SUBSIDIARIES v. AFFILIATES

Treasury Response to Federal Reserve Paper About Subsidiaries of Banks

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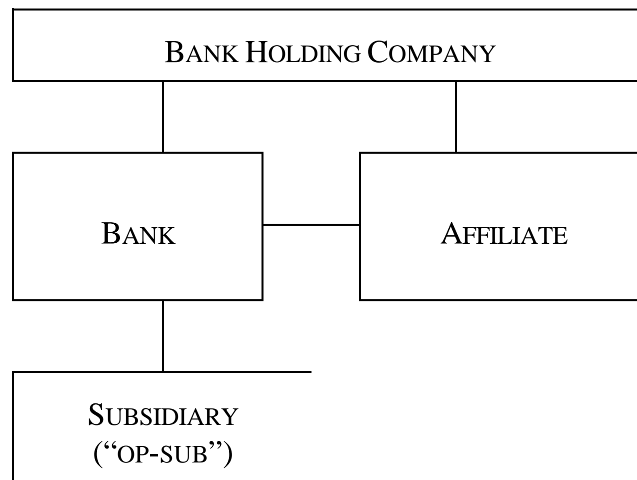
Introduction

Much debate has arisen over whether H.R. 10, the financial modernization bill, should allow companies that include banks to conduct financial activities in both affiliates and subsidiaries of banks, or only in affiliates.



The Treasury would allow a subsidiary or affiliate to conduct any financial activity. The Banking Committee bill would do the same, except that it would not permit subsidiaries to engage in merchant banking and most insurance underwriting. As currently drafted, H.R. 10 -- reflecting the position of the Federal Reserve -- would prohibit subsidiaries from conducting any financial activity as principal (except those that could also be done in the bank). The LaFalce-Vento amendment would restore to the operating subsidiary all financial activities except insurance underwriting.

In a May 4, 1998 letter to Representative Dingell, Chairman Greenspan transmitted a Federal Reserve paper on the operating subsidiary and other issues. Set forth below is a response to the portion of the Fed paper concerning the op-sub issue.

Background

Each of the op-sub proposals starts with the premise that companies that include banks, like other companies, should have the option of conducting their activities in the corporate structure that makes the most business sense for them (whether through subsidiaries or affiliates of banks). Choice is appropriate so long as each structure provides sufficient protections for the bank (and thereby for the deposit insurance funds and the taxpayers who stand behind them). Existing protections include sections 23A and 23B of the Federal Reserve Act, which prohibit a bank from lending more than 10 percent of its capital to any one affiliate, prohibit a bank's combined loans to all affiliates from exceeding 20 percent of the bank's capital, and require that all loans and other transactions between a bank and its affiliates be fully collateralized and on market terms.

Each of the op-sub proposals would apply these protections to credit extended to subsidiaries, with one exception. Rather than applying the 10 and 20 percent limits to a bank's equity (stock) investment in a subsidiary, the op-sub proposals would instead require that the bank deduct the entire amount of such investments from the bank's regulatory capital and remain well-capitalized even after the deduction. In other words, the proposals require that the bank be able to lose its entire stake in the subsidiary and still remain well capitalized. (Thus, whereas sections 23A and 23B would allow a bank that is barely well capitalized to invest up to 10 percent of its capital in a subsidiary, the op-sub proposals would allow no investment.)

It is against this backdrop that objections to subsidiaries must be considered. Set out below are responses to the major points made in the Fed paper.

Main Points

I. Conducting financial activities in a subsidiary is consistent with safety and soundness. Opposing arguments ignore the significant protections in the op-sub proposals.

The Fed staff paper warns of dangers to the safety and soundness of the American banking industry if banking organizations are permitted to engage in financial activities through subsidiaries (pp. 5-6).

Putting the Argument in Context

Until recent weeks, the Federal Reserve has not suggested that its objections to operating subsidiaries included safety and soundness concerns.

- Indeed, only a year ago (in response to a question from Representative Bentsen during a House Banking Committee hearing), Chairman Greenspan stated unequivocally -- twice -- that the federal subsidy, *not safety and soundness,* was his concern with the subsidiary structure:

  "Mr. BENTSEN. But your point is . . . the inequity of allowing the subsidy to be transferred is more your concern than the potential risk?"

  "Mr. GREENSPAN. **My concerns are not safety and soundness**. It is the issue of creating subsidies for individual institutions which their competitors do not have. It is a level playing field issue. Non-bank holding companies or other institutions do not have access to that subsidy, and it creates an unlevel playing field. **It is not a safety and soundness issue**."[1]

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[1]Transcript (p. 136) from Hearing on Financial Modernization, Committee on Banking and Financial

The FDIC, which has a strong interest in protecting the deposit insurance funds, likewise believes that the subsidiary structure raises no safety and soundness concerns.

· Chairman Helfer of the FDIC testified last year that:

> "From a safety and soundness standpoint, both the holding company model and the bank subsidiary model are viable approaches to expanding the powers of banking organizations. The safeguards that are necessary to protect the insurance funds are similar for either structure. If these safeguards are in place and enforced, either approach will work to protect the insured bank and the deposit insurance funds."[2]

· FDIC Acting Chairman Hove reiterated this message in a letter this week:

> "With appropriate safeguards, the operating subsidiary and holding company structures both provide adequate safety-and-soundness protection."[3]

Services, U.S. House of Representatives, May 22, 1997 (emphasis added).

[2]Testimony of Ricki Helfer, Chairman, Federal Deposit Insurance Corporation, Committee on Banking and Financial Services, U.S. House of Representatives, May 22, 1997.

[3]Letter from FDIC Acting Chairman Andrew C. Hove, Jr. to the Honorable John J. LaFalce, Ranking Member, Committee on Banking and Financial Services, U.S. House of Representatives, May 11, 1998.

The Fed paper's safety and soundness argument not only contradicts the Chairman's earlier statements on this issue, but runs counter to the common understanding of the relative risks of financial products. As Chairman Greenspan has explained in another context:

> "[T]he pressures unleashed by technology, globalization, and deregulation have inexorably eroded the traditional institutional differences among financial firms. Examples abound. . . . On the bank side, the economics of a typical bank loan syndication do not differ essentially from the economics of a best-efforts securities underwriting. Indeed, investment banks are themselves becoming increasingly important in the syndicated loan market. With regard to derivatives instruments, the expertise required to manage prudently the writing of over-the-counter derivatives, a business dominated by banks, is similar to that required for using exchange-traded futures and options, instruments used extensively by both commercial and investment banks. The writing of a put option by a bank is economically indistinguishable from the issuance of an insurance policy. The list could go on. *It is sufficient to say that a strong case can be made that the evolution of financial technology alone has changed forever our ability to place commercial banking, investment banking, insurance underwriting, and insurance sales into neat separate boxes*."[4]

New financial activities thus do not pose new or greater risks than those that banks are already managing.

Equivalent Protections for Subsidiaries and Affiliates

Under a fundamental, longstanding and uniform rule of corporate law, a parent corporation is not liable for the obligations of a separately incorporated subsidiary in excess of its investment in that subsidiary; in other words, the parent is treated like any other shareholder in a corporation. This so-called "corporate veil" can be pierced (for subsidiaries as well as affiliates) only under extraordinary circumstances, such as fraud by the parent.

Although a parent would not then be liable for the subsidiary's obligations, it would of course stand to lose *its own* stake in the subsidiary if the subsidiary failed -- that is, any investment in, or loans to, or guarantees made on behalf of the subsidiary. As noted above, however, each of the op-sub proposals expressly limits this exposure.

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[4] Remarks by Chairman Alan Greenspan at the Annual Convention of the American Bankers Association, Boston, Massachusetts, October 5, 1997 (emphasis added).

- Whether conducting new financial activities through op-subs or affiliates, the bank would have to be and remain well capitalized and well managed, and would face sanctions for failing to meet these standards.

- The amount of any equity investment made by a parent bank in a subsidiary would have to be deducted from the bank's capital in determining whether it satisfied the “well capitalized” standard. Thus, if the subsidiary were to fail, the bank's regulatory capital would not be affected and the bank's economic loss could not exceed the amount of its investment.

- Each of the op-sub proposals would apply the funding restrictions of sections 23A and 23B (described above) to credit extended to subsidiaries as well as holding company affiliates. Thus, the bank's ability to provide funding for a new activity would be subject to absolutely the same *strict* limits regardless of where the new financial activities were conducted.

The Fed paper briefly dismisses these protections (p. 10, ¶2) by stating that “in a world of rapid financial transactions, a subsidiary could lose multiples of its capital intra day 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. . . .” An illustration of how the above protections would function demonstrates that this is simply not so.

- Suppose, for example, that a broker-dealer subsidiary of a national bank sustained catastrophic trading losses during the day and could not meet its obligations. The funding limitations contained in the op-sub proposals would prohibit the bank from rescuing the subsidiary if the investment would leave the bank less than well capitalized; any loan to the subsidiary would be limited to 10 percent of the bank’s capital and would have to be collateralized and on market terms. Pursuant to SEC rules, the assets of the broker-dealer would be liquidated that day. The parent bank would lose its capital investment in the subsidiary but would remain well capitalized -- because it had already deducted that investment from its capital (as required by each of the op-sub proposals). If the parent bank also loaned the maximum of 10 percent of its capital to the subsidiary, it could lose some portion of that 10 percent (depending on the collateral and the recovery rates in the liquidation). Other than that, *there would be no effect on the bank’s capital*.

The Fed paper (p. 4) also claims that the restrictions in the LaFalce amendment (which allows subsidiaries to engage in some new financial activities as principal) are less strict for subsidiaries than affiliates because the section 23A limitations would not include equity investments in subsidiaries -- in other words, a bank could invest more than 10 percent of its capital in a subsidiary. This statement ignores two key facts:

- All of the op-sub proposals, including the LaFalce amendment, would require that such an investment be deducted from the bank's capital for purposes of meeting regulatory capital requirements.

- A bank could, under either current law or H.R. 10, pay dividends to its holding company for investment in a new activity without being subject to sections 23A and 23B. Notably, the Banking Committee bill and the LaFalce amendment not only would require a capital haircut for an investment in a subsidiary, but also would not allow a bank to make a downstream investment in excess of what it could legally pay out as a dividend. Treasury supports this step.

The Emerald Isle

Searching for examples of how the bank subsidiary structure can cause problems, the Fed paper cites only "an incident that occurred several years ago in Ireland" (p.6,¶1). A more relevant example would be our own country's long experience with Edge Act subsidiaries of U.S. banks, which as noted below, have for decades engaged in investment and merchant banking overseas -- without safety and soundness problems or subsidy leakage unacceptable to the Fed.

One may find a more relevant foreign experience with subsidiaries in Canada, whose banks operate under a legal regime similar to our own except in one respect: in 1987, Canada amended its version of the Glass-Steagall Act and allowed securities activities to be conducted in subsidiaries of banks.[5] We are aware of no resulting safety and soundness problems.

II. Limiting a bank's ability to fund a subsidiary resolves any concerns about the bank transferring to the subsidiary any funding advantage it derives from the federal safety net.

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[5]Task Force on the Future of the Canadian Financial Services Sector, Discussion Paper, June 10, 1997.

The safety and soundness protections above are also a complete answer to the Fed paper's argument that allowing bank subsidiaries to conduct financial activities would cause an unacceptable leakage of the federal subsidy that banks supposedly enjoy. Even assuming that a subsidy exists, the same allegedly subsidized funds that the bank could invest in a subsidiary could as readily be paid out as dividends to the holding company in order to capitalize new affiliates. If there is, as the Fed paper claims, "an enormous advantage in funding a subsidiary of a bank," there is exactly the same enormous advantage in funding an affiliate. There is no evidence to show that funds paid upstream to affiliates would carry any less of a subsidy than the same funds invested downstream.[6] And the bank's ability to provide such funds would be the same for affiliates as for subsidiaries: it would depend on the bank's capacity to remain well-capitalized after deducting the capital invested in the subsidiary or channeled to the holding company.

There is reason to question whether a net subsidy of any significance actually exists.

- If a measurable subsidy existed, banks would tend to locate activities under the bank to reap a competitive advantage. Yet where banks are free to choose their organizational form, no clear pattern emerges.
    - For example, banks can locate their mortgage banking operations in the bank, in bank subsidiaries, or in bank holding company affiliates. Currently, of the top 20 bank holding companies, six conduct mortgage banking operations in a holding company affiliate, nine conduct mortgage banking activities in the bank or in bank subsidiaries, and five conduct mortgage lending through a combination of the bank and bank holding company. This pattern suggests either that any net subsidy is minimal, or that it is the same for both sorts of organizational arrangements.
- In addition, if a safety net subsidy were substantial and created a large competitive advantage, banks -- even more than their subsidiaries -- would tend to dominate the market in activities that they can conduct within the bank. This has not occurred, however. For example, in the markets for government securities that banks can underwrite and deal in, banks are anything but dominant.

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[6] The Federal Reserve has argued elsewhere that dividends paid by banks have largely gone directly to shareholders as dividends, rather than to capitalize new affiliates. But this provides no evidence of what would happen if bank holding companies were permitted to have broad new activities and affiliations. If a material safety net subsidy existed and were capable of transmission, holding company management would have strong incentives to utilize bank resources to capitalize new affiliates that would benefit shareholders.

III. Subsidiaries of U.S. banks have for decades -- safely, soundly, and with Fed approval -- engaged overseas in investment banking and merchant banking.

The Federal Reserve's denunciation of subsidiaries is inconsistent with its own administration of the Edge Act. Pursuant to that Act, the Federal Reserve has permitted subsidiaries of national banks to engage overseas in investment and merchant banking -- the very activities that it now demands be prohibited to domestic, OCC-regulated subsidiaries.[7]

Edge Act subsidiaries can be extremely large -- one Edge Act subsidiary, for example, has over $73 billion in assets, or approximately 28 percent of the total assets of the bank and its subsidiaries. If a subsidiary's securities activities did pose a danger to a parent bank, the Edge Act would represent a grave threat to the banking system -- particularly as the Fed generally does not apply the restrictions of sections 23A and 23B to bank funding of an Edge Act sub (even though in the domestic context the Fed contends that such application is not only vital but insufficient protection).

The Fed paper (pp. 10-11) argues that when Congress authorized Edge Act subsidiaries in 1919, it did so to allow U.S. banks to compete against universal banks abroad. Thus, the Fed paper argues, its support of conducting overseas securities activities through subsidiaries is not inconsistent with its opposition to conducting the same activities in domestic subsidiaries. However:

- No amount of improved foreign competitiveness would justify a risk to safety and soundness, and the Federal Reserve has never suggested there was such a trade-off.

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[7]Since 1979, the Fed's Reg K has permitted foreign subsidiaries of both U.S. banks and bank holding companies to underwrite and deal in *equity* securities outside the United States, subject to certain restrictions and limitations. Foreign subsidiaries of U.S. banking organizations have been permitted broad authority to underwrite and deal in *debt* securities for over 25 years.

- With respect to the safety net subsidy that the Federal Reserve believes that banks receive, the Fed's defense of the Edge Act is a plain acknowledgment that this subsidy can be outweighed by a need to make our banking system competitive overseas.

- If the need for U.S. banks to compete against foreign banks can outweigh the adverse consequences of an alleged subsidy abroad, the need to compete in global markets would outweigh the concern over a subsidy no less at home. The U.S. banking system now competes on a global basis. According to recent Federal Reserve data, foreign-related institutions account for almost 14 percent of commercial bank assets in the U.S. Domestic banks compete against foreign banks in credit markets worldwide, as corporate customers can choose each day to raise funds in U.S., European, or Asian markets.

IV. Accounting principles do not determine a bank’s exposure to a subsidiary and do not justify limiting the subsidiary’s activities.

The Fed paper argues (pp. 5-6) that generally accepted accounting principles (GAAP) justify a prohibition on conducting as principal those financial activities in subsidiaries of banks that banks cannot conduct directly. The paper claims that because GAAP requires consolidation of the bank’s and subsidiary’s financial statements, national banks would have strong incentives to prop up troubled subsidiaries. Furthermore, it claims that losses at a subsidiary, which would be reflected in the banks’s consolidated financial statements prepared under GAAP, could cause depositors and investors to lose confidence in the bank. There are serious problems with this argument.

- *Accounting does not dictate liability*. As described above, a parent is not generally liable for the obligations of its subsidiaries -- notwithstanding that the assets of the subsidiary are consolidated with the parent for accounting purposes.

- The most heavily relied upon, publicly reported GAAP-based financial statements *are those of the holding company, which consolidate the financial statements of the bank with all of its affiliates as well as subsidiaries*. Thus if banks have a GAAP-induced incentive to prop up subsidiaries, banks have the same incentive to prop up affiliates, and bank holding company statements that reflect poor performance of an affiliate could just as easily concern investors and depositors.

- While it is true that subsidiary losses appear in a bank’s GAAP-based financial statements, the Fed paper neglects to point out that these losses would disappear from the bank's balance sheet when the subsidiary is liquidated or sold. At that point, the bank's financial statements will again reflect its actual economic loss, which would be limited to the bank's

investment (for which it has already taken a capital deduction and remained well-capitalized) and credit exposure within section 23A limits.[8]

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[8]The Fed asserts (p. 10) that "to the extent the bank's capital depends on accumulated retained earnings of the subsidiary -- which are treated ambiguously under the [LaFalce] 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."

This assertion is incorrect. There is nothing ambiguous about the regulatory capital treatment of a op subsidiary's retained earnings. The LaFalce Amendment and all other op-sub proposals provide not only that a subsidiary's "assets and liabilities shall not be consolidated with those of the national bank" but also that the parent national bank must deduct its "equity investment" in the subsidiary from its assets and tangible equity. The combination of these provisions ensures that the regulatory capital of the parent bank would never be inflated by the retained earnings of the subsidiary and that the bank would never be subject to sharp economic or regulatory capital declines due to subsidiary losses.

- The Fed paper asserts that a parent bank will be inclined to rescue its subsidiary. The op-sub proposals, however, would *expressly prohibit the bank from doing so if the new investment would leave the bank less than well capitalized or if any new loans would exceed section 23A limitations*. The potential exposure is thus the same as with a holding company affiliate, where the bank can channel dividends through the holding company to capitalize an affiliate.

V. Allowing banks to conduct financial activities through subsidiaries would not disrupt the Federal Reserve's role in the financial system.

The Fed paper (p. 7) asserts that "this is not a fight for 'turf' by the Federal Reserve," yet it goes on to oppose the op-sub proposals on the ground that they would diminish the Fed's regulatory jurisdiction. However the Fed's concerns are phrased, the Treasury Department has consistently recognized the importance of the Fed's role. While some on Capitol Hill and elsewhere have proposed to eliminate the Fed's bank holding company umbrella supervision role, it was the Treasury Department that began this round of financial modernization with a proposal maintaining the Fed's role. Nothing in the op-sub proposals would deprive the Federal Reserve of the jurisdiction it seeks to maintain. Rather, H.R. 10 as currently drafted would tip the regulatory balance sharply and unalterably toward the Federal Reserve.

Prospects for Holding Companies

The Fed paper (p. 8) expresses vague concerns that any growth in subsidiaries would "undermine the holding company structure" and the Fed's ability "to monitor emerging problems that could threaten our financial structure [and] our ability to manage crises." These concerns are misplaced.

Any bank of significant size would continue to maintain a Fed-regulated holding company under the op-sub proposals:

- Any bank wishing to dissolve its holding company would have to de-register all of its outstanding shares with the SEC and then re-issue stock through the OCC. We believe that no large bank would undertake such a step, given the shareholder relations problems it would cause.

- Each bill that would allow a bank holding company to engage in nonfinancial activities has required it to do so through a holding company affiliate, and not in a bank or its subsidiary. Thus, any bank that wished to use H.R. 10's commercial basket to engage in a nonfinancial activity would have to maintain a bank holding company.

- The Banking Committee bill and the LaFalce amendment would require insurance underwriting (except credit insurance) to be conducted in a bank affiliate. Thus, any bank that wished to underwrite insurance would have to maintain a bank holding company.

Finally, the Fed paper's suggestion that moving a broker-dealer from a holding company affiliate to a subsidiary would reduce the Federal Reserve's ability to monitor the risks of the broker-dealer's activities is simply unfounded. The SEC is the functional regulator of broker-dealers, and would supervise and regulate that activity regardless of where it is housed within the bank holding company. In either case, the Fed would rely on SEC reports.

National v. State Charter

The Fed paper (pp. 7-8) argues that the state bank charter is threatened, stating, "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 . . . advantages in doing business on an interstate basis." This statement is difficult to reconcile with recent history not mentioned in the paper.

- Under H.R. 1306, the Riegle-Neal Amendments Act of 1997, a state-chartered bank may offer a uniform menu of products and services when it branches across state lines. State-chartered banks operating in other states can engage -- at a minimum -- in whatever activities a national bank can engage in, so long as the bank's home state authorizes the activity. In addition, a state-chartered bank can engage in activities beyond those permissible for a national bank if they are allowed by the host state and authorized by the home state.

- The FDIC, the Conference of State Bank Supervisors, and the Fed in late 1996 agreed to provide a single regulatory point of contact at both state and federal levels for state-chartered banks that branch across state lines. Under the agreements, home state law will apply in almost every area; state-chartered banks must comply with host state laws governing intrastate branching and consumer protection.

- Finally, the most tangible consideration a bank faces when choosing between a state and federal charter is its examination fees. Whereas the OCC recoups the examination costs of national banks through fees, the federal taxpayer subsidizes the examination of state member banks, as the Fed deducts those costs from money it would otherwise remit to the Treasury. The Fed has consistently opposed charging state banks for their examinations in the same way that national banks are charged. With national and state banks now having comparable advantages in interstate banking, examination costs may become a more dominant feature in bank charter choice.

VI. Other corrections.

Scope of Operating Subsidiary Activities

The Fed paper states, "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." The paper argues that the financial-in-nature standard for subsidiaries would allow them to "conceivably engage in a variety of commercial activities," including the ownership of television stations.

This assertion is simply incorrect. The Treasury proposal (and the LaFalce Amendment) would prohibit a subsidiary from conducting *non-financial* activities, and the financial-in-nature standard is no broader for subsidiaries than for affiliates. What the Treasury proposal seeks is parity in *financial* activities between subsidiaries and holding company affiliates. Even if Congress decides to permit bank holding companies to engage to any extent in *non-financial* activities -- either through a basket or a unitary thrift structure -- none of the proposals would extend this authority to subsidiaries.

Oversight

The Fed paper argues (p. 4) that while the Federal Reserve must defer to the SEC, state insurance authorities and other functional regulators in supervising functionally regulated holding company affiliates, comparable provisions do not exist in the LaFalce amendment with respect to OCC's authority over functionally regulated subsidiaries of national banks. We strongly support, and our proposal provided for, functional regulation of securities and insurance activities, regardless of whether these activities are housed in subsidiaries or affiliates of banks.

Conclusion

On May 8, 1998, Chairman Greenspan told the *Wall Street Journal* that the question of subsidiaries "appears to be a very small issue, but it will determine the financial regulatory structure of the United States for the next generation." We wholeheartedly agree.