What is a bank?

John J. Di Clemente

In a well known U.S. Supreme Court opinion on pornography, Associate Justice Potter Stewart wrote:

> . . . criminal laws in this area are constitutionally limited to hard-core pornography. I shall not attempt to define the kinds of material I understand to be embraced within that shorthand description; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that.[1]

This "know it when I see it" principle has some adherents in the financial community, particularly with regard to the ambiguities surrounding the question, "What is a bank?"

In an article appearing in *Euromoney*, Walter Wriston, chairman of Citicorp and Citibank, discusses banking and its future.[2] For Wriston, the banks of the 1990s are already here; the only trouble is that bankers are not running them. Wriston suggests that nonbank companies can now do everything a bank does—and more.

Wriston's view essentially reduces to a set of simple propositions: Banks and bank holding companies are highly regulated entities. At the same time, nonbank companies have been expanding into areas that had traditionally been the domain of banks. These nonbank companies are not nearly as restricted in what they may offer customers or where they may make the offering. Accordingly, in Wriston's view, banks and bank holding companies are at a significant competitive disadvantage.

But if nonbank financial institutions can do everything a bank can do, why are they not called "banks"? Or, more importantly, why are such nonbank financial institutions relieved of the regulatory burdens to which banks and bank holding companies are subjected? Is banking by its nature so mutable that it defies definition, leaving one to rely on the "know it when I see it" principle?

It is not the purpose here to attempt a full description of a bank. Without establishing a context in which the term is to be used, it would be nearly impossible to do so. Accordingly, this article seeks to examine the term "bank" only as it is defined in the Bank Holding Company Act of 1956 (the BHCA) and its later amendments. Inasmuch as the Board of Governors of the Federal Reserve System (the Board) has the responsibility of administering the BHCA, it is pertinent to determine the Board's views on what is or is not a bank. Moreover, because the question of whether an institution is a bank for purposes of the BHCA has been litigated only once,[3] the Board's views on the subject possess enormous weight.

The legislative history

Banks, like certain other financial institutions, act as mediators between borrowers and lenders, making loans and incurring liabilities to creditors (including deposit holders). But at the time Congress was debating whether to subject bank holding companies to effective regulation by the Federal Reserve, banks were considered to be "unique" institutions, distinguishable from other financial intermediaries. The uniqueness lay in their power to create liabilities (demand deposits) that are used as a transaction medium.

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[1] *Jacobellis v. Ohio* 378 U.S. 184, 197 (1964).

[2] Walter B. Wriston, "Bank 'n' Burger", *Euromoney* (October 1981).

[3] *Wilshire Oil Company of Texas* v. *Board of Governors of the Federal Reserve System*, 668 Fed. 2d. 732 (3d. Cir. 1981).

This distinguishing feature gave banks a key role in the payments mechanism.[4]

Because of their preeminent role in the nation's payments system, banks became subject to stringent federal regulation. The regulatory framework that developed was one designed primarily to safeguard the integrity of the payments mechanism and to protect holders of bank deposit liabilities. But regulation of bank holding companies lagged the development of comprehensive bank regulation by several decades.

The call by the Board to regulate bank holding companies was made a full decade after the bank failures of the late 1920s and early 1930s. In its *Annual Report of 1943* the Board noted that its existing authority to supervise bank holding companies under the Banking Act of 1933 was severely limited and that:

> Accepted rules of law confine the business of banks to banking and prohibit them from engaging in extraneous businesses such as owning and operating industrial and manufacturing concerns. It is axiomatic that the lender and borrower or potential borrower should not be dominated or controlled by the same management . . . There is now no effective control over the expansion of bank holding companies either in banking or in any other field in which they choose to expand . . . The Board believes, therefore, that it is necessary in the public interest and in keeping with sound banking principles that the activities of bank holding companies be restricted solely to the banking business and that their activities be regulated, as are the activities of banks themselves.[5]

Not until 1956 were the Board's wishes satisfied by the enactment of the BHCA. The purpose of the BHCA was two-fold. First, it was intended to prevent undue concentrations of banking resources by bank holding companies. Second, the BHCA was to control the commingling of banking and nonbanking interests.

The potential adverse consequences of such commingling preyed on the minds of the legislators framing the BHCA. Bank holding companies might, for example, insist on making unsound loans to the holding companies' nonbank affiliates to the eventual detriment of the bank, its depositors, and the public. Or, they might deny credit to or discriminate unfairly against the competitors of their nonbank affiliates. There was also the possibility of tie-in arrangements in which an individual or business would be required to purchase additional services offered by the bank holding company as a condition of receiving bank credit.

All three consequences revolve around the use of ***bank credit*** to create an unfair competitive advantage for the holding company and its subsidiaries. Unfair use of credit by holding companies was thought to have occurred in the past and it seemed therefore reasonable to protect against its possible misuse in the future.

Original act—a chartering test

The original definition of bank in section 2(c) of the BHCA employed a chartering test. "Bank" was defined to include:

> Any national banking association or any state bank, savings bank, or trust company, but shall not include any organization operating under section 25 or 25(a) of the Federal Reserve Act, or any organization which does not do business within the United States.[6]

As amended—the activities test

As originally enacted, the term "bank" was too broadly defined to accomplish the purposes

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[4]In a different context, the U.S. Supreme Court attested to the "uniqueness" of commercial banks in deciding upon the legality of a bank merger under the federal antitrust laws. The Court noted banks' unique ability to accept demand deposits and the role banks play in the provision of business credit. In determining that the cluster of products and services denoted by the term "commercial banking" composed a distinct line of commerce for bank merger analysis, the Court stated:

> Some commercial banking products or services are so distinctive they are entirely free of effective competition from products or services of other financial institutions; the checking account is in this category.

(*U.S.* v. *The Philadelphia National Bank*, 374 U.S. 321, 356 (1963).)

[5]Board of Governors of the Federal Reserve System, *30th Annual Report*, 1943 (1944), pp. 36-37.

[6]Sections 25 and 25(a) of the Federal Reserve Act permit the establishment of "Agreement Corporations" and "Edge Corporations", respectively, which are to engage principally in international or foreign banking. (See Board's Regulation K concerning international banking regulations.)

of the legislation. To remedy this defect, when the BHCA was amended in 1966, the definition of bank in section 2(c) was amended to read:

> "Bank" means any institution that accepts deposits that the depositor has a legal right to withdraw on demand . . .

In explaining the change from a chartering test to an activities test the section-by-section summary of the reported bill reads:

> Section 2(c) of the [BHCA] defines "bank" to include savings banks and trust companies, as well as commercial banks. The purpose of the [BHCA] was to restrain undue concentration of control of commercial bank credit, and to prevent abuse by a holding company of its control over this type of credit for the benefit of its nonbanking subsidiaries. This objective can be achieved without applying the [BHCA] to savings banks, and there are at least a few instances in which the reference to "savings bank" in the present definition may result in covering companies that control two or more industrial banks. To avoid this result, the bill redefines "bank" as an institution that accepts deposits payable on demand (checking accounts), the commonly accepted test of whether an institution is a commercial bank so as to exclude industrial banks and nondeposit trust companies.[7]

Although Congress was concerned with the possible abuse of bank business credit, the definition of "bank" adopted in 1966 made no mention of the credit activities of the organizations to be defined.

Accepts demand deposits and makes commercial loans

In 1970, section 2(c) was again amended. The definition of "bank" was narrowed to include:

> any institution . . . which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans.

The added requirement that an institution be engaged in commercial lending was introduced by Senator Edward Brooke (R., Mass.). While not explained, the amended definition appears to be consistent with the original intent of the BHCA.

Section 2(c) was most recently amended by enactment of the Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320). The act excludes from the definition of "bank" any institution that is insured by the Federal Savings and Loan Insurance Corporation or chartered by the Federal Home Loan Bank Board. (The significance of this exclusion is addressed here in the section entitled "Are Thrifts Banks?")

A narrowing of definitions

With each successive amendment of section 2(c), the definition of "bank" has been narrowed, having moved from a chartering test in 1956 to activities tests in 1966 and 1970. Unfortunately, Congress left little more than the definitions cited as a guide in the administration of the BHCA. Of course, the Board can rely on the purposes and objectives of the BHCA in carrying out its mandate. This course of action is not without pitfalls, for it may be the case in certain situations that the BHCA's literal language and Congressional intent are not in harmony. In these circumstances, the Board has given relatively greater weight to the BHCA's purposes. (See discussion of *Wilshire*, below.)

Board administration of the BHCA and the definition of "bank"

The recent (1982) decision by the Comptroller of the Currency approving the application of McMahan Valley Stores of Carlsbad, Calif., to establish banking units in its retail furniture stores is one in a series of events which raise the issue of the proper definition of "bank" for BHCA purposes. Reportedly, the establishment de novo of Western Family Bank by McMahan Valley Stores marks the first time the Comptroller's office has granted a nonfinancial institution permission to open a bank.[8] Other initiatives in

[7] Bank Holding Company Act Amendments of 1966, S. Rept. 1179, 89 Cong., 2d Sess.

[8] *Wall Street Journal*, August 10, 1982, p. 38.

the recent past also have important ramifications for the financial system and the Board's administration of the BHCA and its interpretation of the term "bank". Among these are the acquisition of Valley National Bank of Salinas, Calif., by Household Finance Corporation and the acquisition of Fidelity National Bank, Concord, Calif., by Gulf & Western Corporation.

All three of these "bank" acquisitions have been by nonbank holding companies. Since, by definition, a company that owns or controls a bank is a bank holding company and therefore subject to regulatory review of its activities and acquisitions, why were these bank acquisitions not subject to official Board review and approval? Why are not Gulf & Western, McMahan, and Household Finance deemed to be bank holding companies pursuant to the BHCA? The answer to these questions lies in the definition of the term bank in section 2(c) of the BHCA and action taken by the acquirers of these institutions (which, for lack of a better term, may be referred to as "consumer banks") to substantially alter the institutions' activities so that they fall outside the reach of that definition.

The definition of bank as contained in section 2(c) of the BHCA as amended in 1970 has three elements: (1) location; (2) the acceptance of demand deposits; and (3) the engagement in commercial lending activities. The definition expressly excludes those organizations, such as Edge Act and Agreement Corporations, whose major purpose is to finance and facilitate international and foreign trade. In addition, federally chartered or insured savings and loan associations and savings banks are excluded from coverage.

The location element has raised few interpretative problems since its administration. But, elements (2) and (3) serve to define those activities which make an institution a "bank" for purposes of the BHCA.

One note of caution is in order. The interpretations and postures by the Board are usually developed within a framework of particular applications or proposals, each with their own set of circumstances. Therefore, not only is it important to read the Board's words at their face value, it is also of paramount importance to understand the circumstances surrounding the words.[9]

Defining the activities which make institutions "banks"

The table "Board Actions Bearing on the Definition of 'Bank' " lists cases in which the Board or its staff undertook to define the activities which make institutions "banks" for BHCA purposes. The table is divided into two sections to allow an examination of the specific question of whether thrift institutions should be regarded as "banks."

What is a "commercial loan" and what is meant by "engages in the business of making commercial loans"?

The commercial loan element of section 2(c) has been addressed by the Board in several letters written in the early 1970s. It has been most recently addressed in the Board's consideration of a proposal by Dreyfus Corporation, New York, N.Y., to acquire banks in New Jersey and New York in 1982.

The Board's earliest pronouncement under the 1970 definition of bank in section 2(c) was made in a letter responding to a proposal by Greater Providence Deposit Corporation to have its commercial bank divest itself of its commercial loan business. The question before the Board, therefore, was, "What is a commercial loan?" In response to the proposal, the Board wrote that it

> . . . is of the view that "commercial loans", as used in section 2(c), must be regarded as including all loans to a company or individual, secured or unsecured, other than a loan the proceeds of which are used to acquire property or services used by the

[9] In addition to the BHCA, the Board has the responsibility of administering other legislation which necessitates from time to time a definition of certain terms such as "demand deposits." (See, for example, Regulations D and Q.) Because these other Regulations administered by the Board were formulated for different purposes, it is possible for the term "demand deposits" to be defined one way for purposes of the BHCA and in some other manner for other regulatory purposes.

Board Actions Bearing on the Definition of "Bank"

Case	Issue	Board Resolution
Greater Providence Letter of July 1, 1971	Would a commercial bank continue to be a "bank" upon divestiture of its commercial loan business?	Commercial loans are considered all loans to individuals or businesses, secured or unsecured, other than a loan the proceeeds of which are used to acquire property or services used by the borrower for his own personal, family, or household purposes, or for charitable purposes. If the commercial bank ceases to engage in the business of making commercial loans, either directly or indirectly, it would not be a "bank".
Greater Providence Letter of July 29, 1971	To what extent may a demand deposit-taking institution support the commercial lending functions of affiliated organizations?	A demand deposit-taking institution may not supply or make available funds to any commercial lending affiliate except through dividends. Section 2(c) contemplates a single institution and is inapplicable when there are two truly separate entities.
Banque National de Paris 58 *FRB* 311 (March 1972)	Are credit balances at Article XII New York Investment Companies the equivalent of demand deposits?	Credit balances at Article XII New York Investment Companies are not demand deposits because such balances arise only incidentally to transactions which such institutions are legally permitted to perform. New York Investment Companies may not accept deposits and credit balances may not be used in the same manner as checking accounts other than to make payments in connection with the importation or exportation of goods.
Boston Safe Deposit Letter of June 8, 1972	Is a trust company that occasionally makes loans to individuals who use the proceeds for business purposes a "bank"?	Loans made to individuals that are used for business purposes are "commercial loans". However, the trust company would not be deemed to be engaged in the business of making commercial loans if: (1) such loans are made on a limited and occasional basis; (2) the loans are made as an accommodation to trust customers; (3) commercial loan business is insignificant in relation to the trust company's total business; and (4) the institution does not solicit commercial loan business or maintain a credit department.
The Bank of Tokyo, Ltd. 61 *FRB* 449 (July 1975)	Would a company established to engage in international transactions and empowered to received "due-to customer accounts", which are similar to credit balances at New York Investment Companies, be a "bank"?	The institution would not necessarily be a "bank". However, because it would closely resemble a "bank", permitting its establishment would violate the spirit of section 3(d) of the BHCA (the "Douglas Amendment"), which limits interstate banking by holding companies.
European-American 63 *FRB* 595 (June 1977)	Should Article XII New York Investment Companies be regarded as "banks"?	Although credit balances at New York Investment Companies are in many respects the functional equivalent of demand deposits, such companies should not be regarded as "banks" because (1) they may not offer checking account facilities to the general public; (2) there exist legal, historical, and administrative distinctions between credit balances and deposit accounts in New York; and (3) Congress exhibited a general intent to exclude international banking corporations from the definition of "bank".

Case	Issue	Board Resolution
Wilshire Order of April 2, 1981	Would Trust Company of New Jersey, Jersey City, N.J., cease to be a bank upon conversion of its demand deposit accounts to NOW accounts while still engaging in a commercial loan business?	The Board is not bound by labels that parties may place on transactions. The Board must look to the substance of transactions to determine whether they fall within the ambit of the purposes of the BHCA. Because the conversion of the demand deposit accounts would have no real economic effect upon the bank and its deposit holders it would not serve to remove such accounts from the definition of "demand deposits" in section 2(c).
Wilshire Oil Company of Texas *v.* **Board** 668 Fed. 2d 732 (3d Cir. 1981)	Would Trust Company of New Jersey, Jersey City, N.J. cease to be a bank upon conversion of its demand deposit accounts to NOW accounts while still engaging in a commercial loan business?	(Court decision) Board may look beyond the plain language in BHCA to ensure that application of the literal terms does not destroy the practical operation of the statute. Trust Company of New Jersey is the type of institution that Congress meant to include in the definition of bank.
Gulf & Western Letter of March 11, 1981	Would Gulf & Western become a bank holding company upon the indirect acquisition of Fidelity National Bank, Concord, Calif., if the bank divested itself of its commercial loan business?	Gulf & Western would not be a bank holding company because Fidelity National Bank would no longer be a "bank" given the divestiture of its commercial loan portfolio; its commitment to limit its lending to loans for personal, household, family, or charitable purposes; and the complete separation of deposit-taking activities from commercial lending activities of affiliates.
Dreyfus Corporation Letter of December 10, 1982	Would the Dreyfus Corporation become a bank holding company upon the acquisition of Lincoln State Bank, East Orange, N.J? How broad is the definition of "commercial loans"?	The definition of "commercial loans" is broad in scope and includes the purchase of such instruments as commercial paper, bankers acceptances, certificates of deposit, and the sale of federal funds. If Lincoln State Bank continues to accept demand deposits and purchases instruments of this type it would be a "bank" and the Dreyfus Corporation would be a bank holding company upon its acquisition.

Thrift Cases

Case	Issue	Board Resolution
American Fletcher 60 *FRB* 868 (December 1974)	Is the operation of a savings and loan association closely related and a proper incident to banking?	The operation of savings and loan associations is closely related to banking. Board noted trend of lessening distinctions between thrifts and banks and indicated that should the trend continue thrifts may become "banks". In context of the particular proposal, the acquisition of a savings and loan association by a bank holding company was considered a proper incident but the application was denied as a result of adverse financial factors and Board's "go slow" policy respecting nonbank acquisitions.

(Cont. on next page.)

Case	Issue	Board Resolution
D.H. Baldwin 63 *FRB* 280 (March 1977)	Is the operation of a thrift institution in general a proper activity for bank holding companies?	Board affirmed its decision in *American Fletcher* that operation of savings and loan associations is closely related to banking. However, in general, such activities are not a proper incident to banking based on concerns relating to (1) the issue of regulatory conflict and problem of determining the permissible scope of savings and loan activities as conducted by a bank holding company affiliate; (2) possible erosion of institutional rivalry of banks and thrifts under common ownership; and (3) the possible undermining of the interstate banking prohibitions in section 3(d) of the BHCA. Board stated that Congress should decide whether thrifts should be regarded as "banks" or "nonbanks" under the BHCA.
First Bancorporation/ Beehive 68 *FRB* 253 (April 1982)	Are NOW deposits at thrift institutions the equivalent of "demand deposits"?	Board noted that institutions accepting NOW deposits reserve the right to require between 14-30 days' prior notice of withdrawal. But, this right is rarely invoked. Thus, for purposes of section 2(c), the Board believes that until the institution invokes the notice requirement, the depositor has a right to withdraw funds on demand. Accordingly, an institution that engages in commercial lending and accepts NOW deposits is a "bank".
Interstate/Scioto 68 *FRB* 316 (May 1982)	Given that NOW deposits are equivalent to demand deposits in section 2(c), would a thrift whose commercial lending powers exceed those of federally chartered thrifts be a "bank"?	Any thrift which accepts NOW deposits and exercises commercial lending powers beyond those granted federally chartered thrifts would be a "bank". To become "nonbanks", such institutions must agree to limit their commercial lending activities so as to achieve parity with federally chartered thrifts.
BankEast Corporation/ Portsmouth 68 *FRB* 379 (June 1982)	Is the operation of a guaranty savings bank in New Hampshire a permissible activity for bank holding companies given the fact that their commercial lending authority exceeds that of federally chartered thrifts?	Guaranty savings banks are unique to New Hampshire and resemble savings banks. Their commercial real estate lending authority exceeds that of federally chartered thrifts. The acquisition, therefore, would be approved conditioned on the guaranty savings bank's promise to limit its commercial lending in order to achieve parity with federally chartered thrifts.
Citicorp/Fidelity 68 *FRB* 656 (October 1982)	Are thrifts "banks" under the BHCA as certain protestants to the proposal asserted?	Board concluded that federal savings and loan associations are not "banks" under the BHCA for two main reasons. First, the lending activities of such institutions are highly specialized, concentrated as they are in home mortgages. Secondly, Congress had designed a separate and independent statutory structure for the regulation of federal savings and loan associations and their holding companies. Moreover, Congress included federal savings and loan associations under the definition of thrift institutions in section 2(i) of the BHCA. Congress did not intend to have federal savings and loan associations to be regarded as "banks".

> borrower for his own personal, family, or household purposes, or for charitable purposes . . . if your commercial bank ceases to engage in the business of making commercial loans of this type either directly or indirectly by channeling deposits to an affiliated institution which does make loans of this type, it would not fall within the definition of "bank" . . .[10]

This rather broad definition of "commercial loans" was expanded upon by the Board most recently in comments provided to the Federal Deposit Insurance Corporation regarding a proposal by Dreyfus Corporation, a mutual fund manager, to acquire Lincoln State Bank, East Orange, N.J. In this letter the Board stated that the definition of "commercial loans" is:

> broad in scope and includes the purchase of such instruments as commercial paper, bankers acceptances, and certificates of deposit, the extension of broker call loans, the sale of federal funds, and similar lending vehicles.[11]

Even if an institution ceases to "engage in the business of making commercial loans", the Board would still require assurances that the resulting demand deposit-taking institution not support the commercial lending activities of affiliates. In its letters in *Greater Providence* and *Gulf & Western*, the Board indicated that the separability of deposit-taking institutions from affiliates engaged in commercial lending was to be complete if they are to avoid the appellation of "bank."[12] That is, deposit-taking institutions would not be allowed to supply or to make available funds derived from the acceptance of demand deposits or from other sources (except through dividends) to any commercial lending affiliate. The basis for this total separation is dictated by section 2(c), which, in the Board's view, contemplates a single institution and which would not apply where there are two truly separate entities.

Even though an institution may extend commercial credit, it may not be "engaged in the business of making commercial loans" under certain circumstances. The Board had decided in the *Boston Safe Deposit* case that although the demand deposit-taking institution did at times make "commercial loans", it was not engaged in the business of making such loans within the meaning of section 2(c).[13] The basis for this determination was fourfold:

(1) Boston Safe Deposit and Trust Company did not make commercial loans except on a limited and occasional basis;

(2) the loans it made were to its trust customers as an accommodation;

(3) in any event, such loans were not in an amount in excess of two percent of Boston Safe Deposit and Trust Company's total assets;

and

(4) Boston Safe Deposit and Trust Company did not solicit commercial loan business and did not maintain a credit department.

Accepting Demand Deposits

In order to be a bank within the meaning of section 2(c), an institution, in addition to being engaged in commercial lending, must also accept deposits that the depositor has a legal right to withdraw on demand. The legislative history of section 2(c) reveals that Congress used the term "demand deposits" and "checking accounts" interchangeably. Accordingly, it would appear

[10]Letter dated July 1, 1971, from Kenneth A. Kenyon, Deputy Secretary, Board of Governors, to Biaggio M. Maggiacomo, President, Greater Providence Deposit Corporation.

[11]Letter dated December 10, 1982, from William W. Wiles, Secretary, Board of Governors, to William M. Isaac, Chairman, Federal Deposit Insurance Corporation.

[12]Letter dated July 29, 1971, from Thomas J. O'Connell, General Counsel, Board of Governors, to Ernest N. Agresti, Esq. and letter dated March 11, 1981, from James McAfee, Assistant Secretary, Board of Governors, to Robert C. Zimmer, Esq.

[13]Letter dated June 8, 1972, from Michael A. Greenspan, Assistant Secretary, Board of Governors, to Laurence H. Stone, Vice President and General Counsel, Federal Reserve Bank of Boston.

reasonable to interpret the section to encompass any organization that offered checking accounts to the general public.

The case of *Wilshire Oil Company of Texas* v. *Board of Governors*, 668 Fed. 2d 732 (3d Cir. 1981), is the only case involving a judicial interpretation of the term "bank" under the BHCA. And revolving as it does around the proper definition of the term "demand deposits", it is invaluable to any understanding of how that term is applied by the Board.

The *Wilshire* case involved Wilshire Oil Company of Texas, Jersey City, N.J., which became a bank holding company on December 31, 1970, as a result of the 1970 Amendments to the BHCA. At the time Wilshire Oil Company became a bank holding company by virtue of its ownership of Trust Company of New Jersey, Jersey City, N.J. (Trust Company), it also engaged in various nonbank activities deemed impermissible for bank holding companies. Wilshire Oil Company was required either to cease engaging in the impermissible nonbank activities or to divest itself of its commercial bank by December 31, 1980.

Wilshire Oil Company informed the Board that it intended to retain its nonbanking interests and that it would comply with the BHCA and cease to be a bank holding company through a plan whereby Wilshire Oil Company would alter the demand deposit-taking activities of Trust Company.

The plan called for Trust Company to notify its demand deposit holders of Trust Company's reservation of the right to require 14 days' prior notice of withdrawal from such accounts. It was believed that this reservation of right to prior notice would legally remove the affected accounts at Trust Company from the definition of demand deposit in section 2(c).

The Board, in its Final Decision and Order of April 2, 1981, rejected Wilshire Oil Company's contention. The Board concluded that Trust Company was a bank; Wilshire Oil Company was a bank holding company; and that the retention of Trust Company beyond 1980 resulted in a violation of the BHCA.

The Board's reasoning, as reflected in the Final Decision and Order, was that the reservation of the right to require 14 days' prior notice was a "sham transaction" intended solely to evade the BHCA's requirements.[14]

Wilshire Oil Company petitioned the Court of Appeals for the Third Circuit for review of the Board's action, centering its position on the literal reading of the BHCA.

The Court of Appeals decided in favor of the Board, stating, in what amounted to a paraphrase of the Board's Final Decision and Order, that:

> While the language of the [BHCA] may be the starting point in construing the statute, we may look beyond the plain language, if necessary, to ensure that application of the literal terms does not destroy the practical operation of the statute.[15]

The Court of Appeals concluded that Trust Company is the type of institution that Congress meant to include within the definition of bank under section 2(c) because Trust Company had made no functional change in its banking operations and the reservation of a right to require notice had no practical effect on the bank's deposits.[16]

Wilshire Oil Company's appeals were denied and the Circuit Court's decision stands as the only judicial interpretation of the scope and applicability of section 2(c) and the limits of the Board's authority with respect thereto.

Credit Balances

The issue of whether certain credit balances may be designated as being the functional equivalent of "demand deposits" has come before the Board on several occasions. (See the *Banque National de Paris*, *The Bank of Tokyo, Ltd.*, and *European-American* cases in table.) This issue is particularly relevant as it concerns companies organized under Article XII of New York State Banking Law (so-called Article XII Investment Companies). Such companies have traditionally been employed as entry vehicles by foreign concerns seeking to enter the U.S. and engage primarily in facilitating foreign commerce.

[14] Final Decision and Order, p. 13, 18.

[15] *Wilshire Oil Company of Texas* v. *Board of Governors of the Federal Reserve System*, 668 Fed. 2d at 735.

[16] Ibid., at 738.

Credit balances arise from, and may be used to settle, a variety of transactions. Sources of credit balances at New York Investment Companies may include, for example, the collection of bills of exchange, the sale of securities by customers, and the collection of interest payments and dividends on securities held for customers' accounts. Credit balances are primarily distinguishable from demand deposits because they only arise from customers who utilize other services at a New York Investment Company. Nonetheless, because such companies possess most of the powers of commercial banks in New York (except being able to accept deposits) and since credit balances bear a close resemblance to demand deposits, the question has arisen as to whether they should be regarded as "banks" under the BHCA.[17]

The Board has maintained that credit balances at New York Investment Companies and similar organizations should not be regarded as demand deposits within the meaning of section 2(c) and that such companies should not be considered to be "banks".

The Board's determination in the matter of credit balances rests on several considerations. First, credit balances arise only incidentally to transactions legally permitted to New York Investment Companies. Such companies are not authorized to solicit or accept deposits of idle funds. Second, credit balances lack the convenience characteristics of general checking account facilities since such balances may not be used in the manner of a checking account for personal or business transactions other than to make payments in connection with the importation or exportation of goods. Third, Congress had exhibited a general intent to exclude international banking corporations from the definition of "bank" in the BHCA.[18]

[17]The general powers of New York Investment Companies are enumerated at section 508 of Article XII of the New York Banking Law. Section 509 of Article XII provides that:

> . nothing contained in this article shall prevent an investment company from maintaining for the account of others credit balances incidental to, or arising out of, the exercise of its lawful powers .

[18]See the dissent by Governor David M. Lilly in *European-American* based on his view that the New York Investment Company should be regarded as a "bank," noting the anomaly that, for monetary policy purposes, the Board views credit balances and demand deposits as equivalents.

Are thrifts "banks"?

The issue of whether thrift institutions (savings and loan associations and savings banks) should be viewed as "banks" has broad implications for the future development of the financial services industry. As one example, if thrifts were deemed to be "banks" any company owning or controlling such a thrift would be subject to the BHCA. As it stands, under the Savings and Loan Holding Company Act[19] companies owning but one savings and loan association are not subject to extensive regulation regarding the activities in which they may permissibly engage.

The history of bank/thrift affiliation is a tangled web of public policy concerns which have been addressed in previous Board Orders. (See the *American Fletcher*, *D.H. Baldwin*, and *Citicorp/Fidelity* cases in the table.) Here, the focus is whether the Board views thrift institutions as "banks" or "nonbanks" under the BHCA.

With *American Fletcher* the Board had determined that the operation of savings and loan associations is "closely related to banking". Indeed, the Board noted the lessening of distinctions between commercial banks and savings and loan associations.[20] The Board, however, was not yet ready to bestow the title of "bank" upon savings and loan associations.

In *D.H. Baldwin*, the Board affirmed its decision that the operation of savings and loan associations is closely related to banking. But the board left it for Congress to decide whether such near-banks as savings and loan associations should be regarded as "banks" or "nonbanks".

Since *D.H. Baldwin*, the powers of federally chartered thrifts have been significantly expanded by the Depository Institutions Deregulation and Monetary Control Act of 1980. The act authorized the issue of NOW accounts, which function as the equivalent of checking accounts at a commercial bank. Moreover, the asset powers of federal thrifts were considerably expanded.[21]

[19]Section 408 of the National Housing Act.

[20]*American Fletcher*, p. 869.

[21]See *Economic Perspectives*, September/October 1980, Federal Reserve Bank of Chicago, especially pp. 18-22.

Given the expanded powers of thrifts, was the Board willing to regard them as "banks" under the BHCA? The answer to this query came in the Board's discussions of the *First Bancorporation/Beehive, Interstate/Scioto, BankEast Corporation/Portsmouth*, and *Citicorp/Fidelity* cases. (See table.)

First, the Board in *First Bancorporation/Beehive* determined that NOW deposits are demand deposits for the purposes of section 2(c). The Board noted that while institutions accepting NOW deposits reserve the right to require between 14-30 days' prior notice of withdrawal, in practice the right is rarely invoked.[22] Accordingly, a nonbank subsidiary of a bank holding company may not accept NOW deposits and also engage in the business of making commercial loans, for such institutions are "banks" for BHCA purposes.

Having concluded that the combination of accepting NOW deposits and making commercial loans would qualify an institution as a "bank", the Board sought to distinguish the activities of savings and loan associations and savings banks from commercial banks. The basis for this reflects several considerations.

First, the Board noted that the lending activities of federal savings and loan associations have historically been highly specialized and that such institutions continue to concentrate their loan portfolios in home mortgages.

Second, the Board noted the design by Congress of a separate and independent statutory structure for regulation of federal savings and loan associations and their holding companies. Moreover, Congress, in constructing the BHCA, included federal savings and loan associations within the definition of thrift institutions under section 2(i) of the act. This, the Board stated, provided evidence of Congress' intent not to have federal savings and loan associations regarded as "banks" under the BHCA.[23]

Garn-St Germain

The Garn-St Germain Depository Institutions Act of 1982 provides for new lending powers for federally chartered thrifts. After January 1, 1984, for example, both savings and loan associations and savings banks will be able to commit up to 10 percent of assets in direct commercial loans.

The Board's position that has been articulated in *Interstate/Scioto, First Bancorporation/Beehive, BankEast/Portsmouth*, and *Citicorp/Fidelity* revolves around the then existing limited commercial lending powers of federally chartered thrifts. Any legislation that broadens thrift lending powers would necessitate that the Board reevaluate its position. Indeed, it might well have been that enactment of the Garn-St Germain legislation would have undermined the basis for the existing exemption of thrift holding companies from the BHCA. After all, the Board had previously stated that "to the extent regulation is necessary at all, institutions providing the same services should be subject to substantially the same regulation in providing these services, regardless of their form of organization."[24]

Congress, apparently, was aware of the dilemma the Board would have encountered had it merely expanded the commercial lending powers of thrifts without indicating an intent to exclude federal thrifts from the definition of "bank". Thus, Congress amended section 2(c). Section 333 of Garn-St Germain expressly excludes from the definition of "bank", "an institution the accounts of which are insured by the Federal Savings and Loan Insurance Corporation or an institution chartered by the Federal Home Loan Bank Board." Even though thrifts, exercising all the powers authorized under Garn-St Germain, may begin to resemble commercial banks to a significant extent, they would not be deemed "banks" for the purposes of the BHCA.[25]

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[22] *First Bancorporation/Beehive*, p. 253.

[23] *Citicorp/Fidelity*, pp. 60-61.

[24] "Statement by Paul A. Volcker, Chairman, Board of Governors, before the Committee on Banking, Housing, and Urban Affairs, October 29, 1981," *Federal Reserve Bulletin*, Vol. 67 (November 1981), pp. 835-45.

[25] In addition to the expanded commercial lending powers already referred to, Garn-St Germain authorizes, among other things, the acceptance of demand deposits; investment in nonresidential real property up to 40 percent of assets; investment in consumer loans up to 30 percent of assets; and investment in personalty up to 10 percent of assets.

Summary and conclusion

The BHCA was enacted to effectively limit the concentration of control over banking resources by bank holding companies and to separate banking from nonbanking interests. At the time the act was passed there was little debate on what constituted a bank. In fact, the act employed a chartering test to separate banks from nonbanks. However, this simple chartering test was found to be largely inconsistent with the purposes of the act. Through amendments to section 2(c) of the BHCA, the definition of the term "bank" has been narrowed so that an institution must now satisfy a two-part activities test to be called a bank. The activities which make an institution a "bank" are (1) accepting demand deposits and (2) engaging in commercial lending activities.

A review of letters and orders of the Board and its staff reveals that:

- "Commercial loans" are considered to be all loans to individuals or businesses, secured or unsecured, except loans the proceeds of which are used for personal, household, family, or charitable purposes. The term also includes the purchase of such instruments as commercial paper, bankers acceptances, certificates of deposit, and similar instruments.
- To be "engaged in the business of making commercial loans", an institution needs to conduct a regular commercial loan business on a more or less unlimited basis with such business constituting a significant portion of the institution's total business.
- The term "demand deposits" represents any deposit available to the general public which is accessible through checks or drafts payable to third parties.
- The term "bank" contemplates a single institution. However, assurances must be given to insure that affiliate organizations are truly separate organizations and that the deposit-taking activities of one affiliate are not supporting the commercial lending activities of another affiliate.

Are thrifts banks for the purposes of the BHCA? Thrifts have typically been distinguished from banks as a result of their limited ability to offer services to commercial enterprises. Recent legislative initiatives have increased the commercial lending authority of federally chartered thrifts. Based on previous rulings, the Board would have had to reevaluate its position.

Congress was cognizant of the dilemma that the Board would have faced and in Garn-St Germain explicitly excluded federally chartered or insured savings and loan associations and savings banks from the definition of "bank". Although thrifts begin to resemble banks to a marked degree, they are not deemed to be "banks" for BHCA purposes. But whether institutions that possess the powers of federally chartered thrifts but are not federally chartered or insured are "banks" remains an open question.

The Board has indicated that it is prepared to recommend changes in the definition of "bank" to Congress.[26] The Board views certain acquisitions of "consumer banks" or "nonbank banks" by nonbanking companies as attempts to evade the requirements of the BHCA. The attempts by Dreyfus Corporation, a mutual fund manager, to acquire a bank in New Jersey and to establish a de novo bank in New York provide recent confirmation of this trend.

It has become increasingly difficult to separate banks from nonbanks. These difficulties arise partly as a result of financial innovation spurred by the desire of institutions to avoid costly regulation. Moreover, with increasing technological change, the term "bank" may become an anachronism. In order to maintain the integrity of the BHCA, it is essential that consideration be given to revising the term "bank" so as to accomplish the purposes of the act without causing undue economic dislocations.

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[26]See Board's *Dreyfus Corporation* letter, op. cit.