## AFFILIATIONS

### ¶ 101 Repeal of Securities Activities Prohibitions

The Banking Act of 1933, better known as the Glass-Steagall Act, placed limits on the ability of banks to engage in many of their traditional financial activities. It was believed that bank involvement in these lines of business—particularly their involvement in securities activities—had contributed to the collapse of many financial institutions during the Great Depression. The most important of these restrictions are repealed by the Gramm-Leach-Bliley Act.

Under Sec. 20 of the Glass-Steagall Act (12 USC 377), banks have been prohibited from associating with any business organization "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities. More recent rules of the Federal Reserve Board have allowed banks to participate to some degree in the securities industry through "Section 20 affiliates." These affiliates were not deemed to be "principally engaged" in prohibited activities as long as they derived no more than 25 percent of their income from securities activities that were prohibited for banks. Sec. 20 of the Glass-Steagall Act is repealed, lifting the prohibition on bank association with organizations in the securities industry. However, these activities are regulated by other parts of the Gramm-Leach-Bliley Act.

The Act also repeals Glass-Steagall Act Section 32 (12 USC 78), which prohibited management interlocks. An officer, director or employee of an organization that engaged principally in securities activities that were prohibited for banks was barred from being an officer, director or employee of a bank, as was any person who engaged in the prohibited activities on an individual basis. Such interlocks no longer are prohibited.

**See Act Sec. 101 at ¶ 1101.**

### ¶ 102 Restrictions on Bank Holding Company Activities

The Act establishes a new type of bank holding company known as a "financial holding company" (discussed in ¶ 103, below). Financial holding companies have powers that are not given to other bank holding companies. Sec. 4 of the Bank Holding Company Act (12 USC 1843) is amended to clarify that a bank holding company may hold shares of any company that the Federal Reserve Board determined, before the amendment, to be engaged in activities that were sufficiently closely related to banking.

Conforming amendments address proceedings before the Federal Reserve Board dealing with applications to engage in nonbanking activity and the locations where bank service companies may operate.

**See Act Sec. 102 at ¶ 1102.**

### ¶ 103 Identifying Financial Activities

Financial holding companies are granted the authority to engage in activities—referred to as "financial activities"—that are not permitted for other bank holding companies. They also are given the authority to affiliate with companies that are engaged in financial activities. New subsections are added to 12 USC 1843 to provide this power and to delineate what constitutes a financial activity.

A "financial activity" is an activity that is (1) financial in nature; (2) incidental to an activity that is financial in nature; or (3) complimentary to a financial activity and that does not pose a safety and soundness risk. The Federal Reserve Board, in coordination with the Secretary of the Treasury, is to determine which activities meet these criteria.

### Determining if Activity is Financial

The question of whether an activity is financial in nature or incidental to a financial activity may arise before the Federal Reserve Board in two ways: it may be raised before the Fed, or it may be brought to the Fed by the Secretary of the Treasury. If the proposal is raised before the Fed, the Secretary of the Treasury is to be given a formal notice and the two regulatory agencies are to consult. The Secretary of the Treasury has the power to prevent the Fed from finding that a proposed activity is financial in nature or incidental to a financial activity by filing an objection within 30 days of the Fed's notice.

If the Secretary of the Treasury is the source of the proposal, the Fed has 30 days in which to give the Secretary notice of its decision either to initiate a public rulemaking or not to seek public comment. If the Fed decides not to go forward on the proposal, it must give its reasons.

### Activities Financial in Nature

Certain activities are listed by the statute as being financial in nature. These include:

- Lending, investing or safeguarding money or securities;
- Underwriting insurance or annuities, or acting as an insurance or annuity principal, agent or broker;
- Providing financial or investment advice;
- Issuing or selling interests in pools of assets that a bank could hold;
- Underwriting, dealing in or making markets in securities;
- Engaging in any activity that the Federal Reserve Board found before the Act to be related closely to banking;
- Engaging within the United States in any activity that a bank holding company could engage in outside of the country, if the Federal Reserve Board determined before the Act that the activity was usual in connection with banking or other financial operations internationally;
- *Merchant banking*—acquiring or controlling ownership interests in an entity engaged in impermissible activities, if: the interests are not held by a depository institution; the interests are held by a securities affiliate or an investment advisory affiliate of an insurance company as part of underwriting, merchant or investment banking activity; the interests are held long enough to enable their sale in a manner consistent with the financial viability of such an activity; and the holding company

does not control the entity except to the extent necessary to obtain a reasonable return on the investment; or

- *Insurance portfolio investing*—acquiring or controlling ownership interests in an entity engaged in impermissible activities, if: the interests are not held by a depository institution; the interests are held by an insurance or annuity company; the interests represent investments made in the ordinary course of business in accordance with state law; and the holding company does not control the entity except to the extent necessary to obtain a reasonable return on the investment.

The Fed is instructed to adopt a regulation or order defining certain additional activities as financial in nature, to the extent they are consistent with the purposes of the Act. These are:

- Lending, exchanging, transferring, investing for others or safeguarding financial assets other than money or securities;
- Providing any method of transferring financial assets; and
- Arranging, effecting or facilitating financial transactions for third parties.

Other activities also may be decided by the Federal Reserve Board to be financial in nature or incidental to a financial activity if they meet specified criteria. The Fed is instructed to consider the purposes of the Act and the Bank Holding Company Act; changes in the market in which financial holding companies compete; changes in the technology used to deliver financial services; and whether the proposed activity is necessary or appropriate to allow a financial holding company and its affiliates to compete effectively, deliver services efficiently and offer services through the most advanced technological means available.

Under Subtitle C of the Gramm-Leach-Bliley Act, the Secretary of the Treasury has the same authority to deal with financial activities for national bank financial subsidiaries (see ¶ 121).

## Required Notifications

As a general rule, a financial holding company that intends either to engage in a new financial activity or to acquire a company that already is engaged in such an activity is required to notify the Federal Reserve Board. The notice must be given no later than 30 calender days after the activity is commenced or the acquisition is consummated. If the activity involved is one specified by the Act as being financial in nature, or one that the Fed has determined by rule or regulation to be financial in nature or incidental to a financial activity, no prior approval is required. Otherwise, 60 days prior notice to, and the approval of, the Federal Reserve Board are required. Thus, prior notice and approval would be required for any activity that was deemed to be complementary to an activity that was financial in nature, according to the Conference Report (¶ 5002).

## ¶ 117 Preserving Federal Deposit Insurance Resources

The Federal Deposit Insurance Act is amended to prevent deposit insurance from being used to pay claims by a failed depository institution's affiliates.

See Act Sec. 117 at ¶ 1117.

## ¶ 118 Savings Bank Powers

Sec. 3(f) of the Bank Holding Company Act (12 USC 1842(f)) previously granted savings bank subsidiaries of bank holding companies the ability to engage in some activities that were impermissible for banks. This included a "grandfather clause" relating to savings bank life insurance activities.

This entire subsection is repealed. The repeal is intended to make the regulation of savings bank life insurance consistent with the regulation of other bank insurance activities.

See Act Sec. 118 at ¶ 1118.

# SUBSIDIARIES OF NATIONAL BANKS

## ¶ 121 National Bank Subsidiary Powers

The Gramm-Leach-Bliley Act gives national banks substantial, but not unlimited, authority to use "financial subsidiaries" to engage in financial activities. A financial subsidiary may be wholly owned by a single bank, or it may be owned by a number of different banks. However, all of the owners must be banks. Financial subsidiaries are created by a new Revised Statutes of the United States Sec. 5136A.

Other than saying that a financial subsidiary is a company controlled by one or more insured depository institutions, the Act gives a negative definition of the term—that is, the Act establishes what a financial subsidiary is by saying what it is not. It is a subsidiary: that does not engage only in activities that are permissible for national banks and that are conducted under the same rules that govern those activities when conducted by banks; and that cannot be owned or controlled by a national bank under any other section of federal law, including the Federal Reserve Act and the Bank Service Company Act. (In other words, it is a subsidiary that does something that a national bank cannot do, and that a national bank could not own if it were not for the Gramm-Leach-Bliley Act.)

### Restrictions on Subsidiaries, Banks

A bank may own a financial subsidiary only if the subsidiary's activities are limited to those that are financial in nature or that a bank could engage in directly. A financial subsidiary may not, as a principal, underwrite insurance or annuities, engage in real estate development or investment, or engage in merchant banking or insurance portfolio investment activities.

There are qualifications for the bank as well as for the subsidiary. The bank and all of its depository institution affiliates must be well capitalized and well managed. There also is a size limitation. The aggregate consolidated total assets of all of a bank's financial subsidiaries may not exceed the lesser of 45 percent of the bank's consolidated total assets or $50,000,000,000 (to be indexed under a method set by the Secretary of the Treasury and the Federal Reserve Board). Also, the bank must have received the prior approval of the Comptroller of the Currency.

In addition, there are requirements aimed at ensuring the financial stability of large banks if they decide to invest in financial subsidiaries. If the bank is one of the 50 largest insured banks, it must have at least one issue of outstanding debt that is rated in one of the three highest investment grade rating categories by a nationally recognized rating organization. The debt issue must be unsecured long-term debt that is not supported by any credit enhancement, and that is not held in any significant part by any person or entity affiliated with the bank, acting for the bank, or using funds of the bank or any of its affiliates.

If the bank is one of the second 50 largest insured depository institutions, it must meet either the same criteria or any other comparable qualifications that are established jointly by the Secretary of the Treasury and the Fed.

These requirements do not apply to a bank's interest in a financial subsidiary that engages in financial activities only as an agent. There are no similar qualifications for a bank that is not one of the 100 largest insured depository institutions.

The Community Reinvestment Act comes into play as well. The bank and all of its financial institution subsidiaries must have received ratings of at least "satisfactory" at their last CRA examination.

### Financial Activities

A financial activity for a national bank is essentially the same as a financial activity for a bank holding company. The activities that the amended Bank Holding Company Act lists as financial activities for bank holding companies (see ¶ 103) automatically are financial activities for national banks. Similarly, the Secretary of the Treasury is mandated to adopt regulations or rules establishing as financial activities the same activities that the Federal Reserve Board must accept. However, as noted above, financial subsidiaries may not be permitted to engage in four activities that are specifically allowed for financial holding companies—insurance or annuity underwriting, developing or investing in real estate, merchant banking and insurance portfolio investing.

The Secretary of the Treasury has the power to find that additional activities are financial in nature or incidental to a financial activity, in the same way the Fed may make such a finding for bank holding company. The process for considering such a proposal mirrors the process that the Fed is to follow. If the proposal is raised before the Secretary of the Treasury, the Fed must be notified. The activity may not be found to be financial if the Fed objects within 30 days.

If the Federal Reserve Board proposes to the Secretary of the Treasury that an activity should be found to be financial in nature or incidental to a financial activity, the Secretary of the Treasury must, within 30 days, decide whether to initiate a rulemaking. The Fed is to be notified of the Secretary of the Treasury's decision and, if the decision is not to proceed, the reasons must be given.

In deciding whether an activity is financial, the Secretary is to consider the following factors: the purposes of the statutes; changes in the markets in which banks compete; technological changes affecting the delivery of financial services; and whether the activity is needed to allow banks to compete effectively, deliver financial services efficiently and offer customers the most advanced technology that is available. Again, the same factors apply to a comparable decision by the Federal Reserve Board.

## Capital Standards, Safety and Soundness

A bank's investment in a financial subsidiary affects the way in which the bank calculates its capital, for purposes of compliance with regulatory capital standards. The bank must deduct from its assets and tangible equity the total of its equity investments in all financial subsidiaries. A financial subsidiary's retained earnings are to be treated as part of the bank's investment. The assets and liabilities of the financial subsidiaries are not to be consolidated with those of the bank.

The bank's published financial statements must present the bank's financial information in two ways: (1) in accordance with generally accepted accounting principles and (2) separately, in a manner that reflects the segregation of the bank's investments in financial subsidiaries.

Separation is to be maintained between the bank and the financial subsidiary. The bank must be certain that its risk management procedures are adequate to protect it from financial and operational risks created both by itself and by any financial subsidiary. It also must have policies that will maintain the separate corporate identities of the bank and its subsidiary and that will prevent each from becoming liable for the obligations of the other.

## Enforcement

In order to maintain an investment in a financial subsidiary, a bank must continue to comply with the safety and soundness rules—it, and its depository institution affiliates, must remain well managed and well capitalized and it must maintain risk management safeguards. If the bank fails to do so, the Office of the Comptroller is to notify the bank of the default.

Within 45 days of the OCC's notice, the bank must come to an agreement with the agency on how it will return to compliance. If the problem arises from one of the bank's affiliates, that affiliate must execute a comparable agreement with its federal regulator. The OCC has the authority to extend the 45-day time limit. Until the necessary agreements are reached, the OCC may place limits on operations of the bank and the subsidiary, and the affiliate's regulator has the same authority to limit the activities of the affiliate.

If the default is not cured within 180 days, the OCC has the authority to require the bank to divest the financial subsidiary.