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Affiliates in Banking, Finance, and Commerce: Development and Regulatory Background

William D. Jackson
Specialist in Financial Institutions
Government and Finance Division

Summary

The proliferation of corporate affiliates in banking, finance, and commerce has figured in discussion of several policy issues, including how to protect against (1) losses incurred by affiliated companies; (2) anticompetitive "tying" of bank and nonbank financial services; and (3) misuse of financial data of consumers. The Gramm-Leach-Bliley Act in 1999 greatly increased affiliations. Sharing of consumer financial information among affiliates, one issue in reauthorization of the Fair Credit Reporting Act, requires considerable attention to affiliations. Proposed Community Reinvestment Act regulations involve affiliates of banks. Comptroller of the Currency efforts to bring subsidiaries of national banks under federal banking law, preempting than state laws, also involve affiliations. This report outlines the nature and evolution of affiliates, primarily from a regulatory perspective. It provides background for discussing financial issues involving corporate affiliates and will be updated as events warrant.

Background and Analysis

Conducting "nonbanking" activities directly within a bank has generally been viewed as a threat to the integrity of the bank. Periodically in American financial history, and in other nations today, bank diversification into nonbanking financial and commercial business has emerged.[1] Safety problems often followed because of a tendency for entrepreneurs to combine captive sources of (bank) funds with their own (commercial) uses of funds, without regard for normal due diligence. By forcing nonbanking activities into a separately capitalized, separately run company associated with a bank, policymakers sought to lessen the risks that self-funding may pose to banks, to deposit

[1] Joseph G. Haubrich and Joao A. C. Santos, "Alternative Forms of Mixing Banking with Commerce: Evidence from American History," *Financial Markets, Institutions & Instruments*, vol. 12, no. 2, pp. 121-164.

insurance funds, and to other governmental policies. Overall, financial policy has periodically limited commercial/banking affiliations since the 1830s.

The term "affiliate" refers to "any company that controls, is controlled by, or is under common control with another company."[2] Companies with ownership interests of 25% or more in common are usually always affiliates. Sometimes, a common ownership interest as low as 5% is sufficient if it involves director selection, policy direction, and similar control matters. Affiliations are often valued for their potential of cross-marketing, involving sharing of consumer financial information; thus becoming one focus of the Fair Credit Reporting Act debate in Congress,[3] which resulted in the Fair and Accurate Credit Transactions Act of 2003, P.L. 108-159. Application of it must address cross-marketing/information-sharing involving affiliates.[4]

The simplest affiliation is that of a subsidiary, where a bank owns another financial business 100%. Examples are a bank owning an insurance agency, small business investment company, or securities broker. Subsidiaries are regulated by the primary regulator(s) of the owning banks. A more complicated structure involves a company controlling banks. This state-chartered business is known as a "bank holding company." It "holds" the stock of one or more banks and, often, of other financial businesses. A bank holding company typically holds all the stock of at least one bank, and a mortgage company, a securities firm, or a commercial finance business. It may also hold all or part of joint ventures, foreign alliances, investment companies, and other businesses within its structure.[5] The Federal Reserve (Fed) regulates bank holding companies.

A more complex form of bank holding company is the financial holding company, authorized by the Gramm-Leach-Bliley Act (GLBA, P.L. 106-102) in 1999. As specially empowered bank holding companies, these entities may additionally hold full-service securities and insurance operations, including those making nonfinancial equity "merchant banking" investments. Similar diversification arrangements allow securities-based entities to form investment bank holding companies, and savings associations to come under "thrift" holding companies. GLBA listed activities for such affiliations: underwriting and dealing in securities, sponsoring and distributing mutual funds, selling and underwriting insurance, and making insurance company and merchant banking portfolio investments. Regulators may allow other business affiliations.

The Fed, as the regulator of financial holding companies, oversees them to prevent affiliations from lowering the soundness of deposit-insured banks. Sections 23A and 23B of the Federal Reserve Act built financial "firewalls," which prevent banks from supporting failing nonfinancial affiliates, or engaging in anticompetitive tying in financial

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[2] 12 U.S.C. 1841.

[3] CRS Report RS21576, *Fair Credit Reporting Act: Frequently Asked Questions*, by Angie Welborn and Loretta Nott, and CRS Report RS21427, *Financial Privacy Laws Affecting Sharing of Customer Information Among Affiliated Institutions*, by Maureen Murphy.

[4] Richard Cowden, "FACT Act Affiliate-Sharing Regulations Likely to Be Separate From FCRA Rules," *Daily Report for Executives*, Feb.11, 2004, p. A-32.

[5] The Fed restricts lines of business that may be affiliated through bank holding companies, including their financial holding company form, in 12 C.F.R. Part 225, "Regulation Y."

services. Risk of collapse of securities, insurance, and other affiliated businesses evoking deposit insurance, lender-of-last resort, or outright appropriation to cover bank losses becomes less likely. Flows of information between banking and nonbanking affiliates, or as in the Fair Credit Reporting Act, affiliated entities even if no bank is involved, are limited to preserve competition and privacy concerns. A bank or securities affiliate may also provide advice to an investment company, even without ownership. Regulators have warned bank-based organizations against contributing banking resources to advised funds.

Legislative and Regulatory Actions

Beginning in the 1970s, a scramble for funds encouraged businesses ranging from banks to real estate to manufacturing to affiliate with nontraditional financial firms, taking market shares from regulated U.S. banks. Regulatory and statutory reactions may have peaked in 1982.[6] **Table 1** summarizes the basic developments by which Congress, states, and regulatory bodies have changed relevant affiliation relationships, increasing or limiting their extent. Continuing congressional debate involves whether GLBA allows affiliation of banking with real estate activities.[7] Current congressional activity questions the extent to which affiliates of national banks, such as mortgage company subsidiaries, are subject to the Comptroller of the Currency's preemption of state laws.[8]

Table 1. 100-Year Time Line of Affiliation Environment of Banking

Years	Action	Affiliation Change
1906-1907	Many state laws	Separated life insurance from commercial and investment banking.
1910-1929	State banking practice, 1927 McFadden Act	Securities affiliates of state and national banks became prominent.
1933	Banking Act of 1933: four sections are known collectively as the Glass-Steagall Act (GSA)	Defined affiliate and holding company arrangements for Federal Reserve member banks. Added Section 23A to Federal Reserve Act, limiting member bank transactions with affiliates. Outlawed ties between commercial and investment banking. Section 20 prevented Federal Reserve member banks from affiliating with companies "engaged principally" in underwriting or dealing in securities. Section 32 prevented their affiliations with securities firms via interlocking directorates.

[6] CRS Report RL31981, *Industrial Loan Companies/Banks and the Separation of Banking and Commerce: Legislative and Regulatory Perspectives*, by William D. Jackson, and CRS Report RS21188, *Enron's Banking Relationships and Congressional Repeal of the Glass-Steagall Act Separating Bank Lending from Investment Banking*, by William D. Jackson.

[7] CRS Report RS21104, *Should Banking Powers Expand Into Real Estate Brokerage and Management?*, by William D. Jackson.

[8] CRS Report RL32197, *Preemption of State Law for National Banks and Their Subsidiaries by the Office of the Comptroller of the Currency*, by M. Maureen Murphy.

Years	Action	Affiliation Change
1956	Bank Holding Company Act of 1956 (BHCA)	Prohibited affiliations of nonbanking entities with companies controlling two or more banks. Federal Reserve could allow affiliations "...closely related to the business of banking...." Douglas Amendment prevented multi-bank affiliations; containing holding company banks inside state lines.
1968	Savings and Loan Holding Company Act of 1968	Restricted affiliations for holding companies owning two savings and loan associations. Exempted control over one ("unitary") association.
1969	National Association of Insurance Commissioners	Model Insurance Holding Company Act for states, like BHCA but allowing nonfinancial affiliations.
1970	Bank Holding Company Act Amendments of 1970	Prohibited nonbanking affiliations for a holding company owning one bank. Prohibited banks from tying services, reciprocity, and exclusive dealing arrangements with customers generally.
1970	New York Stock Exchange Rule Change	Member broker/dealer firms could sell their own stock to the public, allowing affiliates directly or via holding companies in many business lines.
1974-1975	Losses in Bank Affiliates	Real estate investment trusts associated with banks weakened by economic conditions. Banks and their holding companies took large losses.
1978	International Banking Act of 1978	Subjected foreign bankers in U.S. to BHCA affiliation restrictions.
1980s	Comptroller of the Currency and Federal Reserve Rulings	Permitted affiliations of limited-service "discount broker" securities firms with banks.
1982	Garn-St Germain Depository Institutions Act of 1982	Allowed affiliation involving savings and loan associations, not only real estate but also industry ownership. Prevented most insurance affiliations for banks; contained Banking Affiliates Act of 1982 restricting transactions.
1982	Comptroller of the Currency Chartering	Allowed nationally-chartered "nonbank banks" to offer credit cards and other services, in affiliation with financial and industrial firms.
1982	Bank Export Services Act	Allowed bank holding companies to invest in export trading company affiliates.
1982	Federal Deposit Insurance Corporation Policy Statement	State-chartered banks not members of Federal Reserve could affiliate with full-service securities companies, declared as not covered by GSA.
1986-1988	Federal Reserve Rulings	Authorized bank holding company affiliates to provide joint investment advice and brokerage.
1987	Federal Reserve "Section 20 Subsidiaries" Ruling	Allowed bank holding company subsidiaries to underwrite municipal revenue bonds, commercial paper, and asset-backed securities.

Years	Action	Affiliation Change
1987	Competitive Equality Banking Act of 1987	Forestalled affiliations of nonbank banks with nonfinancial firms. Put moratorium against new banking affiliations in securities, insurance, and real estate. Added Section 23B to Federal Reserve Act, restraining nature of transactions with affiliates. Exempted industrial banks from BHCA, allowing commercial affiliations.
1989	Federal Reserve "Section 20 Subsidiaries" Ruling	Extended 1987 authority to corporate bonds in affiliates within bank holding companies.
1989	Financial Institutions Reform, Recovery, and Enforcement Act of 1989	Tightened affiliation/investment qualifications affecting savings and loan associations.
1990	Federal Reserve "Section 20 Subsidiaries" Ruling	Extended 1987 authority to equity dealings (for JP Morgan.)
1991	Federal Deposit Insurance Corporation Improvement Act of 1991	Gave Federal Deposit Insurance Corporation veto over state-allowed subsidiaries of banks. Prohibited state bank affiliation with insurers.
1994	Riegle-Neal Interstate Banking and Branching Efficiency Act	Repealed 1956 Douglas Amendment to BHCA, allowing holding companies' bank affiliates across state line boundaries.
1996	Comptroller of the Currency Regulation	Allowed subsidiaries of national banks to expand activities, including insurance and securities.
1997	Federal Reserve "Section 20 Subsidiaries" Ruling	Lessened restrictions on affiliation relationships and transactions involving member banks and securities operations. Exempted holding company affiliates from certain anti-tying rules.
1998	Federal Reserve Ruling on Citigroup Business Activities	Allowed insurance firm Travelers to acquire Citicorp, to become bank holding company Citigroup. Conditioned on divestiture of then-impermissible affiliations.
1999	Gramm-Leach-Bliley Act, Title I	Repealed Sections 20 and 32 of GSA: allowed affiliations of banks, insurance companies such as Travelers, securities businesses, etc. via financial holding companies or investment bank holding companies. Merchant banking investments of financial holding companies allowed nonfinancial affiliations. Authorized bank subsidiaries in these businesses, except insurance underwriting, title insurance, merchant banking, and real estate. Future expansion of affiliations via rulemaking.
1999	Gramm-Leach-Bliley Act, Title IV	Disallowed affiliations of savings and loan holding companies for a single institution ("unitary thrift holding companies") with nonfinancial businesses.
2002	Comptroller of the Currency Ruling	National banks could purchase bonds convertible into equity (stock).

Years	Action	Affiliation Change
2002-2004	Citigroup Business Activities	Divested most insurance business lines of Travelers previously acquired.
2003	Federal Reserve Regulation	Gave bank holding company affiliates much ability to process, store, and transmit nonfinancial data.
2003-2004	Federal Reserve Rulings	Gave financial holding company affiliates authority to take and make delivery of physical commodities.
2004	Comptroller of the Currency Regulation	Preempted many state laws governing national banks and their affiliates (subsidiaries).
2005	Comptroller of the Currency Ruling	Allowed national banks to engage in electricity derivative activities, beyond oil and gas derivatives.

Source: Congressional Research Service, The Library of Congress.

Community Reinvestment Act Regulation of Affiliates?

Regulators have shown concern over affiliates of banks that may be engaging in undesirable ("predatory") lending practices, in proposed regulatory language. Through evaluations under the Community Reinvestment Act of 1977 (P.L. 95-128, Title VIII), they report bankers' socially graded performance, largely in lending. They may penalize banks whose affiliates engage in "discriminatory, illegal, or abusive credit practices," by reducing the bank's Act ratings . They may require disclosure of bank loans purchased by affiliates.[9]

Tying?

Banks and their affiliates cannot require customers to "tie" purchases of banking and nonbanking (securities, etc.) services together, nor give special treatment to some customers through affiliate arrangements. Customers may, however, voluntarily request such bundling of financial services. The Fed grants certain exemptions from its rules that otherwise limit cross-selling of banks with affiliates. It has sanctioned at least one holding company for direct tying. A trade group found that banks frequently condition corporate credit on purchase of other services.[10] In the other direction, the Comptroller of the Currency found that the appearance of "tying" was a permissible, understandable phenomenon.[11] The Government Accountability Office (GAO; formerly named General Accounting Office) examined whether banks tie credit to securities underwriting services, but could not prove occurrences. GAO suggested stronger enforcement of laws.[12]

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[9] See CRS Report RS20197, *Community Reinvestment Act*, by William D. Jackson.

[10] Association for Financial Professionals, *2004 Credit Access Survey: Linking Corporate Credit to the Awarding of Other Financial Services*, June 2004, 15 p.

[11] Office of the Comptroller of the Currency, *Today's Credit Markets, Relationship Banking, and Tying* , Washington: Sept. 2003.

[12] U.S. General Accounting Office, *Bank Tying: Additional Steps Needed to Ensure Effective Enforcement of Tying Prohibitions,* GAO Report GAO-04-03, Oct. 20, 2003.