

May 1997

# BANK OVERSIGHT

## Few Cases of Tying Have Been Detected



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**General Government Division**

B-261747

May 8, 1997

The Honorable John D. Dingell  
Ranking Minority Member  
Committee on Commerce  
House of Representatives

The Honorable Thomas J. Manton  
Ranking Minority Member  
Subcommittee on Finance and  
Hazardous Materials  
Committee on Commerce  
House of Representatives

The Honorable Edward J. Markey  
House of Representatives

With increasing cross-industry competition in financial services in the United States, market participants have raised concerns about the so-called tying provisions adopted in the Bank Holding Company Act Amendments of 1970. The provisions, which were enacted to safeguard against banks' misuse of their perceived economic power, generally prohibit a bank from engaging in "tying" practices or, in other words, requiring customers to obtain credit, property, or services as a condition of their obtaining credit or other desired products or services.<sup>1</sup> As you are aware, the banking industry generally advocates removal of the tying provisions, while certain securities firms, insurers, and independent insurance agents have advocated retaining or strengthening them.

This report responds to your request that we provide information on banks' compliance with the tying provisions and the views of financial industry representatives about the provisions. Specifically, the objectives of this report are to provide information about (1) evidence of tying abuses by banks and their affiliates and regulatory efforts to ensure compliance with the provisions, (2) views on the tying provisions expressed by representatives of securities and insurance firms and independent insurance agents, and (3) views on the tying provisions expressed by representatives of banks and bank regulators.

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<sup>1</sup>Tying typically involves a customer being required to purchase a tied product or service from the bank or its holding company or one of its affiliates, but the practice may also involve a bank offering to discount the price of a product or service if the customer obtains another product or service.

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## Background

When Congress passed the Bank Holding Company Act Amendments of 1970, it prohibited tying practices by banks involving products other than those regarded to be traditional products provided by banks.<sup>2</sup> The prohibition, in Section 106(b) of the 1970 amendments,<sup>3</sup> was based on the unique role banks have in the economy, in particular their important role as a source of credit, which Congress feared could allow them to gain a competitive advantage in other financial markets. Section 106(b) applies only to banks and generally prohibits banks from tying any service or product, except for traditional bank products.

The tying provisions also allowed the Federal Reserve Board to make exceptions that are not contrary to the purposes of the tying prohibitions. During the first 20 years after the enactment of the tying provisions, the Board received few requests from banking organizations for exceptions to the tying provisions, and it granted none. More recently, however, the Board has decided to use its exception granting authority to allow banks to offer broader categories of packaging arrangements if in its judgment they benefit consumers and do not impair competition.

In 1971, the Board adopted a regulation that applied tying rules to bank holding companies and their nonbank subsidiaries, and at the same time it approved a number of nonbanking activities these entities could engage in under the Bank Holding Company Act. The Board recently relaxed the tying restrictions. Citing the competitive vitality of the markets in which nonbanking companies generally operate, the Board rescinded its regulatory extension of the statutory tying provisions to bank holding companies and their nonbank subsidiaries in February 1997. At the same time, the Board broadened the traditional bank products' exception by expanding it to include those products when offered by the bank's affiliates.<sup>4</sup>

The other federal regulator with key responsibilities related to bank practices, such as tying, is the Office of the Comptroller of the Currency (OCC), which regulates U.S. national banks. In recent years, OCC has

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<sup>2</sup>The act exempted from the tying prohibition a number of traditional banking products, defined specifically as "loans, discounts, deposits, or trust services" provided by banks, which were regarded to have little potential for anticompetitive effects.

<sup>3</sup>Section 106(b) of the Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 12 U.S.C. section 1972, prohibits three types of anticompetitive practices by banks: reciprocity arrangements, exclusive dealing, and tying, which is the subject of this report.

<sup>4</sup>This regulation expands on earlier Board exceptions that, among other things, allowed banks to offer products that included discounts on brokerage services and other products based on a customer's relationship with the bank or bank holding company.

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increasingly allowed banks to expand the number of products and services they offer. Concerns have been raised by some groups that OCC's actions allowing national banks to expand into new financial product markets could lead to increased tying.

Many financial institutions that compete with banks and bank holding companies, notably securities firms and insurance companies, are not covered by the tying restrictions. However, they, along with banks and their affiliates, are subject to the more broadly applicable antitrust laws, such as the Sherman Act, which prohibit anticompetitive practices such as tying arrangements. In a tying claim under the antitrust laws, a plaintiff must prove, among other things, that the seller had economic power in the market for the tying product, that the alleged tie had an anticompetitive effect in the tied-product market, and that the arrangement did not have an insubstantial effect on interstate commerce.<sup>5</sup>

This burden of proof contrasts with the less stringent evidentiary requirements that apply to the bank tying provisions, which do not require proof of any of the above three elements. Congressional hearing records indicate that policymakers made plaintiffs' burden of proof less stringent for the tying provisions because they believed that proving an antitrust violation involving banks, bank holding companies, and subsidiaries could pose difficulties for plaintiffs. Their reasoning was that few plaintiffs could be presumed able to readily ascertain a bank's economic power in a particular product or service market and its ability to impose a tying arrangement.

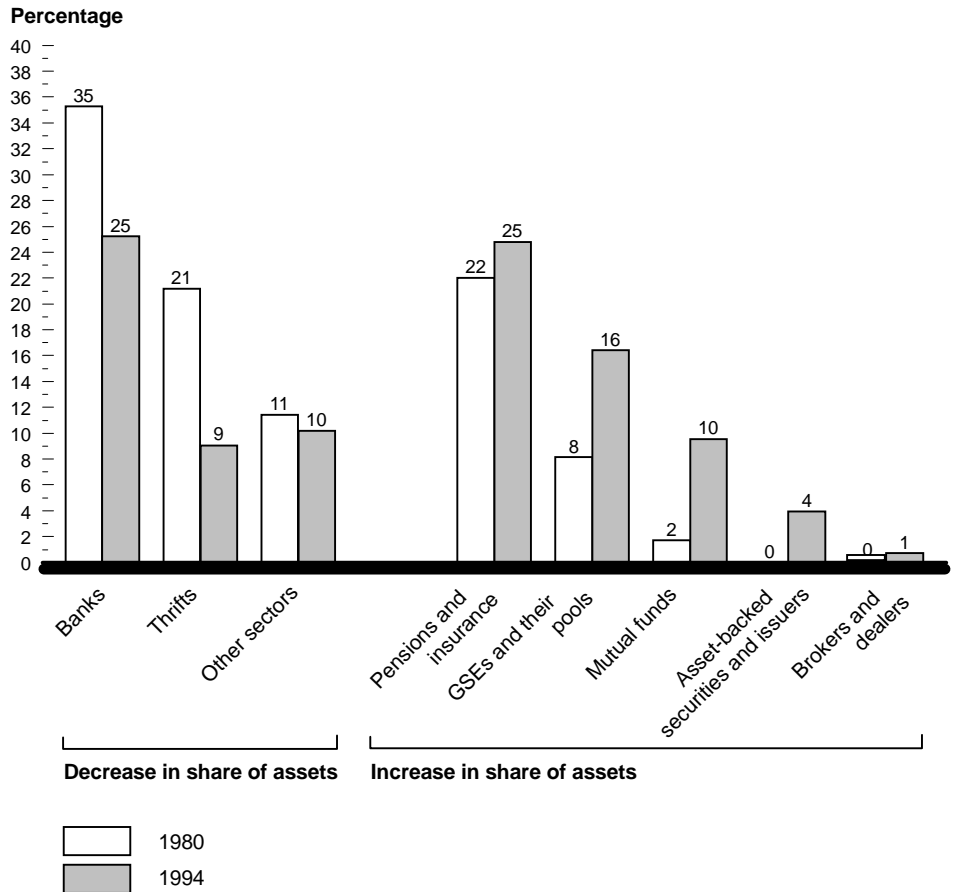
Since 1980, increased cross-industry competition in the financial services marketplace has altered the position banks occupy in the nation's credit market. Some have argued that this change could reduce a bank's ability to engage in tying activities. Aggregated balance sheet data show that the banking sector's share of the overall assets of U.S. financial intermediaries declined from about 35 percent in 1980 to about 25 percent in 1994, as shown in figure 1.<sup>6</sup> In the same period, several other financial sector participants, including mutual funds and government sponsored enterprises (GSE), increased their share of those assets.

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<sup>5</sup>See *Integon Life Ins. Corp. v. Browning*, 989 F.2d 1143, 1150 (11th Cir. 1993).

<sup>6</sup>Industry data also show that over the past three decades, banks and trust companies have made more loans secured by real estate and fewer commercial loans. Commercial and industrial loans dropped from 38 percent of bank lending in 1970 to 26 percent in 1994, while loans secured by real estate increased from 25 percent to 43 percent.

**Figure 1: Share of U.S. Financial Intermediaries' Assets**



Source: Federal Reserve Board.

However, other changes in the marketplace, including the growth of new types of credit-related activities that do not appear on the balance sheet, may have had an offsetting effect on the banking industry's position in the overall U.S. credit market. Two research papers<sup>7</sup> by Federal Reserve staff have suggested that U.S. banks' share of the credit market is not declining. One paper showed that the proportion of total bank revenues coming from

<sup>7</sup>Edward C. Ettin, *The Evolution of the North American Banking System*, Board of Governors of the Federal Reserve System, July 1994, and John H. Boyd and Mark Gertler, *Are Banks Dead? Or Are The Reports Greatly Exaggerated?* Federal Reserve Bank of Minneapolis, Quarterly Review, Summer 1994.

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off-balance sheet banking activities, such as backup lines of credit, guarantees to commercial paper issuers, and derivatives, rose from 25.0 percent in 1982 to 36.7 percent in 1995. But a lack of information about the role these new off-balance sheet activities play in the U.S. financial services market complicates attempts to assess recent overall credit market trends or the effect these trends may have on banks' market power.

Interest in the tying provisions has been heightened by regulatory actions and Supreme Court decisions, most recently one in March 1996, that have permitted banks to further expand their marketing activities in annuity and insurance sales.<sup>8</sup> These actions and decisions have added to the insurance industry's apprehensions about the banking industry's marketing of annuities and insurance and the possible effect it may have on the banking industry's ability to engage in tying activities. The future impact of the tying provisions may also be affected by the outcome of proposed reforms to the 1933 Glass-Steagall Act that would allow banks to offer a greater range of services and products. Proposed reforms stem from the belief that the separation of banks from securities firms and insurers incorporated in the U.S. bank regulatory framework are out-of-date in today's converging credit and capital markets. Although these proposals are viewed as potentially leading to greater efficiencies in the marketplace, concerns have also been raised about their possible effects on banks' ability to link the services and products they offer by engaging in tying.

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## Results in Brief

We found limited evidence of tying activity by banks. Federal Reserve and OCC officials we interviewed were aware of only one violation identified during regulators' routine bank examinations or bank holding company inspections since 1990. In addition, from January 1990 through September 1996, the Federal Reserve and OCC received and investigated 13 tying-related complaints, only 3 of which resulted in actions against the bank or holding company. Further, bank regulators' special investigation of seven large bank holding companies and four large banks in response to a 1992 tying complaint identified only one instance of tying that led to regulatory action. Likewise, limited evidence of bank-tying activity has been disclosed in private litigation involving allegations of illegal tying. Finally, our interviews with state regulators, small business groups, and others identified little evidence of tying violations, although it was

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<sup>8</sup>*NationsBank v. Variable Annuity Life Insurance Co.*, 115 S.Ct. 810 (1995); *Barnett Bank v. Nelson*, 116 S.Ct. 1103 (1996).

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suggested that the limited evidence could be based, at least in part, on borrowers' reluctance to report violations for fear of jeopardizing their banking relationships.

Some representatives of securities and insurance firms and independent insurance agents we contacted were concerned about tying by banks. Independent insurance agents we contacted expressed the greatest concern about tying practices. Those representatives and agents that expressed concern about tying advocated maintaining or strengthening the tying provisions as a way of offsetting the competitive advantages they believe banks enjoy, such as access to the Federal Reserve's discount window and coverage by federal deposit insurance. Some industry representatives and academic experts we interviewed said that a more important consideration than the banking industry's share of the credit market is the availability of credit, specifically the credit available to small businesses in certain geographic areas.

Bank industry representatives viewed the tying provisions as impairing banks' ability to maximize the economic benefits they might otherwise obtain by offering complementary services. Some banking representatives also said that banks' evolving role as only one of many providers of credit makes them less able to coerce customers into accepting tied products or services. With regard to banks' access to the discount window and federal deposit insurance, banking representatives pointed out that, with recent legislative changes, it is now easier for the Federal Reserve to lend directly to various financial firms with liquidity needs in a crisis, not just banks. They also said that banks pay for deposit insurance through premium assessments and are subject to more stringent regulatory restrictions and oversight than competing firms in other financial sectors. Banking regulators expressed varying views of the need for the provisions. While the Federal Reserve chose not to take an official position on the need for the tying provisions, OCC cited the provisions' importance in making banks aware of their responsibilities to customers as they provide an increasing array of products and services. During discussions, some regulatory staff of the agencies expressed the belief that the tying provisions may have a deterrent effect, but others believed the provisions have little effect since, in their view, increased competition in the marketplace makes it difficult for banks to force a borrower into a tying arrangement.

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## Objectives, Scope, and Methodology

The objectives of our review were to provide information on (1) evidence of violations of the tying provisions by banks and their affiliates and



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regulatory efforts to ensure compliance with the provisions, (2) views on the tying provisions expressed by representatives of securities and insurance firms and independent insurance agents, and (3) views expressed by representatives of banks and bank regulators.

In addition to reviewing bank regulators' files for evidence of possible tying abuses, we contacted (1) the Securities Industry Association (SIA) to obtain referrals to securities firms that were concerned about tying activities, (2) groups representing insurance companies and agents who may have knowledge of tying activities, and (3) academic experts. Based on referrals from SIA, we spoke with officials at six securities firms and groups representing securities firms in New York; San Francisco; Washington, D.C.; and Richmond, VA, to obtain their views on the continuing need for the tying provisions. Based on insurance industry referrals, we had similar discussions with officials of eight insurance companies and groups representing insurance companies and agents in New York; Washington, D.C.; San Francisco; and Lynchburg, VA.

We also interviewed officials representing 11 state financial regulators<sup>9</sup> and representatives of 24 local governments or consumer/small business advocates in Texas, California, North Carolina, and Minnesota to determine if any tying complaints had been directed to them. We interviewed consumer/small business organizations in North Carolina and Minnesota, two states that have allowed state-chartered banks to sell insurance, because we were told that instances of insurance product tying were most likely to show up in such states if they were occurring. In addition, we contacted the Securities and Exchange Commission and the Federal Trade Commission to determine whether they had received tying complaints involving banks. We also reviewed studies of private litigation under the tying provisions and updated this information with our own legal research. We conducted our interviews prior to the Board's September 1996 proposal to relax the tying restrictions.

To identify possible tying abuses and regulatory practices used to detect and prevent such abuses, we interviewed Federal Reserve and OCC examiners and officials about the results of their routine examinations and about their procedures and practices during routine examinations. We focused on the Federal Reserve and OCC because the banks or bank holding companies they regulate are more likely to offer a broader range

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<sup>9</sup>Interviews were conducted with state financial regulators, including banking department officials, in the states of Alaska, Arizona, California, Hawaii, Idaho, Minnesota, Montana, Nevada, Oregon, Texas, and Utah. These states were selected because they are rural or relatively thinly populated and thus might likely be affected by declining credit availability.

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of products and services, which are believed to be susceptible to tying.<sup>10</sup> To determine how examiners implemented examination procedures for tying, we also judgmentally selected three examinations conducted in 1994 at a large, medium, and small bank by the OCC Dallas office and three inspections conducted at bank holding companies with insurance or securities activities by the Dallas Federal Reserve Bank. We also reviewed examinations conducted by the San Francisco Federal Reserve during 1993 and 1994 of banks identified as not being in compliance with the tying requirements. We spoke with agency attorneys and examiners about the special joint Federal Reserve and OCC investigation of specific allegations involving tying violations and reviewed related workpapers. We also reviewed complaint files at the Board in Washington, D.C., and OCC headquarters to determine the number and type of complaints received about tying violations. In addition, we interviewed representatives from two corporations and eight local government organizations in California whose transactions were identified as being affected by tying in a complaint to the Federal Reserve.

To obtain the banking industries' views on the continued need for the tying provisions, we contacted officials from (1) four banking trade associations located in Washington, D.C., and Austin, TX, and (2) three banks in San Francisco and New York. We also discussed the tying provisions' effects on the industry with regulators from the Federal Reserve and OCC in Washington, D.C., Dallas, San Francisco, and New York. In addition, we spoke with Federal Reserve officials in Richmond, VA. We also spoke with Federal Reserve economists in Washington, D.C., Richmond, VA, and a former Federal Reserve economist in Minneapolis on changes in the credit market.

We conducted our work from April 1995 through November 1996 in accordance with generally accepted government auditing standards. We provided a draft of this report for comment to the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Chairman, FDIC. The resulting written comments are discussed on p. 17 and reprinted in appendixes I, II, and III.

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<sup>10</sup>We did not perform work at the Federal Deposit Insurance Corporation (FDIC) because officials from FDIC's Division of Supervision in Washington, D.C., told us that few banks regulated by FDIC are directly involved with securities underwriting, dealing, or private placements—activities that are more likely to be subject to tying than other activities.

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## Evidence of Tying by Banks Has Been Limited

We found little evidence of tying by banks. Agency officials we interviewed were aware of only one instance of a tying violation identified during regulators' routine examinations of banks or inspections of bank holding companies since 1990. Likewise, they said regulators' investigations of complaints since 1990, including an SIA allegation of tying practices at several banks and bank holding companies, have identified only a few instances of tying.

Inquiries with a cross section of state and local officials, academic experts, consumer groups, and small business contacts who we were told were knowledgeable about tying likewise revealed few instances of bank tying. Several bank representatives have argued that the lack of evidence indicates that tying is not occurring, although others believe that it indicates that the tying provisions are having a deterrent effect on such activity. Finally, the limited evidence of tying may be indicative of the difficulty involved in identifying instances of tying or consumers' general hesitance to report such instances due to their reluctance to jeopardize their credit relationships.

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## Routine Examinations Revealed Few Tying Abuses

During routine examinations, both OCC and Federal Reserve examiners are expected to evaluate a banking organization's compliance with the tying provisions. They are also expected to investigate potential tying practices that they become aware of during the course of their work. OCC officials said they were not aware of any instances of tying identified through their routine examinations since 1990. Over the same period, Federal Reserve officials cited one instance of tying identified during a bank examination. Officials at both agencies explained that tying violations are difficult to find during examinations because illegal tying arrangements are not clearly evident in loan documentation, and it is difficult to know where to look for evidence of tying without a specific complaint.

OCC procedures require examiners to look for tying arrangements among the various types of loans being reviewed, including commercial, real estate, and construction loans. Examiners are expected to address tying practices along with other credit-related bank practices while reviewing credit and collateral files, especially those relating to loan agreements.

Federal Reserve procedures also require examiners to review tying policies and to follow an inspection checklist in their examinations. Examiners are required to review bank holding companies' and state-chartered banks' written policies and procedures, training programs,

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and audit practices. These reviews are to look at a bank's review of pertinent loans where products or services may be susceptible to improper tying arrangements and to include a review of specific transactions if the banking organization is found to be deficient in its antitying policies and procedures. In addition, procedures call for examiners to assess whether employees are aware of tying and of how to prevent tying violations. Finally, examiners are required to determine whether internal audit departments perform any work to detect or prevent tying violations.

In the nine OCC and Federal Reserve examinations or inspections we reviewed, we found that examiners followed required examination procedures for monitoring compliance with the tying provisions. Although the portions of these OCC and Federal Reserve examinations or inspections devoted to tying, which typically involved 1 to 2 days of work, were less extensive than other portions, it appeared that examiners performed the required steps to review the adequacy of an institution's antitying practices.

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### Regulators' Investigations of Complaints Revealed Few Tying Abuses

Examiners told us that specific complaints filed with the regulatory agencies were the most effective means of detecting tying violations. However, they said that few complaints have been brought to their attention over the years. Both OCC and the Federal Reserve typically handle complaints from their Washington, D.C., headquarters offices, although consumers can notify the regulators of tying complaints at either the district or headquarters level. From January 1990 through September 1996, records show that the regulators received a total of only 13 tying complaints, of which 7 were handled by OCC and 6 were handled by the Federal Reserve.

Records also show that at the time of our review, seven cases were determined to be unfounded, three resulted in actions against the bank or holding company, and the remaining three were unresolved, as shown in table 1. The three cases that resulted in actions against the bank or holding company were resolved through written agreements or orders by the Federal Reserve, one of which included a \$10,000 civil penalty.

**Table 1: Resolution of Tying Complaints Received by the Federal Reserve and OCC From January 1990 Through September 1996**

<b>Resolution</b>	<b>Federal Reserve</b>	<b>OCC</b>	<b>Total</b>
<b>Action against the bank or holding company</b>			
Administrative action	3		3
<b>Unfounded</b>			
After investigation	2	3	5
By the court	1	1	2
<b>Unresolved</b>			
On appeal		1	1
Pending investigation		1	1
Other <sup>a</sup>		1	1
<b>Total</b>	<b>6</b>	<b>7</b>	<b>13</b>

<sup>a</sup>One case was never resolved because the bank closed before OCC could follow up on allegations.

Source: Federal Reserve and OCC.

## Regulators' Special Tying Investigation Found One Violation

A 1992 complaint by SIA prompted the Federal Reserve and OCC to launch a special investigation of tying abuses that ultimately identified one violation of the tying provisions. The investigation, which represented an extensive joint effort by the two regulators, was undertaken largely as a response to SIA solicitation of its membership that elicited a small number of responses. An SIA official we contacted attributed the low number of responses to members' reluctance to jeopardize their banking relationships. Nevertheless, one large securities firm responded with a list of transactions involving characteristics that might indicate tying abuses. SIA included this list in its complaint to OCC and the Federal Reserve.

In response to the complaint, OCC and the Federal Reserve agreed to jointly investigate seven large bank holding companies and four large banks. During the investigation, the regulators reviewed 344 transactions from a universe of 3,213 transactions that included both credit and underwriting components completed between 1987 and 1992. They reviewed transaction fee structures to determine if fee-splitting was prevalent, interviewed selected customers as well as bank holding company and bank officials, and attempted to determine if the bank and nonbank subsidiary referred customers to one another.

The investigation found 24 transactions that were regarded as suspicious out of the 344 transactions reviewed. The examiners found that these

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suspicious transactions generally involved either aggressive marketing by bank officers or discounts offered by a bank to customers who purchased more than one nontraditional bank product or service. In the one instance in which the team concluded regulatory action was required, regulators found three questionable transactions. One involved a loan officer who included on a terms sheet sent to the customer a condition that the bank's affiliate be selected for placement of a revenue bond issue. The case was resolved through an agreement reached by Federal Reserve officials and bank officers that required the bank to strengthen its policies, procedures, and internal compliance program relating to compliance with the tying provisions.

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### Litigation Results Did Not Indicate Tying Was a Major Problem

Our review of legal literature and cases shows that private claims of unlawful bank tying have been relatively infrequent and that the courts seldom have found violations of the tying provisions. Three studies we identified noted limited use of the tying provisions. For example, one study published in 1993, which identified 44 federal court decisions published since 1972 that involved the tying provisions, reported that the courts found violations in only 4 cases.<sup>11</sup> Our research of cases decided after 1992, reviewing 43 federal court decisions and 9 state court decisions involving bank tying allegations, found no decisions in which a bank was found liable for violating the tying provisions.<sup>12</sup>

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### State, Local, and Trade Groups Disclosed Little Evidence of Tying, but Industry Sources Differed on Reasons

Our discussions with representatives of various groups, including state regulators, academic experts, small business trade organizations, and firms identified as possible sources by SIA, produced little evidence of tying practices by banks. For these discussions, we selected insurance groups, small business trade organizations, and chambers of commerce that we were told had a close relationship with businesses that might be affected if tying were occurring. Financial regulators in 11 states, representatives of 8 local governments, and 16 consumer or small business groups, were generally not aware of or were unable to provide any details on complaints of tying. In a few instances in which we learned of a complaint, the affected parties would not respond to our inquiry or said that they were concerned that the use of their information would affect their relationship

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<sup>11</sup>Bernard Shull, Tying and Other Conditional Agreements Under Section 106 of the Bank Holding Company Act: A Reconsideration, *The Antitrust Bulletin*, Winter 1993.

<sup>12</sup>In one state court decision, the court determined that a bank and trust company had engaged in an unlawful tying arrangement under the tying provisions but was not liable because the plaintiff was not harmed by the tying arrangement. Connell v. East River Savings Bank and Trust Company of New Jersey, 666 A.2d 1379 (NJ Super. Ct. 1995).

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with their bank. Some securities and insurance representatives also claimed to be aware of bank tying activities but said they were unable to obtain permission from their customers to release the information to us.

Although the limited evidence of tying may indicate that little tying is actually occurring, other explanations that possibly account for the lack of evidence include consumers' reported reluctance to make formal complaints and the difficulty of detecting tying practices. Some bank representatives maintain that the lack of evidence indicates that tying is not occurring to a significant extent because market forces allow few opportunities, and that the provisions are thus unnecessary. Others, including some regulators and representatives of securities firms, agree that the lack of evidence indicates little tying is occurring but maintain that the absence of tying is a result of the deterrent effects of the tying provisions and the associated regulatory monitoring. It is also possible that the limited evidence of tying may reflect consumers' reluctance to make formal complaints, as in instances we encountered when borrowers were reportedly reluctant to talk with us for fear of jeopardizing their relationship with a bank. Finally, the possibility cannot be ruled out that the shortage of evidence of tying may indicate the difficulty consumers or regulators have identifying tying violations.

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### Securities and Insurance Industry Representatives Most Concerned About Tying Viewed Banks as a Threat to Their Market Share

The extent of concern about tying varied within the insurance and securities industries. Industry groups that were most concerned about tying by banks included independent insurance agents, who expressed the greatest concern, and some insurance and securities firms that viewed banks as a threat to their share of the market. Representatives of firms and agents that expressed concern about tying advocated maintaining or strengthening the tying provisions, which they said help offset banks' competitive advantages and ensure adequate consumer protection.

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### Insurance and Securities Representatives Favor Maintaining or Strengthening Tying Measures as Banks Diversify

Insurance industry representatives we contacted who said tying was a problem were generally concerned about the ongoing expansion of bank services into insurance. One such representative expressed particular concern about the tying of various common types of insurance policies easily linked to bank customers' preexisting bank-related business. Potential markets she cited included the profitable markets of automobile loans, where she said that banks will likely increasingly take over automobile insurance sales, and mortgages, where she said that banks

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could be expected to take over title and homeowners insurance sales. She added that basic competitive pressures push banks toward aggressive sales behavior that verges on violating the tying provisions when they influence customers to take products or services or offer discounts. She said that most insurance agents believe that banks at times violate the tying provisions in offering complementary services and products to customers, but that it is difficult to detect such instances.

Representatives of a major association of independent insurance agents had initially expressed concerns about OCC actions that have allowed national banks to expand their insurance activities and about court decisions upholding these actions. However, in November 1996, the association changed its position and supported the possible integration of financial services. In doing so, however, it expressed its view that future federal legislation should establish the states as the “functional regulators” responsible for insurance activities along with the continued enforcement of the tying provisions by federal banking regulators.<sup>13</sup>

Securities industry representatives have also expressed concern about proposals to eliminate the tying provisions. For instance, a securities firm association and a securities firm we contacted expressed concerns about changes in the laws regarding tying prohibitions in the face of pending reforms to the Glass-Steagall Act. Both said that they opposed any easing of the tying provisions because of their view that such restrictions are necessary for fair competition in the financial market.

Proponents of maintaining or strengthening the tying provisions from the insurance and securities industries said that the tying restrictions are needed to offset banks’ economic advantages. They argued that such economic advantages derive from banks’ access to the Federal Reserve’s discount window and their coverage by federal deposit insurance, both of which are perceived as either lowering the cost of funds or reducing the amount of capital banks need to hold as a buffer against risk to satisfy creditors.

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## Concerns About Market Concentration for Some Products in Local Markets

Although some viewed overall credit market changes occurring since 1980 as an indication that banks may now be less able to engage in anticompetitive tying practices than when the tying provisions were adopted, others, including insurers, securities firms, and academic

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<sup>13</sup>Functional regulation involves regulation of all similar business activities in the financial services industry by a federal or state regulator designated to supervise those activities regardless of whether the activity is performed, for example, by a bank, securities firm, or insurer.



experts, have suggested that certain specific markets may still be susceptible to the exercise of market power. Instead of focusing on broad measures of banks' share of the overall U.S. credit market, they suggest that the focus should be on the availability of credit to small businesses in certain geographic areas.

Recent economic analyses of changes in the banking industry and in the availability of credit provide differing views on the effects these changes may have on small borrowers.<sup>14</sup> Several papers observe that small borrowers in certain local credit markets may be more likely affected by the exercise of market power by banks than those in other localities. While some agree that consolidation of the banking industry may result in a decline in the number of small banks, the main lender to small businesses, they disagree on the effects this decrease will have on the availability of credit to small businesses. For example, one paper suggests that with the likely decline in the number of small banks, the flow of credit to small businesses will likely decline. Another observes that if small businesses are not being served, large banks will have a strong profit motive to expand their small business lending.

## Bank Representatives Viewed Tying Provisions as Limiting Banks' Ability to Compete

Banking industry officials we contacted believed that marketplace changes since the passage of the tying provisions over 25 years ago have significantly reduced the original economic justification for the tying provisions. The officials said that the provisions have been made largely unnecessary by increased competition among credit providers in the financial marketplace. This increased competition, they said, makes it more difficult for any particular bank to exert sufficient credit leverage to force a customer into a tying arrangement. Those holding this view point to the reduction in banks' share of the overall U.S. credit market.

## Arguments for Removing the Tying Provisions

Several bank representatives we contacted expressed a desire to have Congress remove the tying provisions, particularly since they believed there is limited evidence of tying violations. They noted that banks alone are subject to the tying provisions, which do not prevent other financial institutions from combining products that banks are prohibited from

<sup>14</sup>Lawrence J. White, *Tying, Banking, and Antitrust: It's Time for a Change*, Leonard N. Stern School of Business, New York University, July 1994; Allen N. Berger, Anil K. Kashyap, and Joseph M. Scalise, *The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been*, *Brookings Papers on Economic Activity*, 2:1995; Philip E. Strahan and James Weston, *Small Business Lending and Bank Consolidation: Is There Cause for Concern?* Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, March 1996; and John A. Weinberg, *Tie-in Sales and Banks*, Federal Reserve Bank of Richmond, *Economic Quarterly*, Spring 1996.

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linking. An official from one bank noted that securities firms are subject only to the less restrictive antitrust laws applicable to all businesses, which require, among other things, that a plaintiff demonstrate that the firm charged with tying has sufficient economic power to enable it to tie and that a tying arrangement has a substantial effect on interstate commerce. In contrast, the official noted, the tying provisions do not require the plaintiff to demonstrate the bank's market power.

Bank officials we contacted also pointed out that maintaining internal controls to guard against tying within banks adds extra costs that other financial providers do not bear. They said such internal controls limit information, resource, and financial linkages between banks and their holding companies or affiliated entities. According to the officials, the internal control limitations impair economies of scale otherwise possible in the provision of complementary services. In addition, they said customers are adversely affected by banks' inability to reduce overall prices by offering complementary services as a package.

Bank industry representatives we contacted disagreed that banks have a competitive advantage that must be offset by requirements, such as the tying provisions. They acknowledged that banks have access to the Federal Reserve's discount window and federal deposit insurance, but they do not view these as advantages. They pointed out that banks pay for deposit insurance through premium assessments and are subject to regulatory restrictions and to oversight of their activities that competing firms in other sectors are not subject to. A banking representative also pointed out that, with the passage of the 1991 Federal Deposit Insurance Corporation Improvement Act, it is now easier for the Federal Reserve to lend directly to all types of financial firms with liquidity needs in a crisis—not just banks.

Given the ongoing convergence of credit and capital markets, banking officials expressed concerns about potential adverse effects on their industry if the tying provisions are not relaxed or removed. They felt that the existence of the Sherman Act obviates the need for the tying provisions. They did not feel that the banking industry has special characteristics that necessitate a separate set of provisions.

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## Views of Bank Regulators on the Need for the Provisions

In response to our questions about the need for the tying provisions, OCC's official view emphasized the importance of the provisions that prohibit banks from conditioning the availability of one product on the purchase of another, while the Federal Reserve chose not to provide an official position. OCC observed that the tying provisions increase banks' awareness of their responsibilities to their customers as they expand the array of products and services offered. For example, OCC, in its October 1996 guidance to national banks regarding sales of insurance and annuities, stated that the agency remained committed to enforcing the provisions and emphasized the need for national banks to maintain procedures to prevent violations. Although the Federal Reserve responded that the agency had no official position on our questions about the need for the tying provisions, it likewise has cited the tying provisions in connection with its recent action to ease restrictions on banks' marketing activities. For example, in November 1996, the Federal Reserve noted the role of the tying provisions in preventing banks from gaining unfair competitive advantages by tying or otherwise linking their products together.

We also discussed the tying provisions with staff at both agencies. In general, the staff were not surprised that we had found limited evidence of bank tying, but they expressed mixed views on the reasons. Several regulators attributed the lack of evidence to the tying provisions' deterrent effects or to the difficulty involved in finding documentation to support allegations of tying. Other regulators believed that increased competition among credit providers makes it difficult for any particular bank to exert enough economic leverage to force a borrower into a tying arrangement. A Federal Reserve official suggested that the sophistication and price sensitivity of today's consumers limit banks' ability or power to tie products. He explained that, although consumers may not realize that tying is illegal, they are able to recognize a bad deal when they see it.

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## Agency Comments

The Federal Reserve, OCC, and FDIC reviewed a draft of this report and either agreed with the information presented or had no formal comments. The comment letters are reprinted in appendixes I, II, and III. In its comments, the Federal Reserve suggested that we had found that it had effective examination procedures to review compliance with the tying provisions. Our review, however, did not assess the effectiveness of the Federal Reserve's examination procedures.

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As agreed with your office, unless you publicly announce the report's contents earlier, we plan no further distribution of it until 7 days from the date of this report. We will then send copies to the Chairman of the House Commerce Committee, and to the Chairmen and Ranking Minority Members of the Senate and House Banking Committees. We will also send copies to the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Chairman, FDIC. We will also make copies available to others on request.

This report was prepared under the direction of Kane A. Wong, Assistant Director, Financial Institutions and Markets Issues. Other major contributors are listed in appendix IV. If you have any questions, please call me on (202) 512-8678.



Thomas J. McCool  
Associate Director, Financial Institutions  
and Markets Issues

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## Abbreviations

FDIC	Federal Deposit Insurance Corporation
GSE	government sponsored enterprise
OCC	Office of the Comptroller of the Currency
SIA	Securities Industry Association

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# Comments From the Federal Reserve System



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20561

DIVISION OF BANKING  
SUPERVISION AND REGULATION

March 25, 1997

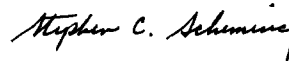
Mr. Thomas J. McCool  
Associate Director  
Financial Institutions and  
Market Issues  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. McCool:

We have read with interest the draft report, Bank Oversight: Few Cases of Tying Have Been Detected.

The report contains no recommendations to the Federal Reserve and, therefore, we have no formal comments. We are pleased that your office found that the Federal Reserve has effective examination procedures to review banking organizations' compliance with the tying provisions during routine examinations, and that our examiners followed required procedures during the examinations and inspections that the GAO reviewed. Thank you for the opportunity to comment on this draft report.

Sincerely,

  
Stephen C. Schemering  
Deputy Director



# Comments From the Office of the Comptroller of the Currency



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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

April 10, 1997

Mr. Thomas J. McCool  
Associate Director, Financial Institutions and Markets Issues  
General Government Division  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. McCool:

We have reviewed your draft audit report titled Bank Oversight: Few Cases of Tying Have Been Detected. The audit was conducted at congressional request to evaluate the effectiveness of Section 106(b) of the Bank Holding Company Act Amendments of 1970. The section generally prohibits a bank from engaging in "tying" practices, that is, requiring customers to obtain one product or service as a condition for acquiring another.

Your review was conducted in a thorough and thoughtful manner. You found that there is limited evidence of tying by banks. You also found that representatives of the securities, insurance and banking industries have a range of views on the need for and effectiveness of the provisions, based largely on their position in a competitive marketplace.

We concur in your findings and note that the GAO does not express a view about the provisions. We believe that the tying provisions are important. They serve as a reminder to banks of their responsibilities to their customers as they expand the array of products and services they offer.

Thank you for the opportunity to review and comment on the draft report.

Sincerely,

Judith A. Walter  
Senior Deputy Comptroller for Administration

# Comments From the Federal Deposit Insurance Corporation

**FDIC**

Federal Deposit Insurance Corporation  
Washington, D.C. 20429

Office of Internal Control Management

April 11, 1997

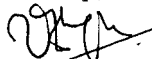
Thomas J. McCool  
Associate Director, Financial  
Institutions and Markets Issues  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for your letter of March 13, 1997 in which you transmitted five copies of your report entitled Bank Oversight: Few Cases of Tying Have Been Detected. The Federal Deposit Insurance Corporation does not have any formal comments to make on this report.

Thank you for the opportunity to review the draft report. We look forward to working with you and your staff in the future.

Sincerely,



Vijay Deshpande  
Director  
Office of Internal Control Management

cc: Dennis F. Geer  
James D. Collins  
Robert Russell  
Annie Moore  
Kane Wong, GAO

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