BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

May 4, 1998

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
House of Representatives
Washington, D.C. 20515

Dear Congressman:

This is in response to your letter of April 30, 1998. The enclosure provides detailed responses to the questions you posed.

Enactment of H.R. 10 would effect a sweeping change in the American financial services industry, allowing affiliations of securities and insurance firms with banks--associations that have long been prohibited in this country. Such a far reaching change will inevitably pose substantial challenges and risks to these financial services firms and their supervisors. In authorizing these new activities and affiliations, it is essential that Congress establish a supervisory framework that is strong enough to deal with these challenges and risks, including those that may be unanticipated. The framework must assure that this change in law will be accomplished without endangering the safety and soundness of our insured banks, their insurance funds, or the financial system. Moreover, every effort must be made to assure that this is accomplished without imposing additional burdens on the taxpayer, without damaging the competitive vigor or viability of independent financial services providers, and without harming the consumers of financial services.

To assure achievement of these goals, the Board is strongly of the view that the changes contemplated by H.R. 10 must be accomplished using the holding company framework with reliance on the strengths of functional regulation and consolidated or umbrella oversight for the new financial holding companies as well as appropriate consumer protections. The Board believes that it would be imprudent to allow these new affiliations to be accomplished as operating subsidiaries of federally insured banks. The use of operating subsidiaries would allow banks to transfer to their subsidiaries the clear funding advantage banks obtain from support of the federal safety net, inevitably leading to a substantial weakening in the competitiveness of independent financial service providers. Operating subsidiaries also pose serious risks to banks and their deposit insurance funds, and potentially the taxpayer, and will cause serious conflicts in the ability of functional regulators to carry out their supervisory responsibilities.

Simply put, an operating subsidiary of a bank is consolidated with, and controlled by, the bank and the fate of the bank and its subsidiary are inextricably intertwined and interdependent. A holding company affiliate is separate from the bank and is not consolidated with it, providing much greater insulation and protection for the bank and the taxpayer. Moreover, banks are supported by the federal safety net; holding companies are not. No insured funds may be used to bail out holding companies and they have no greater access to the discount window than other nonbank entities.

Given the magnitude of the changes contemplated in H.R. 10, the Board believes it prudent for Congress to use to the greatest extent possible proven supervisory techniques and mechanisms and not to experiment with unproven theories and untested systems, or systems that have, in other contexts, failed the taxpayer. The holding company framework allows achievement of all of the public and consumer benefits contemplated by H.R. 10 in a manner that better protects our nation's banks, the federal safety net, and the taxpayer, and that provides for a more level playing field for financial services providers than the operating subsidiary approach. Moreover, the holding company approach maintains the ability of the Federal Reserve to effectively monitor evolving developments so necessary to crisis management, particularly in an environment of financial mega-mergers.

I hope these comments and the responses in the enclosure are useful.

Sincerely,

Enclosure

Enclosure to Response to April 30, 1998 Letter

A. Combining Banking and Commerce

The first question raised in the text of your letter addresses permitting banking and commerce combinations beyond those authorized in the latest version of H.R. 10 (hereinafter, "H.R. 10"). The Board would urge that such an amendment not be adopted.

As noted in your letter, there is every reason to move with caution in this area. The combining of banking and commerce is clearly irreversible; once permitted, the Congress is unlikely to impose the costs and disruption of disentanglement. That should be borne in mind as we focus on the reality that no one can predict the implication of banking and commerce combinations, particularly in a world that is rapidly changing in response to technology, interstate banking, and financial modernization. It would be better to proceed cautiously and first digest the broad financial reform contemplated by H.R. 10 before addressing in a more substantial way the complicated banking and commerce issues.

The current turmoil in some Asian economies highlights the risks that can arise from the interrelationships between banks and nonbank corporate entities. First, if the interrelationships are too close, banks' decisions with respect to lending might be based, not on the underlying creditworthiness or other relevant characteristics of the borrowers, but rather on such factors as implicit or explicit subsidies, personal and business relationships, and common managers. Second, the interrelationships can become so complex and nontransparent that investors and counterparties cannot properly understand or assess the banks' financial soundness. Both of these risks are important elements in the problems now facing some Asian banking systems and are the reasons why banking and commerce have historically been separated in the United States.

The combinations of banking and commerce authorized in H.R. 10 are, by themselves, quite significant. H.R. 10 limits the commercial investments and activities of a financial holding company to the lesser of 5 percent of the holding company's total revenues or $500 million. By itself, restricting large financial conglomerates to generating only 5 percent of their revenues from nonfinancial businesses would still allow such conglomerates the possibility to own and operate any one of all but the top 250 nonfinancial firms from the current universe of such firms. Thus, it is critical that H.R. 10 retain its ongoing $500 million cap. Such a cap allows the controlled experimentation of the mixing of banking and commerce, without locking policymakers into one particular approach that, as noted, may be impossible to reverse and that could do more harm than good. The Amendment proposed by Congressmen LaFalce and Vento that was attached to the April 30 letter would allow up to 15 percent of a financial holding company's revenues to be derived from nonfinancial businesses and would remove the $500 million revenue cap. With the Amendment, a large financial conglomerate could literally own hundreds of nonfinancial entities--in fact, all but the largest 3 nonfinancial companies could be acquired--without hitting this percentage restriction.

If the fundamental and long-standing structural separation of banking and commerce in this country is to be changed, the Board strongly believes that any modifications should proceed at a deliberate pace, in order to test the response of markets and technological innovations as well as the supervisory regimes to the altered rules. There will be ample opportunity to revisit this issue in the future once financial modernization legislation has been implemented and well established.

B. Operating Subsidiaries

The letter requests an analysis of the provisions of the Amendment proposed by Congressmen LaFalce and Vento that was attached to your April 30, 1998, letter (hereinafter, "the Amendment") relating, in particular, to the provisions governing the powers of operating subsidiaries. This analysis is incorporated into the answers to the following questions posed in your letter.

1. What activities does H.R. 10 allow in an operating subsidiary and how would this benefit banks?

The Amendment would dramatically expand the activities that national banks may conduct through subsidiaries, not only beyond those permitted for national banks under current law, but also beyond those permitted for both national banks and bank holding companies under H.R. 10. Specifically, the Amendment would permit a subsidiary of a national bank to engage, as principal, in a broad list of activities that are defined to be permissible by the Amendment as well as any activity that the Comptroller of the Currency determines to be a financial activity, the functional equivalent of a financial activity, or "related" to a financial activity. The language of the Amendment describing the activities that are by statute financial in nature is so broad--broader even than that proposed for financial holding companies--that operating subsidiaries could conceivably engage in a variety of commercial activities, including the ownership of television stations, newspaper companies, communication companies, any type of data processing company, and armored car manufacturing companies. In addition, the Amendment would grant broad authority to the Comptroller to authorize a national bank to invest in any company that is engaged in an activity that is the functional equivalent of a financial activity as well as any activity that is "related" to a financial activity. The "related" test is significantly broader than the "incidental" test that applies to financial holding companies, and could permit operating subsidiaries to engage in activities that have only a distant nexus to financial activities.

The only activities that the Amendment would prohibit operating subsidiaries from conducting are underwriting non-credit related insurance, real estate investment and development, and merchant banking. However, the limitation on merchant banking activities, in particular, is not well defined and could be read to permit national banks to acquire a noncontrolling interest in the shares of any company for investment purposes. These investments, moreover, would not appear to be limited by the commercial basket contained in H.R. 10 or the Amendment.

On the other hand, H.R. 10 would prohibit operating subsidiaries of national banks from engaging in any activity as principal that is not permissible for the parent bank to conduct directly, unless otherwise specifically authorized by Federal law. H.R. 10, however, would provide broad new authority for national banks, specifically authorizing operating subsidiaries to engage in any agency activity that is both financial in nature (or incidental to a financial activity) and permissible for a subsidiary of a financial holding company. Agency activity involves only modest assets, thereby requiring only modest use of subsidized funds. As discussed further below, these and other provisions of H.R. 10 would provide national banks with significant benefits.

It should be noted that the Amendment does not impose the same prudential and other limitations on nontraditional subsidiaries of national banks that would apply to a holding company affiliate of the bank. For example, the Amendment does not subject a national bank's investments in its operating subsidiaries to the full limitations contained in sections 23A and 23B of the Federal Reserve Act. The Amendment also does not require that a national bank seeking to establish a nontraditional subsidiary offer low-cost basic banking services, although all of a holding company's insured subsidiary banks must provide such services for the holding company to qualify for expanded activities and affiliations.

Your letter refers to several provisions in H.R. 10 that limit the consolidated oversight authority of the Board. These provisions, with which the Board agrees, require the Board to defer to the examinations, reporting requirements and interpretations of the Securities and Exchange Commission, the relevant state insurance authority and other functional regulators in supervising functionally regulated affiliates in a financial holding company, and to consult with these functional regulators on a variety of matters. These provisions also prohibit the Board from imposing capital requirements on a functionally regulated affiliate and from requiring an insurance company or a securities broker or dealer to provide funds to support a depository institution in the event that the functional regulator determines in writing that this action would have a material adverse effect on the insurance company or the securities broker or dealer. The Amendment does not contain comparable provisions that would apply to the Comptroller's authority to supervise, examine, impose capital requirements on, or take other action regarding nontraditional subsidiaries of the bank. Moreover, applying similar limitations on the Comptroller's authority with respect to a federally insured bank would raise serious public policy and safety and soundness issues. For example, should actions taken by the OCC under prompt corrective action in the case of an undercapitalized national bank be limited by the findings, enforcement and other restrictions applicable to the Board's supervision over holding companies?

2. What activities are required to be conducted in a holding company affiliate and why, and with what benefits to banks and with what protections to the Government safety net and taxpayers?

As noted, the Amendment would prohibit subsidiaries of national banks from engaging in underwriting noncredit-related insurance, real estate investment and development, and merchant banking. The Amendment would prohibit operating subsidiaries from conducting property and casualty insurance underwriting, real estate investment and development and speculative securities investment activities out of concern for the impact such activities could have on the financial solvency of the parent bank. In the 1980s, for example, thrifts and their subsidiaries were permitted to engage in real estate development activities and these activities contributed significantly to the losses incurred by the deposit insurance funds and, ultimately, the American taxpayer.

The same reasoning, however, also justifies H.R. 10's prohibition on operating subsidiaries conducting as principal those activities that banks cannot conduct directly. Under generally accepted accounting principles ("GAAP"), any losses incurred by an operating subsidiary must be consolidated into the parent bank's financial statements, even when those losses exceed the parent bank's investment in the subsidiary, or even the parent bank's own total capital. Because the financial condition of an operating subsidiary is directly reflected in the consolidated financial statements of the parent bank prepared under GAAP, national banks would have a particularly strong incentive to provide assistance to an operating subsidiary experiencing financial difficulties. Furthermore, because the parent bank's consolidated financial statements prepared under GAAP are publicly reported, losses at an operating subsidiary would reduce the parent bank's publicly reported earnings and capital and could cause investors and depositors to lose confidence in the parent bank. Moreover, because profits generated by an operating subsidiary enhance the financial statements of the parent bank, the bank has a strong incentive to make maximum use of the bank's funding advantage to help the subsidiary reduce the subsidiary's funding costs and exploit its competitive advantages.

The holding company structure used by H.R. 10, on the other hand, better protects federally insured banks, the federal deposit insurance funds, and the American taxpayer from the risks associated with newly authorized principal activities. It also has proved a more effective means of containing the federal safety net, as well as the subsidy and moral hazard inherent in the safety net. Although GAAP requires that a bank's financial statements reflect all losses experienced by its subsidiary, a bank's financial condition and its publicly reported financial statements would *not* be directly affected by any losses incurred by a subsidiary of the bank's holding company (beyond any limited amount that the bank may have lent to the affiliate in accordance with federal law). Instead, any losses incurred by a subsidiary of a holding company would fall, not on the bank, but on the holding company parent. Thus, the bank may face less pressure to support the affiliate and face less contagion risk arising from any losses incurred by the affiliate.

The dangers to the safety and soundness of parent banks is real and is demonstrated by an incident that occurred several years ago in Ireland. Allied Irish Bank, one of the largest banks in Ireland, owned as a subsidiary The Insurance Corporation of Ireland, which was one of the largest insurance companies in Ireland (though small in relation to the Allied Irish Bank). When the insurance company experienced financial problems, the government of Ireland assumed control of the insurance company in order to assure that the financial troubles of the insurance company would not spill over to the bank or to the Irish banking system.

3. **Treasury officials have indicated that this debate is at base a turf fight based on practical implications. They argue that the advantages of the national bank charter have eroded over time and that, to add insult to injury, national banks today have to pay more for examinations than state-chartered Fed member banks. They say that they are concerned with a flight from the national system on that basis when exacerbated by the effects of H.R. 10. Please respond to this argument, giving specifics, and also please advise us whether H.R. 10 discriminates against national banks vs. state-chartered banks, again providing specifics. If there is an imbalance, with or without H.R. 10, please identify what it is and how it might be addressed other than by authorizing risky merchant-banking and securities-and insurance-underwriting activities in bank operating subsidiaries.**

First, this is not a fight for "turf" by the Federal Reserve. The debate on the structure of our financial system affects the lives of all Americans. Were the Federal Reserve interested in "turf," *per se,* The Federal Reserve would never have strongly supported passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which authorized broadened interstate banking and branching. That Act clearly enhanced the franchise of national banks relative to state member banks, which the Federal Reserve supervises, and the Federal Reserve understood that, as a result, we would likely witness a shift to national charters. Nevertheless, The Federal Reserve strongly supported this legislation because interstate banking and branching is clearly a major advance to an enhanced domestic financial structure.

It is widely recognized that the national bank charter is far superior to the state bank charter for interstate banking and provides national banks with significant operational and cost advantages in doing business on an interstate basis. That is why virtually all significant interstate branching now involves national banks. Moreover, it is the reason why the share of bank assets accounted for by national banks *rose* by 2.5 percentage points in 1997, to 55 percent, the highest level so far this decade. We do not understand, given this, how there can be a claim that the national bank charter has eroded. It is true that examination costs of national banks are higher than those imposed on state banks. Given the superior franchise that a national bank charter offers, this is wholly appropriate.

H.R. 10 does not alter to the detriment of national banks the balance constructed by current law between the national bank charter and the state bank charter. H.R. 10 does not reduce the current power of national banks to conduct banking activities. In fact, H.R. 10 improves the national bank charter by authorizing national banks to underwrite all types of municipal securities and by authorizing national banks to engage through subsidiaries in all types of financial agency activities. In addition, H.R. 10 allows all national banks to engage through a subsidiary in a full range of insurance agency activities with protections against state anti-affiliation laws; state banks, on the other hand, continue to be able to engage in insurance agency and other activities only if permitted by the state chartering authority and must comply with applicable state laws.

If anything, H.R. 10 rectifies an imbalance in current law by imposing on state banks a prohibition against underwriting and dealing in ineligible securities through a subsidiary of the bank. State banks are already prohibited under the Federal Deposit Insurance Corporation Improvement Act from engaging in insurance underwriting and equity investment activities, including merchant banking, and H.R. 10 does nothing to change these prohibitions. The major difference between the powers of national and state banks upon the enactment of H.R. 10 would be in the area of real estate development activities, but the Treasury Department has indicated that national banks should not be permitted to engage in real estate development or investment activities.

H.R. 10 would impose two limitations on national banks that do not exist today. H.R. 10 requires a national bank that seeks to engage in insurance agency activities in a new state to enter the insurance agency business by acquiring an insurance agency that has been operating for at least two years in that state. H.R. 10 also includes a limitation on the Comptroller's ability to authorize national banks in the future to provide new products that are determined to be insurance, and includes a mechanism for determining which products are insurance for these purposes.

The Treasury Department contends that banking organizations should be given the ability to choose the structure (holding company subsidiary or direct subsidiary of a bank) through which they conduct new activities and that national banks would be at a disadvantage if not given this choice. In light of the funding advantage that operating subsidiaries derive from their parent's access to the federal safety, this is not a real choice. Rational banking organizations would virtually always decide to conduct new activities through an operating subsidiary, rather than through a holding company subsidiary. This would undermine the holding company structure and, since it is through these holding companies that the Federal Reserve is able effectively to monitor emerging problems that could threaten our financial structure, our ability to manage crises would be weakened, with possible highly destabilizing consequences. If this trend were to accelerate, it would diminish the Board's understanding of and supervisory authority to engage large financial institutions during a systemic crisis, and would seriously impair the ability of the Federal Reserve to fulfill its statutory responsibility to maintain the stability of the financial system. This is especially an issue for mega-merged banking organizations that are beginning to form and will be more easily formed under H.R. 10.

4. In a March 26 document encaptioned "The Treasury's Principal Concerns About H.R. 10," the Treasury Department made the following argument (underlining supplied):

> **"The choice between the subsidiary structure and the holding company affiliate structure should be a business decision, not a governmental dictate. Allowing the subsidiary structure has manifest advantages. First, a bank's conduct of new activities in a subsidiary diversifies the bank's assets and income -- providing a cushion against losses in other lines of business. Second, conduct of activities in a subsidiary may allow bank management to better direct the activity. Indeed, a recent OCC study concludes that overseas subsidiaries of banks earned higher returns and ran lower risks in conducting securities activities than did holding company affiliates. Third, if the bank were to fail, the FDIC could sell the subsidiary and use the proceeds to protect depositors -- something it could not do if the activities were conducted in an affiliate. Taxpayers would thus be better insulated from loss. Finally, flexibility in organizational structure maximizes the potential for synergy with existing financial products -- better enabling market participants to meet their customers' full range of financial services needs. While for some companies an affiliate structure may be optimal, for others it may be the subsidiary structure.**
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> **"Moreover, forcing a financial services company -- as a prerequisite for engaging in new activities -- to transfer resources from its bank to its holding company would deplete the bank's resources, leave the bank's earnings less diversified, and thus increase risk to the deposit insurance funds."**

In a market unaffected by subsidy, moral hazard and systemic risk, the Board agrees that the choice of structure should be left to the market. However, the Board believes that the subsidy provided to banks through the safety net, as well as the macro stability and taxpayer concerns with the safety and soundness of U.S. banks, argue that structure for financial modernization *must* be a government decision, not a business decision. This is particularly so when all the benefits of H.R. 10 may be accomplished in a holding company framework with less risk and damage to a fair and open financial services industry than through an operating subsidiary. The Federal Reserve supports the broad extension of powers granted in H.R. 10. We do not believe, however, that they should be financed with the assistance of the sovereign credit of the United States.

As argued by Treasury, new activities in bank subsidiaries do provide the potential for diversification and profit for their parent bank. Importantly, the operating subsidiary approach also creates the potential for loss, and that loss--like the profit--accrues to the bank. The Treasury argues that (1) all that will be lost is the bank's original investment in the subsidiary, and (2) since that investment would, under the Treasury proposal and the Amendment, be deducted (for non-GAAP regulatory purposes) from the "excess" capital of the bank, it will cause no economic problem for the bank if the subsidiary fails because the subsidiary will be closed by the OCC before the subsidiary can lose more than the original investment.

In fact, in a world of rapid financial transactions, a subsidiary could lose multiples of its capital intraday before the OCC is even aware of it, and *all* that loss would fall on the parent bank's capital. That means that any loss of the subsidiary--and especially its failure--can cause the capital position of the parent bank to fall dramatically, perhaps creating an undercapitalized insured bank. Indeed, to the extent that the bank's capital depends on accumulated retained earnings of the subsidiary--which are treated ambiguously under the Amendment and may or may not be deducted from the bank's regulatory capital under the Amendment--the capital of the parent bank would be inflated (and allowed to support a wider base of bank assets) and would be more susceptible to sharp regulatory and economic declines should the operating subsidiary incur losses.

The Treasury points to an OCC study of foreign securities subsidiaries to argue that because such direct subsidiaries of banks earned more than bank holding company subsidiaries engaged in the same activities, ". . . bank management . . .[is able] to better direct the activity." The evidence, in fact, fully supports the Federal Reserve's position: subsidiaries of banks, by leveraging the banks' capital and drawing on subsidized funds advanced by the parent bank, *will* be more profitable than bank holding company subsidiaries. Indeed, as testimony of U.S. banks' skill in minimizing costs, in 1996 only 2 percent of the assets held by foreign securities subsidiaries of U.S. banking organizations were in holding company subsidiaries. If a subsidy is offered, it will be taken, but that does not demonstrate management's skill in better directing the activity.

It should be underscored that the foreign subsidiaries being discussed here are Edge Corporations that only conduct business abroad under special congressional legislation enacted early this century. The Edge Corporation was designed to allow U.S. banks to compete on more equal terms, outside the U.S., with foreign entities receiving a subsidy from their governments.[1/] Since foreign bank competitors of Edge Corporations enjoy the support of their own safety nets, the Edge Corporation levels the playing field abroad, a principle worthy of support. Enabling significant new powers for domestic operating subsidiaries would *unlevel* the playing field here.

The United States currently enjoys the broadest, deepest, most liquid and efficient capital markets in the world. This has been accomplished without making a government subsidy available to securities firms. It is critical that one understand that the subsidy in banking is an unavoidable consequence of a safety net established to protect small depositors and to provide macroeconomic stability to the United States. There is no evidence that a subsidy to securities firms is necessary for macro stability. To extend such a subsidy by permitting securities activities in the domestic subsidiaries of U.S. banks would destabilize the existing domestic competitive balance, contrary not only to the general principle that markets should operate without government subsidies but also increasing pressure to extend the subsidy to other financial entities, such as insurance or finance companies. In U.S. law, there are many exceptions to general rules. As this issue demonstrates, the existence of an exception for Edge Corporations should not be used to overturn the general principle.

[1/] It is noteworthy that the great bulk of the foreign business of U.S. banks is commercial banking and that securities activities are still a relatively small, although growing, part of their business.

Treasury also argues that a still functioning subsidiary of a failed bank parent may be sold and the resultant resources used to reduce FDIC resolution costs. While that is true, all swords have two edges. A failed subsidiary of a functioning parent also could cause the bank to fail and *increase* the FDIC resolution costs.

Furthermore, H.R. 10 would not force the transfer of resources from banks to holding companies. H.R. 10 does not scale back the current power of national banks to conduct banking activities and does not require any national bank to terminate any of its existing activities.[2/] Subsidiaries of national banks currently are not authorized to engage in noncredit-related life or casualty insurance underwriting activities or ineligible securities underwriting activities. H.R. 10 would only limit the ability of the Comptroller in the future to authorize a subsidiary of a national bank to engage in activities as principal that are beyond the scope of activities that Congress has permitted for the parent bank. This limit is necessary and appropriate to protect banks, the federal safety net and the taxpayer, as well as to ensure a fair and level playing field for all financial service providers.

Nor would H.R. 10 diminish in any way the Community Reinvestment Act ("CRA"), as contended by the Treasury. As explained more fully in the attached letter, the CRA is not affected by whether new activities are authorized in an operating subsidiary of a bank or in a holding company affiliate. The CRA focuses on the lending activities of insured depository institutions, not on their asset size. Moreover, under the regulations and interpretations of all of the federal banking agencies, the activities of subsidiaries of depository institutions are counted for CRA purposes *only* at the option of the depository institution (which is the same treatment as for holding company affiliates of depository institutions).

Finally, H.R. 10 contains several provisions designed to strengthen the CRA. For example, H.R. 10 would allow a financial holding company to benefit from the newly authorized activities and affiliations only if: (1) all the

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[2/] As in the Treasury proposal, H.R. 10 would require that banks register as a broker/dealer if they conduct certain securities activities. Under both the Treasury proposal and H.R. 10, banks may, however, conduct these activities in a broker/dealer subsidiary of the bank.

subsidiary depository institutions of the holding company have achieved a satisfactory or better CRA rating, and (2) all the insured depository institution subsidiaries of the holding company that offer consumer transaction accounts also offer low-cost basic banking accounts.

5. **Several commentators have concluded that allowing national banks to own operating subsidiaries engaged in a broad range of new activities not permitted to the bank itself would extend the safety net (both FDIC deposit insurance and access to the Federal Reserve's discount window and payment system) to the operating subsidiary and greatly increase the financial exposure of the FDIC and the American taxpayer. In addition, they say that such operating subsidiaries would create an unfair playing field in the market for financial service. Please indicate whether you agree or disagree, and explain why.**

The Federal Reserve, as you know, is convinced that those activities conducted in operating subsidiaries extend the safety net, create an unbalanced playing field for financial services providers, and increase the risk exposure of the FDIC, and ultimately the American taxpayer.

The investment in the subsidiary of a bank is funded from the general resources of the bank. The cost of such funds is lowered by (that is, subsidized by) deposit insurance, access to the discount window, and access to the Federal Reserve payments system (collectively called the safety net). The stratagem of lowering regulatory bank capital by the amount of the equity investment (even though GAAP capital remains unchanged) in no way eliminates this enormous advantage in funding a subsidiary of the bank. Moreover, creditors of the subsidiary, aware that the bank can provide more subsidized funds to the subsidiary and that the bank will be strongly motivated to avoid the subsidiary's failure to meet its obligations because such a failure by the subsidiary could disrupt the bank and might require regulatory assistance, will also provide funds at a lower rate to the subsidiary than to non-affiliated entities, adding to the subsidy enjoyed by subsidiaries of banks.

Such subsidiaries would, as a result, enjoy a significant cost advantage over both holding company subsidiaries and independent firms. An important reason for financial modernization is to create a level playing field by permitting all financial institutions to do the same things under the same rules.

The operating subsidiary creates an unlevel playing field by producing an advantage for those that--to use the Treasury's word--"choose" to use the operating subsidiary. That "choice" is to use the sovereign credit of the United States for private benefit.

In using that sovereign credit, banks are exposing the FDIC, and ultimately the taxpayer, to greater risk of loss. Losses of holding company subsidiaries fall on the *uninsured* holding company, while losses of the bank subsidiary must be absorbed by the *insured* bank.

6. What additional firewalls (e.g., 23A and 23B, capital deductions, enhanced corporate separateness, restrictions on credit enhancements, loan prohibitions, FDIC protections) would you recommend for these operating subsidiaries? Please explain the reason for each.

As explained above, the Board believes that Congress would create an unlevel competitive playing field between subsidiaries of banks and independent providers of financial services if Congress were to permit banks to use the funding advantage that they derive from access to the federal safety net to invest in other financial service providers. In addition, permitting banks to own companies that conduct activities that Congress has deemed that the bank should not conduct within the bank could, no matter how stringent the firewalls, affect the safety and soundness of the parent bank and have the effect of extending the federal safety net. Firewalls are not adequate to address the funding advantage of banks or the safety and soundness implications of operating subsidiaries of banks.

It is important to be aware that the firewalls included in the Amendment are not as secure as they would seem. For example, the Amendment would not apply sections 23A and 23B to transactions between a bank and its operating subsidiaries to the full extent that those sections apply to transactions between a bank and its holding company affiliates--even though the potential for loss from activities in an affiliate is less than for activities conducted in a subsidiary of the bank. The Amendment would *not* apply sections 23A or 23B to the investment made by a bank in its subsidiary, notwithstanding the fact that those sections currently do apply to the purchase by a bank of securities of a holding company affiliate.

7. Lastly, but by no means least, what impact would the operating subsidiary proposal have on the American public? Why should John Q. Public care?

After spending more than $130 billion on the savings and loan crisis, John Q. Public should be concerned about any issues that involve the federal safety net. The operating subsidiary structure creates a greater risk of systemic contagion and loss of public confidence in the bank and the banking system, compared with the bank holding company structure, because of the bank's direct ownership interest in and management responsibility for it subsidiaries. The bank holding company structure allows achievement of all of the public and consumer benefits contemplated by H.R. 10, but in a safer manner that minimizes risk to the bank, the federal safety net, and the taxpayer.

Furthermore, as outlined above, the operating subsidiary structure allows banks to gain a competitive advantage over independent providers of the same service. Forcing other financial firms to become subsidiaries of banks in order successfully to compete reduces John Q. Public's choices as a customer.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

LAURENCE H. MEYER
MEMBER OF THE BOARD

May 4, 1998

The Honorable James A. Leach
Chairman
Committee on Banking and
Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I appreciated the opportunity to testify at the recent hearing on bank mergers. We touched on many important issues. Among them was the question of the Federal Reserve's concerns about the operating subsidiary approach as compared to the holding company framework. One aspect of the discussion with the regulators on this issue--the effect on CRA of the two approaches--did not seem very clear. I fear that the Committee was left with the wrong impression on this important matter, and, consequently, wanted to follow up.

The key question is whether CRA performance is likely to be affected by whether the bank operating subsidiary approach or the bank holding company framework is chosen for nonbank activities. The representatives from the Treasury suggested that CRA is advanced if the operating subsidiary route is followed. I disputed this, but unfortunately, the discussion on all sides was a bit muddled.

The law, however, does not suffer from this problem. Under the CRA regulations of all of the federal banking agencies--which are identical--activities of a subsidiary or an affiliate of a depository institution count towards the CRA performance of the institution *only at the option* of the depository institution. This approach reflects the fact that the CRA, by its terms, applies only to insured depository institutions and does not apply to non-depository institution affiliates. Neither the CRA nor the agency regulations make any distinction between companies that are subsidiaries of a depository institution or companies that are affiliates of a depository institution. Since these nondepository companies are not covered by CRA, the decision to accept CRA-type responsibilities is entirely voluntary for these companies. Thus, a decision to allow new activities in a subsidiary of insured banks would not increase, diminish or in any way change the CRA obligation of the bank, and would have no greater, lesser or different effect than a decision to permit new activities in affiliates of banks.

Some have made the argument that operating subsidiaries must increase the CRA obligation of banks because operating subsidiaries are consolidated into the bank for purposes of determining the size of the bank and larger banks must have a greater CRA obligation than smaller banks. While this argument has intuitive appeal, it is based on a misunderstanding and oversimplification of the agencies CRA regulations.

It is important to keep in mind that, by its terms, the CRA requires the agencies to encourage and evaluate the *lending activities* of insured depository institutions. Consequently, the primary focus of CRA examinations and assessment is on lending activities, with secondary components that involve assessment of the institution's investments in community development activities and the effectiveness of the institution in delivering retail banking services. Under current law, banks already are authorized to conduct a number of non-lending activities, such as securities brokerage activities, insurance agency activities in certain locations, and the provision of trust services. Neither the CRA nor the agencies' CRA regulations or examinations apply to these non-lending activities.

This discussion is best understood with an example that is relevant to H.R. 10. Assuming passage of H.R. 10 with the amendments proposed by the Treasury Department, a bank that doubles in size because it acquires an insurance underwriting company as a subsidiary of the bank does not suddenly have twice the CRA obligation that the bank had on the day before it acquired the insurance company. Both before and after the acquisition of the insurance company, the CRA evaluation of the bank will focus on the lending activities, community development investments and retail banking services of the bank.

Some have argued that actual CRA performance of insured banks can be expected to increase if insured banks are permitted to engage in insurance underwriting, merchant banking, and other new activities through subsidiaries. However, there is no legal requirement under H.R. 10 or the CRA, and in fact no reason to assume, that any profits generated by subsidiaries of insured banks from nontraditional activities will be used to further CRA lending activities. To the contrary, it is most likely that funds generated by non-traditional subsidiaries will be retained in the subsidiary to support expansion of these new activities--activities that are not subject to CRA--or that the profits will be distributed through the bank to the bank's shareholders. There is no mechanism for the agencies to require that these profits be used for CRA purposes.

Moreover, to the extent that one believes that profits generated by a subsidiary of a bank will increase the CRA performance of the bank, one must also be concerned that losses generated by new nontraditional activities--which must under GAAP be reflected in the financial statements of the bank--will diminish the CRA performance of the bank. This concern is not the case with holding company affiliates. Losses incurred by a holding company affiliate are not consolidated into an affiliated bank. On the other hand, a bank that wanted to increase its CRA resources can as easily obtain funds from a profitable holding company affiliate to expand the bank's CRA activities.

To the extent that the OCC wishes to consider operating subsidiary activities as part of the bank's record in every case, the OCC should change its current regulation, which grants the option to banks to include this activity as part of their record for purposes of a CRA examination, instead to mandate that the operating subsidiary activity always will be evaluated by examiners. To our knowledge, the OCC has not done this and is not planning to do so. In the absence of such a proposal, we do not believe the true state of affairs is other than as reflected in the regulation, which affords identical treatment to bank subsidiaries and to holding company affiliates.

Sincerely,

Laurence H Meyer