure the statistical indices. For example, if the Federal Reserve buys government bonds from a bank, the bank will take a fraction of the proceeds and make a loan. That loan money may then be taken and used to buy commercial paper from a nonbank bank. In this way the banking system is bypassed. Yet, the seller of the commercial paper will probably deposit the funds from the commercial paper sale into a bank. Thus, the funds have returned to the banking system. Telephone interview with Christine Pavel, Associate Economist at the Federal Reserve Bank of Chicago (Apr. 3, 1986). But see infra note 170.

169. See supra notes 8-13.

170. The lagged effect has been interpreted in a variety of ways by economists. If the Federal Reserve alters bank reserves by buying securities, then the full effect of the economy may be felt in four months. But the effect on real output and inflation may not be felt for one to ten years in the future with the actual effect lasting for several years. Since the exact effect of the Federal Reserve’s actions cannot be measured, economists disagree on the actual lag effect time spans. Yet, all economists agree on one point: the Federal Reserve Board has the “power, clout, and tools to change the economy.” Telephone interview with Tom Gittings, Senior Economist at the Federal Reserve Bank of Chicago (April 3, 1986). If the Board wants to slow the economy, it can do so by using a strict monetary policy.

The most recent example of an exercise of this power occurred in 1979. At that time, the inflation rate in the United States was 12% annually, and the Board wanted to slow down the economy by reducing the rate of inflation. To combat inflation, the Federal Reserve Board slowed the money supply too rapidly, which was one of the factors resulting in the recession of the early 1980’s. This recession was also caused by oil
tical monetary indices. If nonbank banks are excluded from the umbrella of the Board’s regulatory powers, monetary policy will be affected. Nonbanks operating outside the banking system could slow or distort the tools the Board uses to measure its monetary policy; thus, nonbanks can affect the Board’s monetary policy.

Also, large nonbanks could operate in such a manner as to slow the effectiveness of the Board’s monetary policy. Again, if the Board raises or allows the discount rate to rise, banks will be less willing to lend and the economy should contract. A large captive finance nonbank bank would not be affected by this attempt to contract the economy until the policy had affected banks first. An automobile captive finance nonbank could issue commercial paper to fund its loans instead of borrowing from banks. In this manner, monetary policy could be slowed by circumventing the banks. The captive finance nonbank would cause the time lag in the Board’s policy to be lengthened. Yet, economists generally agree that financial markets are very efficient and short term interest rates move quickly in response to a change in policy or other external shocks. Thus, nonbanks may not actually hamper the Federal Reserve Board’s implementation of monetary policy.

Congress and the states must carefully evaluate the following major concerns: the effects on commercial banks, the safety of the financial system, and the effects of nonbank banks on the Federal Reserve Board and monetary policy. Regarding nonbank banks, the drafting of the law and the effects of such laws are closely intertwined with prices, deficit spending, and a strong dollar. After the recession, the inflation rate was only 4-5%.

Thus, if nonbank banks have an effect on the measuring indices of the money supply, the Federal Reserve could theoretically be hampered in using monetary policy. The Federal Reserve attempts to ameliorate distortions in the indices by monitoring the aggregate money supply, individual indices, financial institutions, economic indicators, and the overall economy. Id.

171. By distorting the indices of the money supply (M1, M2, and M3), the Board would be hampered in its analysis of the indices. The indices can be distorted by a combination of nonbank banks and the deregulation of the Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. §§ 1464(c), 1832(a), 3501-03 (1982). During the 1970’s, economists thought that Money Market Demand Accounts (MMDA’s) would act as a substitute for transaction accounts, thus slowing the growth of M1. Gittings, supra note 170. In the 1980’s, the opposite effect occurred. When NOW and SNOW accounts (Super NOW accounts) were authorized by the deregulation act, people placed their money in these transactional accounts. The result was a distorted M1 figure: the money supply grew at a faster rate than the overall economy. The Federal Reserve referred to this phenomena as a “temporary shift in the demand for money.” Id. Although the nonbank banks by definition exist outside the regulatory framework of the Bank Holding Company Act, they should be viewed only as another type of financial intermediary. Since most nonbank banks use the banking system when they want to make a receipt deposit, they do not truly exist completely outside the bank regulatory system. Id.

172. Id.
173. Id.
the financial and economic well-being of the United States. Policy-makers must be careful in choosing a path for nonbanks.

V. CONCLUSION

The nonbank bank represents a new type of financial intermediary in the United States financial system. By utilizing a structure that avoids the regulations of the Bank Holding Company Act, the nonbank bank has carved a new niche for itself in the areas of intrastate and interstate banking. For financial consumers, the nonbank bank is an essential and viable intermediary in a rapidly changing financial system.

Nonbank banks provide financial consumers with a variety of financial services absent the problems associated with the stodgy banker and his irregular hours. Catalyzed by the technological information wizardry of electronic banking, the nonbank bank represents another stage in the standardization of the United States financial system. Likewise, the nonbank bank presents a challenge to federal and state legislators who are seeking to provide safety and central control for the financial system. Yet, by allowing the nonbank bank to operate outside the banking regulatory framework, Congress has recognized the importance of balancing the interests of the financial consumer and the safety of the financial system.

In the future, the nonbank bank may become regulated as Congress feels the pressure of special banking interest groups. By then, however, the nonbanks will have served the useful purpose of forcing banks to respond to the needs of the financial consumer.

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