FEDERAL RESERVE BANK OF NEW YORK

[Circular No. **10560**
August 4, 1992]

SECURITIES UNDERWRITING ACTIVITIES OF BANK HOLDING COMPANY SUBSIDIARIES

Proposal to Change the Current 10 Percent Revenue Test on Ineligible Securities

Comments Invited by August 27

To All Bank Holding Companies, and Others Concerned, in the Second Federal Reserve District:

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

> The Federal Reserve Board has requested public comment on alternative methods to adjust the 10 percent revenue test limiting ineligible securities activities of Section 20 subsidiaries of bank holding companies.
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> Comment is requested by August 27, 1992.
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> Section 20 of the Glass-Steagall Act prohibits a member bank from being affiliated with a company that is "engaged principally" in underwriting and dealing in bank ineligible securities.
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> The current test is based on the revenue earned from ineligible and total securities activities.
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> The Board is proposing alternatives because it believes that changes in the level and structure of interest rates since the revenue test was last examined in September 1989 can alter the measure of whether an underwriting and dealing subsidiary is "engaged principally" in ineligible securities activities in ways that were not foreseen by the Board.
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> In addition, because the Board is concerned that these changes may have severe immediate effects on the operations of some of these subsidiaries, it is allowing the subsidiaries to temporarily elect to comply with the current "engaged principally" test on a quarter-by-quarter basis as opposed to the 8-quarter rolling average presently mandated.

Printed on the following pages is the text of the Board's notice, which has been reprinted from the *Federal Register* of July 29. Also, one of the alternative tests proposed by the Board of Governors is a revenue test that is indexed to interest rate changes. A sample table of adjustment factors that can be used under the proposed indexing revenue test to adjust interest and dividend revenue, together with other supplemental information, is also printed on the following pages. Comments on the proposal should be submitted by August 27, 1992, and may be sent to the Board of Governors, as specified in the Board's notice, or to our Banking Applications Department.

E. GERALD CORRIGAN,
President.

FEDERAL RESERVE SYSTEM

[Docket No. R-0770]

10 Percent Revenue Limit on Bank-Eligible Securities Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: In 1987 and 1989 the Board authorized bank holding companies to engage, through separate subsidiaries ("section 20 subsidiaries"), in underwriting and dealing in securities that a bank may not underwrite and deal in directly ("ineligible securities"). In order to ensure compliance with section 20 of the Glass-Steagall Act, the Board provided that the amount of revenue a section 20 subsidiary may derive from ineligible securities activities may not exceed 10 percent of the total revenue of the subsidiary. Section 20 prohibits a member bank from being affiliated with a company that is "engaged principally" in underwriting and dealing in securities. The Board believes that recent changes in the level and structure of interest rates involving unusually low levels of short-term rates and an historically steep yield curve have the potential for distorting the revenue test as an accurate measure of whether a section 20 subsidiary is engaged principally in ineligible securities activities. The Board, therefore, proposes to provide an alternative to the current revenue test to take into account such changes, and requests comment on possible alternative tests.

DATES: Comments must be received by August 27, 1992.

ADDRESSES: Comments, which should refer to Docket No. R-0770, may be mailed to the Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551, to the attention of Mr. William Wiles, Secretary. Comments addressed to the attention of Mr. Wiles may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m., and to the security control room outside of those hours. Both the mail room and security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in room B-1122 between 9 a.m. and 5 p.m. weekdays, except as provided in § 261.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Richard M. Ashton, Associate General Counsel (202/452-3750), Scott G. Alvarez, Associate General Counsel (202/452-3583), Thomas M. Corsi, Senior Attorney (202/452-3275), Legal Division; Michael J. Schoenfeld, Senior Securities Regulation Analyst (202/452-2781), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorthea Thompson (202/452-4544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, D.C.

SUPPLEMENTARY INFORMATION:

Section 20 of the Glass-Steagall Act

Section 20 of the Glass-Steagall Act prohibits a member bank from becoming an affiliate of any company that is "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities. 12 U.S.C. 377. The Board and the courts have recognized that section 20 permits a member bank to be affiliated with a company whose largest activity is underwriting and dealing in the kind of securities that banks may underwrite and deal in directly ("eligible securities", so long as the company does not conduct sufficient underwriting and dealing activities with regard to ineligible securities to be deemed to be "engaged principally" in those ineligible securities activities.[1]

Calculation of "Engaged Principally"

After careful review of the terms, legislative history, and purpose of section 20 and related provisions of the Glass-Steagall Act, the Board in 1987 concluded that a company would not be "engaged principally" in ineligible securities activities for purposes of the Glass-Steagall Act if those activities were not "substantial" relative to the other activities of the company.[2] The Board also concluded that an activity was not substantial if the gross revenue derived from the activity did not exceed the range of between 5 and 10 percent of the total gross revenues of the company.

The Board determined to base its consideration of the substantiality of an activity on a measure of the gross revenue of the company because the Board believed that a test based on gross revenue was "an objective and meaningful measure of the importance of the activity to the enterprise as a whole."[3] The Board also found that a test based on gross revenue "reflects the level of risk involved in the activity," which was an important consideration behind enactment of the Glass-Steagall Act. Finally, the Board indicated that a gross revenue test would pose the fewest operational difficulties and would "avoid the potential for manipulation present in a test based solely on sales volume," which was the test advocated most strongly by the applicants.[4]

The Board determined to adopt the more conservative 5 percent threshold when the first section 20 applications were initially approved in April 1987, but committed to review that level within a year. In September 1989, following that review, the Board permitted securities affiliates to engage in ineligible securities activities up to 10 percent of gross revenues.[5]

In authorizing and regulating the section 20 subsidiaries, the Board has sought to achieve two objectives: to approve only those activities that most clearly comply with applicable statutory limits, and to assure that, as shown by the section 20 subsidiaries' actual experience with newly-authorized functions, expanded securities functions do not impair bank safety and soundness or result in conflicts of interest.

Effect of Recent Changes in Interest Rate Structure

In monitoring the operations of the existing section 20 subsidiaries, the Board has noted that historically unusual changes in interest rate configurations recently have affected the revenue test as a measure of the relative importance of eligible and ineligible securities activities in ways that were not anticipated by the Board when that test was established. Short-term interest rates have declined to their lowest levels since the early 1960's and, although long-term rates have also declined, these rates have declined much less than short-term rates, leaving an unusually sharply upward sloping yield curve. These unforeseen developments in turn have biased the relative revenue derived by some

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[1] *Citicorp*, 73 Federal Reserve Bulletin 473, 484 (1987) ("*Citicorp*"); *Securities Industry of America v. Board of Governors*, 839 F.2d 47, 67-8 (2d Cir. 1988).

[2] *Citicorp* at 484.

[3] *Citicorp* at 484.

[4] *Id.*

[5] 75 Federal Reserve Bulletin 751.

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section 20 companies from their securities operations.

The sharp decline in short-term rates has an especially marked effect on revenues obtained by section 20 subsidiaries from their eligible securities operations. First, eligible securities activity at many subsidiaries tends to involve a high proportion of short-term instruments and, second, eligible activity on average derives a greater percentage of revenue from interest earnings than does ineligible activity. Recent revenue data from a number of section 20 subsidiaries do show significant declines in revenue derived from eligible securities activities. Since there has been very little corresponding decline in long-term rates, revenue earned by these subsidiaries from holding ineligible securities, many of which tend to be of medium- to long-term maturity, has not declined to the same extent. Thus, the revenue currently derived by some section 20 subsidiaries from eligible and ineligible activities suggests that the relative importance of eligible activities in the subsidiary's business has declined, in some cases substantially.

However, according to recent data on the section 20 subsidiaries, other indicators of the relative importance of eligible activities, in particular, the proportion of eligible and ineligible assets held by these subsidiaries, have not decreased, suggesting that the relative level of eligible activity has not declined as much as the revenue data suggest. The decline in the ratio of eligible to total revenue at these subsidiaries apparently can be attributed more to the extraordinary level and shape of the yield curve rather than to changes in the subsidiary's mix of eligible and ineligible activities. The results produced by the revenue test may not be indicative of any shift in underlying activity, and the revenue test, due to its dependence on interest rates, may not be as reliable a measure of "engaged principally" as the Board had anticipated in September 1989 and in earlier orders.

While the degree of the decline in eligible revenues will necessarily vary from section 20 subsidiary to section 20 subsidiary, depending on the kinds and maturity of assets each subsidiary holds and the nature of the business it conducts, a comparison of rates prevailing when the 10 percent limit was established and rates prevailing at present suggests that the effect of the sharp drop in short-term rates in the past few months will very likely have a large impact on at least some of the section 20 subsidiaries. For example, using the most simplistic assumptions—that the duration of the ineligible securities held by a section 20 subsidiary can be represented by a corporate bond, that the duration of its eligible securities can be represented by a 3-month Treasury bill rate, and that all of the subsidiary's revenue is derived from interest on securities held—at interest rates prevalent in September 1989, when the Board increased the revenue limit to 10 percent, the amount of ineligible securities that the subsidiary could hold under the 10 percent revenue limit was approximately 7-1/4 percent of total assets, given the difference at that time between Treasury bill and corporate bond rates. With the interest rate structure prevalent today, the same subsidiary could hold only about 3-3/4 percent of its total assets in ineligible securities, because of the current very wide disparity between short- and long-term rates.

This effective change in the revenue test was not intended by the Board when it established the 10 percent limit. In the Board's view, the reduction in a section 20 subsidiary's eligible revenues due solely to the highly unusual and unforeseen alteration in the historic relationship between short- and long-term interest rates should not artificially force the subsidiary to restrict its ineligible activities to levels below what would be permitted by the 10 percent test under the interest rate patterns that prevailed when the Board established that limit. Accordingly, the Board has decided to allow section 20 subsidiaries, at their election, to use an alternative test for determining compliance with the statutory "engaged principally" restriction, instead of the current revenue test.

The Board notes, however, that the existing revenue test can be adjusted by a variety of methods to account for unusual changes in the yield curve. The Board requests public comment on appropriate methods that may be employed to achieve this objective. The Board is specifically requesting comment on two different methods of creating an alternative test:

1. Revenue Test Indexed to Interest Rate Changes

Under this proposed technique, the 10 percent revenue test would be modified to account for changes in the level and slope of the yield curve since September 1989. Section 20 subsidiaries would be allowed to adjust their current interest and dividend revenue on a quarterly basis to compensate for the unintended consequences of the shift in risk-free rates since 1989. In effect, this adjustment would be an attempt to calculate the revenue that would have been earned from eligible and ineligible activities in the current period if the Treasury yield curve were as it was in September 1989.

Several steps would be required under this method of adjusting revenue. These steps could be incorporated in the memoranda section of the FR Y-20, Schedule SUD-I, which section 20 subsidiaries use to report current financial information.

a. The subsidiary would need to calculate the average duration of its eligible and ineligible assets for the quarter in question. Ideally, such a calculation would be made at the close of business each day, since interest and dividends are earned on securities held as of that time. The Board requests comment on whether less frequent calculations, such as weekly or monthly, might be adequate.

b. Having made this calculation, the subsidiary would consult a table, published by the Board, that provides an adjustment factor corresponding to various portfolio durations. Each adjustment factor represents the ratio of interest rates in September 1989 on Treasury securities to average interest rates on Treasury securities in the most recent quarter for obligations having that particular duration.

c. Current interest and dividend revenue for the eligible and ineligible categories would then be scaled by the appropriate adjustment factors.

d. Adjusted interest and dividend revenue would be added to the other types of revenue earned by the subsidiary to calculate an adjusted ratio of ineligible to total revenue for the subsidiary.

The Board recognizes that computation of daily duration estimates might prove burdensome for some section 20 subsidiaries. Section 20 subsidiaries would not be required to use the indexed revenue limit and could continue to use the current revenue test. However, once a subsidiary chooses the alternate indexed method of applying the 10 percent limit, the subsidiary would be expected to continue to use that method for some fixed period of time, such as five years.

The adjustment technique outlined may not be the best one available. For one thing, because it is applied to all interest and dividend revenue, in effect this technique adjusts risk premiums embodied in interest rates as well as the base risk-free rate. More complex methods taking account of additional factors seem to entail even more

burdensome data and reporting requirements. The Board solicits comments on other methods that might be used to accomplish the same adjustment, as well as comments on the feasibility and burden of the technique suggested.

2. Alternate Asset-Based Test

A section 20 subsidiary, at its election, would be allowed to compute compliance with the "engaged principally" language of section 20 on the basis of assets, rather than on the basis of the existing revenue test. Specifically, such a subsidiary would be viewed as in compliance with section 20 for any quarter if the average daily assets held in connection with underwriting and dealing in ineligible securities for that quarter, when added to the average daily assets held in connection with ineligible securities activities for the previous seven quarters, does not exceed 10 percent of the average daily total assets of the subsidiary for that quarter and the previous seven quarters.

A test based on the value of securities assets held by a section 20 subsidiary is less sensitive to alterations in interest rate relationships than a test based solely on revenue. Thus, an asset-based test might represent a more accurate measure of the relative importance of eligible and ineligible securities activities.

When the Board initially selected revenue as the best indicator of whether specific securities activities are a substantial activity of a section 20 subsidiary, the Board noted two basic problems with a test based on average assets. The Board expressed concern that, compared to a revenue test, an asset-based test can be more easily manipulated by inflating the asset base solely to support ineligible activity. Also, the Board found that an average asset test, even if computed on a daily basis, would not take into account underwriting activities, since underwriters typically hold the securities being sold only for a few hours.[6] The Board seeks comment on whether it is appropriate to implement modifications to an asset-based test designed to minimize these defects.

For example, in order to prevent section 20 subsidiaries from engaging in "matched book" or similar transactions in eligible securities for the sole purpose of offsetting ineligible securities activities, specific limits could be imposed on the use of such transactions to artificially increase eligible assets totals in an asset-based test. One other possible restriction is a separate cap on the total amount of revenues that may be derived from ineligible securities activities during any calendar quarter This cap would serve as a check to assure that manipulation of the eligible asset base does not allow a subsidiary to substantially expand its ineligible securities business. Such a revenue limit would be set at a level somewhat higher than 10 percent, such as 15 percent. If an asset-based test is adopted, the Board would expect to scrutinize, through the examination process, transactions that do not appear to have been entered into for any ostensible business purpose but rather for manipulating the eligible asset base. Comment is also solicited as to any other objective standards that may be adopted to ensure the integrity of an asset-based test.

If an asset-based test is adopted, a section 20 subsidiary could be given the option of compliance with that test in lieu of the current revenue limit. In order to prevent a subsidiary from repeatedly shifting between revenue and asset tests in an effort to maximize its eligible securities base, a section 20 subsidiary that chooses the asset-based test may be precluded from changing back to the revenue test for some fixed period of time, such as five years.

In addition to proposing basic changes in the 10 percent revenue test, the Board is also concerned that the recent sharp and unanticipated alterations in the yield curve might have severe immediate effects on the operations of at least some section 20 companies. The Board is also concerned that these effects will occur before an alternative to the current revenue limit can be implemented and that section 20 subsidiaries may need time to adjust to these unforeseen changes.

For this reason, the Board amends its earlier section 20 orders to permit a section 20 subsidiary to elect to comply with the 10 percent test on a quarter-by-quarter basis, instead of the 8-quarter rolling average prescribed in those orders, until an alternative test for complying with the 10 percent limit is implemented by the Board, or until the end of the fourth quarter of 1992, whichever is earlier.[7] The alternative quarter-by-quarter computation period as a measure of the substantiality of a section 20 company's compliance with the "engaged principally" limit is fully consistent with the terms and purpose of the Act. The availability of a quarter-by-quarter basis for computation may alleviate the need for drastic adjustments in the level of ineligible activity caused by recent pronounced declines in short-term rates and eligible revenue that might otherwise be necessary under the 8-quarter average method where no adjustment is made for interest rate distortion. A section 20 subsidiary is not required to use the quarter-by-quarter method and may continue to compute compliance with the revenue test using an 8-quarter rolling average.

To prevent manipulation, a section 20 subsidiary that elects to comply with the 10 percent limit on a quarter-by-quarter basis must continue to comply on that basis until the Board adopts an alternative to the current revenue test, or until the end of the fourth quarter of 1992, whichever is earlier. A section 20 subsidiary that chooses to use the quarter-by-quarter computation period for the current quarter, must advise the appropriate Reserve Bank within 10 days from the date of this order.

By order of the Board of Governors of the Federal Reserve System, July 22, 1992.

William W. Wiles,

Secretary of the Board.

[FR Doc. 92-17839 Filed 7-28-92; 8:45 am]

BILLING CODE 6210-01-F

[6] *Citicorp*, at 484.

Section 20 Supplemental Information

The current 10 percent test was designed to prevent Section 20 subsidiaries from being "engaged principally" in underwriting and dealing in bank-ineligible securities in violation of Section 20 of the Glass-Steagall Act.

The Board proposed alternative tests because it believed that changes in the level and structure of interest rates since the revenue test was last considered in September 1989 can alter the measure of whether a Section 20 subsidiary is "engaged principally" in ineligible securities in ways that were not foreseen by the Board. One possible alternative test suggested was a revenue test that is indexed to interest rate changes. The method of indexing proposed is to adjust current interest and dividend revenue in order to calculate the revenue that would have been earned in the current period if the Treasury yield curve were as it was in September 1989.

Under the proposed indexing method, current revenue would be adjusted by a series of factors supplied by the Board that vary according to the average duration of the securities portfolio. For each duration the factor represents the ratio of interest rates in September 1989 on Treasury securities to the average interest rates in the most recent quarter. These adjustment factors would then be applied to current interest and dividend revenue.

In order to allow interested parties to determine how such a proposed index might operate in practice, and thereby to be in a better position to comment on the appropriateness of a test using such an index, the Board is providing a sample table of adjustments that could be used under the proposed indexing revenue test to adjust interest and dividend revenue in the second quarter, assuming that this test were in effect. The sample table of adjustment factors being provided is constructed from the ratios of average interest rates in September 1989 to average interest rates in the second quarter of 1992. The risk-free rates used in calculating these factors are secondary-market quotes of the yields on Treasury bills for durations of three, six, and twelve months and on STRIPS, or zero-coupon Treasury securities, for durations of two years or more. The adjustment factors in this sample table are calculated using Wednesday observations but the Board would anticipate using daily data to calculate adjustment factors. A more detailed selection of durations could be made available if necessary.

To use the indexing method described in the Board's request for comments in conjunction with the sample table provided to determine compliance with the 10 percent revenue limit for the current quarter, a Section 20 subsidiary would calculate the average duration of its eligible and its ineligible securities portfolios over the quarter. To calculate indexed eligible revenues, the subsidiary would calculate the average duration of its eligible securities portfolio over the quarter

and select from the sample table the adjustment factor appropriate for the duration. The subsidiary would then multiply the actual eligible interest and dividend revenue for the quarter by this adjustment factor to determine the indexed eligible interest and dividend revenue. The subsidiary would repeat this procedure based upon the average duration of its ineligible securities portfolio and the appropriate adjustment factor for the duration category to determine indexed ineligible interest and dividend revenue for the quarter. The indexed eligible and ineligible interest and dividend revenues would then be added to the other types of revenue earned during the quarter to calculate an adjusted ratio of ineligible revenue to total revenue subject to the 10 percent test.

The table of factors being provided is only one method by which current revenue could be adjusted to account for the level and structure of interest rates in September 1989. The Board requests comments on whether other methods of calculating these adjustments bay be more appropriate.

The sample table is attached.

Factors to Adjust Interest and Dividend Revenue

(ratio of interest rates in September 1989
to second quarter 1992)

Duration	Adjustment Factor
Months	
1	2.10
3	2.10
6	2.06
12	1.93
Years	
2	1.46
3	1.33
4	1.23
5	1.17
6	1.13
7	1.10
10	1.04
20	0.99
30	0.95

Note: Adjustment factors were calculated using secondary-market quotes of the yields on Treasury bills for duartions of three, six, and twelve months and on STRIPs, or zero-coupon Treasury securities, for durations two years and greater. Data are averages of Wednesday observations.