March 27, 2000

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Docket No. R-1057; Interim Rule for Financial Holding Companies

Dear Ms. Johnson:

The Securities Industry Association ("SIA")[1] welcomes the opportunity to comment on the interim rule issued by the Board of Governors of the Federal Reserve System ("Board") to implement provisions of Title I of the Gramm-Leach-Bliley Act ("GLB Act") authorizing bank holding companies and foreign banks that meet certain statutory criteria to become newly created "financial holding companies." Under the GLB Act, financial holding companies may engage in a broader range of financial activities than previously permitted, including underwriting, dealing in, or making a market in securities.

SIA commends the Board for acting quickly to establish procedures for bank holding companies and foreign banks to elect to convert to financial holding companies. In doing so, the Board has enabled financial institutions to utilize the expanded financial activities as soon as permitted by the GLB Act. Clearly, the priority the Board has given to implementing this rule underscores the importance of the legislation to the future of the U.S. financial services industry. SIA also appreciates the Board's effort to write a rule in

[1] The Securities Industry Association brings together the shared interests of more than 740 securities firms throughout North America to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates more than $300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about SIA is available at our Internet web site, http://www.sia.com.)

a plain English and simple question and answer format. There are, however, issues raised by the rule that SIA wishes to address.

In general, the interim rule raises SIA's concerns about: 1: the Board's exercise of its supervisory authority to restrict financial holding company activities; and 2.) the standards required for foreign banks to qualify as financial holding companies. In addition, SIA has several specific suggestions regarding revisions to particular sections of the rule that are also addressed herein.

- **Provisions to Restrict Financial Holding Companies That Satisfy Statutory Criteria Are Not Authorized by GLB Act**

SIA respectfully submits that the interim rule goes beyond the authority granted to the Board under the GLB Act by giving authority to the Board under section 225.82(d) of the interim rule to restrict the activities of a financial holding company, even if the financial holding company satisfies the statutory requirements. Section 225.82(d) provides that the "Board may, in the exercise of its supervisory authority, restrict or limit the commencement or conduct of additional activities or acquisitions of a financial holding company, or take other appropriate action, if the Board finds that the financial holding company does not have the financial resources, or managerial resources to engage in activities, make acquisitions, or retain ownership of companies permitted for financial holding companies." As explained below, there is no statutory foundation for such authority. Moreover, the Board's exercise of such authority would undermine the intent of the GLB Act that institutions be able to engage in the expanded activities based solely on a showing that the statutory criteria are met. The Board's exercise of such authority would also create uncertainty in the conduct of those activities to the detriment of the financial holding company and its customers.

The GLB Act is devoid of any provision granting the Board authority to limit financial holding companies that meet the statutory criteria. The language of the GLB Act is clear that a bank holding company may engage in the new expanded activities under subsections (k), (n) or (o) of section 4 of the BHC Act if: 1.) all of the company's depository institutions are both well-capitalized and well-managed; and 2.) the bank holding company has filed a declaration to become a financial holding company and a certification that its depository institutions are well-capitalized and well-managed. The only instance the legislation sets out for prohibiting a financial holding company from commencing any new activity or acquiring any company engaged in such activity is if an insured depository institution receives less than a satisfactory rating under the Community Reinvestment Act of 1977.

The legislative history of the GLB Act also makes clear that the Board was to have no power to restrict companies that satisfied the statutory criteria and that these companies were to be permitted to engage in the new expanded activities without restriction. "After the filing of [] a declaration and certification [to become a financial holding company], an FHC may engage de novo, or through an acquisition, <u>in any activity</u> that has been determined by the Board to be financial in nature or incidental to

such financial activity." Statement of Managers at 3 (emphasis added). Similarly, the Statement of Managers provides that "[n]ew section 4(k) permits bank holding companies that qualify as FHCs to engage in activities, and acquire companies engaged in activities, that are financial in nature or incidental to such financial activities." Statement of Managers at 2. However, there is no discussion in the legislative history, or any provision in the legislation itself, authorizing the Board to take action based on its review of the financial holding company's financial or managerial resources.

In short, the Board's retention of such authority to restrict the activities of qualified financial holding companies undermines Congress's judgment that companies that meet the statutory criteria are qualified to engage in the expanded activities. Furthermore, the Board's exercise of such unfettered discretion will negate Congress's intent to establish a self-executing filing process. Nor is there any safety and soundness justification for such authority because a financial holding company that maintains well-capitalized and well-managed depository institutions poses no risk to the Federal deposit insurance funds.[2]

Section 225.83(d)(1) of the rule, which permits the Board to restrict the activities of a financial holding company when a depository institution falls below the well-capitalized or well-managed level, also exceeds the Board's authority. Under section 225.83(d)(1), the Board "may impose any limitations or conditions on the conduct or activities of the company or any of its affiliates as the Board finds to be appropriate and consistent with the purposes of the Bank Holding Company Act." However, under the GLB Act, the Board is only authorized to limit the newly expanded activities of a financial holding company if one of the company's depository institutions drops below the well-capitalized or well-managed level. See newly added section (m)(3) to section 4 of the BHC Act. The Board should not be able to limit any activity authorized under section 4(c)(8) of the BHC Act for which the company is not required to maintain the well-capitalized or well-managed thresholds. Indeed, section 225.83(e)(2) of the rule demonstrates that the Board's remedies for failing to sustain these thresholds only go so far as the expanded activities authorized by the GLB Act. Under that section, a company can comply with an order to divest a depository institution if it has not satisfied the conditions to become well-capitalized or well-managed "by ceasing to engage in all activities that are not permissible for a bank holding company to conduct under section 4(c)(8)." Thus, a company could choose not to satisfy the well-capitalized or well-managed threshold, but the company's activities under section 4(c)(8) would be unaffected. Accordingly, section 225.83(d)(1) should be revised to reflect that the Board's authority to limit activities does not extend to those activities previously authorized by section 4(c)(8) of the BHC Act.

We have several other suggested revisions to various provisions of the rule. The Board's notice under section 225.82(f)(1) to a bank holding company that its election to become a financial holding company is ineffective should be in writing and specify the

[2] The Board's retention of such supervisory authority is also inconsistent with its position, expressed in speeches by members of the Board, that market discipline play a greater role in regulation.

reasons why the election is ineffective. Under section 225.83(c)(1), a company must execute an agreement acceptable to the Board to comply with all applicable capital and managerial requirements. SIA suggests that agreement should be limited to complying with all applicable capital and managerial requirements for only the depository institution that ceased to be well-capitalized and well-managed. The Board should not be able to impose conditions that go beyond the institutions that fell below the required threshold.

In addition, SIA believes that the rule should include provisions that would enable companies to withdraw their election, and provisions to terminate the activities of a financial holding company, if an entity chooses to do so. Such provisions would also clarify that an institution does not lose its bank holding company status by becoming a financial holding company, and that it can rely on its bank holding company authority while a financial holding company or if it terminates its financial holding company status. The rule should also include a provision for institutions to seek review of a determination by the Board under section 225.83(a) that a depository institution has ceased to be well-capitalized or well-managed. Clearly, principles of fundamental fairness and due process dictate that institutions should have some redress from such a detrimental determination by the Board.

- **Burden Imposed on Foreign Banks**

The interim rules impose a much greater burden on foreign banks in meeting the well-capitalized and well-managed standards. For this reason, SIA believes that the rule as applied to foreign banks does not give due regard to principles of national treatment and equality of competitive opportunity, as required by the GLB Act.[3]

Section 225.90(b) of the interim rule requires foreign banks to meet two more rigorous tests than U.S. bank holding companies in order to be considered "well capitalized." First, foreign banks must satisfy a leverage test – the ratio of tier 1 capital to total assets must be at least 3 percent. This is the fist time a leverage test has been imposed on foreign banks operating in the U.S. and results in the application of a U.S. regulatory standard not imposed by foreign home country supervisors. In addition, the application of a leverage test is contrary to the Basel Capital Accord, which does not contain such requirement. Moreover, the Board's requirement that foreign banks meet a leverage test ignores differences between U.S. and foreign regulation and capital requirements; and fails to recognize that because of those differences foreign banks have a much broader range of activities and holdings than their U.S. counterparts, which makes compliance with the leverage test more difficult.[4] Second, even if a foreign bank

[3] SIA appreciates that the Board has recently amended the interim rule to allow foreign banks to use the 31-day notice procedure that applies to U.S. bank holding companies. However, this amendment does not go far enough in creating a financial holding company election process for foreign banks that is comparable to the process for U.S bank holding companies.

[4] One of the inequities of the leverage test imposed on foreign banks is that U.S. bank holding companies have lived with the requirement for many years, but foreign banks have not. Yet, the Board expects foreign

meets the objective test, it still must be judged by the Board to have capital comparable to the capital required of a U.S. bank owned by a financial holding company. Therefore, even if a foreign bank meets the objective test posed by the leverage ratio, it must still satisfy the test that is left largely to the Board's discretion.

The interim rule's application of the "well-managed" standard is problematic because it not only works a hardship on foreign banks but also contains several ambiguities. On the one hand, section 225.2(s)(3) of the rule states that a foreign banking organization qualifies as well-managed if the "combined operations of the foreign banking organization in the United States have received at least a satisfactory composite rating at the most recent annual examination." This criterion -- a composite rating -- could be read to apply well beyond a foreign bank's branches, agencies and commercial lending subsidiaries in the United States to also include any other U.S. operating affiliate, such as a broker-dealer or investment advisor. [5] On the other hand, section 225.90(c)(1) adopts an office by office approach and requires each of the foreign bank's U.S. branches, agencies and commercial lending subsidiaries to have received at least a satisfactory composite rating.

Moreover, the Board has created a three-part test that foreign banks must meet but leaves the ultimate test of well-managed to the unfettered discretion of the Board. Under section 225.90(c), a foreign bank is well managed if: (1) each of the foreign bank's U.S. branches, agencies and commercial lending subsidiaries has received at least a satisfactory composite rating at its most recent examination; (2) the home country supervisor considers the overall operations of the foreign bank to be satisfactory or better; and (3) the Board determines that the management of the foreign bank meets standards comparable to those required by a U.S. bank.[6] Thus, even if a foreign bank satisfies the objective criteria set out in the first two parts of the test, the Board has given itself an escape clause in 225.90 (c)(3) which allows it to declare a foreign bank not to be well-managed even though it has met the tests in 225.90(c)(1) and (2).

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banks to immediately meet a standard that has never been applied to them. While SIA believes the leverage test is unwarranted, if the test is maintained, the Board should permit foreign banks a transition period for compliance – to permit an opportunity for these institutions to adjust their operations to fit within a test not previously applied to them.

[5] The Board's Supervisory Letter, SR 00-1, dated February 8, 2000, does not eliminate the confusion as to whether the Board will look at the combined operations or take an office by office approach. The SR letter states that a foreign bank will be considered well managed if, among other things, "each of the U.S. banking offices (depository institutions, branches, agencies, and commercial lending subsidiaries) of the foreign bank has received at least a satisfactory composite rating at its most recent examination."

[6] Further ambiguity in the well - managed standard for foreign banks results because Section 225.91(b)(4), on the other hand, states that a foreign bank must be well managed as defined in Section 225.90(c)(1) and (2). However, section 225.90(c), titled "Standards for 'well managed' actually contains three subsections. Presumably, all three clauses apply even though Section 225.91(b)(4) states that only 225.90(c)(1) and (2) apply.

In addition, the rule requires more extensive financial supporting information from foreign banks. Under section 225.82(b)(4), U.S. institutions are required to provide financial information as of the most recent quarter. However, Section 225.91(b)(2) of the interim rules requires additional information from foreign banks. Specifically, foreign banks must provide risk-based and leverage capital ratios as of the close of the most recent quarter and as of the close of the most recent audited reporting period.

In short, SIA believes that given the differences in the financial holding company declaration process for U.S. and foreign institutions, the interim rule fails to apply comparable capital and management standards to foreign banks with due regard to the principles of national treatment and equality of competitive opportunity. The Board should address these issues in its review of the interim rule.

In conclusion, SIA believes the opportunities presented by the new legislation are crucial to the U.S. financial services industry as it moves into the new millennium. By issuing the interim rule, the Board has taken the first step in implementing the new regulatory framework. We believe our recommended revisions to the rule will enable the financial holding company certification process envisioned by the GLB Act to be achieved. SIA looks forward to working with the Board during the implementation of the legislation. If we can provide any further information, please contact the undersigned or Alan E. Sorcher, Staff Advisor to the Holding Company Regulatory Committee, at (202) 296-9410.

Sincerely,

Robert C. Dinerstein
Chairman
Holding Company Regulatory Committee