

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. **10623**]
February 10, 1993]

**SECURITIES UNDERWRITING ACTIVITIES OF BANK
HOLDING COMPANY SUBSIDIARIES**

**Alternative Method to Measure Compliance with the
10 Percent Revenue Test on Ineligible Securities**

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

The following statement has been issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has announced approval of an alternative method to calculate the 10 percent revenue test limiting ineligible securities activities of Section 20 subsidiaries of bank holding companies.

The alternative method is effective immediately and is designed to accommodate changes in the level and structure of interest rates since the revenue test was last examined in September 1989 and to preserve the same level of activity.

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.

The current test is based on the revenue earned from ineligible and total securities activities.

The alternative test will index revenue to interest rate changes, comparing current interest rates for various portfolio durations with rates of corresponding durations in September 1989.

A company can elect to use either the original 10 percent revenue standard or the alternative indexed revenue test for purposes of calculating compliance.

Enclosed — for bank holding companies — is the text of the Board's order permitting Section 20 subsidiaries of bank holding companies to use an alternative index revenue test to measure compliance with the 10 percent limit on bank-ineligible securities activities, together with the dissenting statement of Governors Mullins and Angell. Single copies will be furnished to others upon request directed to the Circulars Division of this Bank (Tel. No. 212-720-5216 or 5215).

Questions concerning this matter may be directed to our Banking Applications Department (Tel. No. 212-720-1465).

E. GERALD CORRIGAN,
President.

FEDERAL RESERVE SYSTEM

Order Approving Modifications to Section 20 Orders To Allow Use of Alternative Index Revenue Test To Measure Compliance with the 10 Percent Limit on Bank-Ineligible Securities Activities

Beginning in 1987 the Board has approved, under section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. § 1843(c)(8)), applications by a number of bank holding companies to establish separate subsidiaries ("section 20 subsidiaries") to underwrite and deal in securities that a bank may not underwrite or deal in directly ("ineligible securities").^{1/} In order to ensure compliance with section 20 of the Glass-Steagall Act, which prohibits a member bank from being affiliated with a company that is "engaged principally" in underwriting and dealing in securities,^{2/} the Board found that a section 20 subsidiary's underwriting and dealing in ineligible securities may not be a substantial activity of the subsidiary. In particular, the Board provided that the amount of revenue the subsidiary may derive in any quarter from such ineligible securities activities may not exceed 10 percent of the total revenue of the subsidiary for that quarter, when revenue is averaged over a rolling 8-quarter period.

I. PROPOSED MODIFICATIONS TO THE 10 PERCENT REVENUE LIMIT

On July 23, 1992, the Board requested public comment on two methods for creating an alternative to the 10 percent revenue

^{1/} E.g., Citicorp, 73 Federal Reserve Bulletin 473 (1987); J.P.Morgan & Co., 75 Federal Reserve Bulletin 192 (1989). As of December 31, 1992, 30 bank holding companies are authorized under section 4(c)(8) to underwrite and deal in ineligible securities.

^{2/} 12 U.S.C. § 377.

test.^{3/} The Board took this action in response to historically unusual changes in the level and structure of interest rates, which have distorted the revenue test as a measure of the relative importance of ineligible securities activities in a manner that was not anticipated when the Board established the 10 percent limit in September 1989. The Board noted that short-term interest rates had declined sharply in recent months but that there had been very little corresponding decline in longer term rates, producing an unusually wide difference between short- and long-term rates.

In its request for public comment, the Board noted that since eligible securities^{4/} tend to be shorter term than ineligible securities, recent revenue data suggested that the current unusually sharp increase in the steepness of the yield curve has caused the revenue earned by at least some section 20 subsidiaries from holding eligible securities to decline in relation to ineligible revenue, even though the relative proportion of eligible and ineligible securities activities being conducted by these subsidiaries has remained essentially unchanged. Thus, the Board found that this decline in the eligible revenue base of section 20 subsidiaries could be attributed to extraordinary factors beyond the control of the

^{3/} 57 Federal Register 33507.

^{4/} Bank-eligible or "eligible" securities are those securities that a national bank may underwrite or deal in pursuant to 12 U.S.C. § 24(7), and include obligations of the United States, and obligations of states and their political subdivisions.

subsidiary rather than to an increase in the relative importance of its ineligible activities. Accordingly, the Board stated that the results produced by the revenue test, due to their dependence on interest rates, may not be as reliable as the Board had anticipated when the 10 percent limit was established.

The Board proposed two alternatives to the current revenue test designed to take into account the current unforeseen alteration in historic interest rate relationships. First, the Board proposed that current interest and dividend revenue from eligible and ineligible securities could be adjusted to approximate the revenue that would have been derived if interest rate conditions were those that existed in September 1989. Under this proposed modification, current interest and dividend revenue for each quarter would be increased or decreased by an adjustment factor provided by the Board according to the average duration of a subsidiary's eligible and ineligible securities portfolios. The adjustment factor would represent the ratio of interest rates on Treasury securities in September 1989 to average interest rates on Treasury securities in the most recent quarter for obligations having that particular duration. On July 29, 1992, as supplemental information to the request for public comment, the Board published a table of adjustment factors based on interest rates prevailing in the second quarter of 1992 that could be used under the proposed indexing method.

Second, the Board proposed an alternative test under which compliance with the current 10 percent limit would be computed based on assets rather than revenue.^{5/}

II. ADOPTION OF ALTERNATIVE INDEXED REVENUE TEST

After review of relevant information, the Board has decided to modify its section 20 orders to allow section 20 subsidiaries to measure compliance with the "engaged principally" test in section 20 on the basis of an indexed revenue test, as described in the request for public comment. To use the indexed revenue test as an alternative to the current revenue test section 20 subsidiaries must notify the Federal Reserve of such an election and may not alter that election for two years.

Compliance with the Glass-Steagall Act

The Board believes that measuring compliance with the "engaged principally" standard based on a test that indexes revenues according to interest rate conditions prevailing when the current 10 percent revenue test was adopted is fully consistent with section 20 of the Glass-Steagall Act. As noted above, the Board in 1987 concluded that a bank affiliate would not be "engaged principally" in ineligible securities activities for purposes of section 20 if those activities are not

^{5/} Under the proposed asset-based test, a section 20 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.

"substantial" relative to other activities of the subsidiary, i.e., do not exceed 10 percent of the subsidiary's total activities.^{6/} This view was upheld by the courts.^{7/}

Although the statutorily-imposed "engaged principally" limitation on ineligible activities represents a "hard and fast limit" that may not be administratively modified,^{8/} nothing in section 20 itself dictates what criteria must be used to determine compliance with that limit. Indeed, the statutory term "engaged principally" is "intrinsically ambiguous."^{9/} Thus, the statute gives the Board discretion in selecting the criteria for determining when ineligible securities activities become substantial.

In the Board's view, the proposed indexed revenue test is consistent with the language and purposes of section 20 and is a permissible means to measure compliance with the "engaged principally" standard set forth in that section. When the revenue limit was initially established, the Board found that revenue is an appropriate factor for assessing whether a section

^{6/} Bankers Trust New York Corp., 73 Federal Reserve Bulletin 139, 140-45 (1986); Citicorp, supra, 73 Federal Reserve Bulletin at 481-86.

^{7/} Securities Industry Association v. Board of Governors, 839 F.2d 47, 62-67 (2d Cir.), cert. denied, 486 U.S. 1059 (1988); Securities Industry Association v. Board of Governors, 847 F.2d 890, 894-99 (D.C. Cir. 1988).

^{8/} Securities Industry Association v. Board of Governors, 839 F.2d at 68.

^{9/} Id., at 63; see Securities Industry Association v. Board of Governors, 847 F.2d at 894.

20 subsidiary is engaged principally in ineligible activities because revenue is an "objective and meaningful measure of the importance of the activity to the enterprise as a whole and reflects the level of risk involved in the activity."^{10/} As noted above, the 10 percent revenue limit has been judicially upheld as a reasonable interpretation of the language of section 20. As explained below, the proposed indexing modification is designed to treat current interest and dividend revenue as if such revenue had been earned under interest rate conditions that prevailed in September 1989, when the existing 10 percent revenue limit was established. There can be no reasonable dispute that the 10 percent revenue limit, as applied under those interest rate conditions, is consistent with the terms and purposes of the "engaged principally" test.

Indexed Revenue Test as an Appropriate Measure of Substantial Activity

The Board finds that the proposed indexed revenue test is a reasonably reliable method for measuring the substantiality of ineligible securities activities in light of the current highly unusual interest rate structure. First, it is not disputed that the size of the recent decline in short-term interest rates as compared to the decline in long-term rates is historically significant, and has resulted in a steepness of the yield curve that is highly unusual. The comments also confirm that current interest rate conditions have, at least for some

^{10/} Bankers Trust New York Corporation, 73 Federal Reserve Bulletin at 145; Citicorp, 73 Federal Reserve Bulletin at 484.

section 20 subsidiaries, caused an artificial decline in the eligible revenue base and that this in turn has made the revenue test a less reliable indicator of the relative mix of eligible and ineligible activities than the Board had anticipated when the 10 percent limit was adopted in 1989.

The commenters also do not contest that the method proposed by the Board of indexing eligible and ineligible revenue, which adjusts revenue based on comparable rates on Treasury securities based for categories of average portfolio duration, will reasonably approximate what current revenue would be if the interest rate conditions prevailing in 1989 exist during the current quarter.

For this reason, the Board finds no merit in the allegations of commenter the Securities Industry Association (the "SIA") that the indexed revenue test would permit the ineligible securities activities of section 20 subsidiaries to become substantial in violation of section 20. Rather than allowing the relative level of ineligible securities activities to increase, as the SIA asserts, the index formula represents a more refined method for measuring whether a section 20 subsidiary has exceeded the level of ineligible activity that the Board believed to be substantial when it set the 10 percent limit.^{11/}

^{11/} The Board also finds without merit the SIA's concerns that under the current revenue test some section 20 subsidiaries have made incursions into underwriting markets traditionally dominated by nonbank firms. Although the Board initially imposed a separate market share test because of perceived weaknesses in using revenue alone as the sole measure of "engaged principally" (continued...)

The Board also finds that the fact that the current unusual yield curve may have an impact on only some section 20 subsidiaries does not preclude the adoption of the indexed revenue test, since the Board believes that the current test does in fact produce less reliable results than the indexed adjustment for those companies.

The Proposed Alternative Asset-Based Test

The Board does not find it necessary at this time to decide whether to adopt the proposed alternative asset-based test because the Board is unable to determine satisfactorily at this time the potential practical effect of such a test.

Continued Use of Current Revenue Test

Many banking organizations that commented on the proposed modifications to the 10 percent limit stated that the proposed indexing of the current revenue test, which would adjust revenue according to the duration of the eligible and ineligible securities portfolio, would impose additional costly and burdensome recordkeeping and compliance requirements. For example, a number of banking organizations stated that their section 20 subsidiaries do not have in place computer systems to calculate the duration of all of the securities in their portfolio on a regular basis.

11/ (...continued)

(Bankers Trust New York Corporation, 73 Federal Reserve Bulletin at 146), the market share test was rejected by the court on judicial review as inconsistent with the statute and a revenue-only measure was upheld. Securities Industry Association v. Board of Governors, 839 F.2d at 67-68.

Accordingly, the Board believes that it is appropriate to allow section 20 subsidiaries the option of continuing to use the current unadjusted revenue test to measure compliance with the "engaged principally" standard. Each existing section 20 subsidiary that elects to use the indexed revenue test for the current quarter shall notify the relevant Federal Reserve Bank of this fact within 30 days of publication of this order.

Thereafter, any existing section 20 subsidiary that elects to use the indexed revenue test shall notify the appropriate Reserve Bank no later than 30 days prior to the beginning of the calendar quarter during which the indexed test will be used. Upon making this selection, the subsidiary will be required to continue using the indexed revenue test for a period of at least two years.

After such a period, the subsidiary may change its compliance measurement if it chooses. The Board believes that it is necessary to require a section 20 subsidiary to continue to comply with the test that it chooses for a set period of time in order to guard against potential manipulation that may occur should a subsidiary be permitted to continually switch between the two alternative tests.

Operation of the Indexed Revenue Test

As with the current revenue test, under the indexed revenue test a subsidiary will be in compliance with section 20 for any quarter if adjusted revenue from ineligible securities underwriting and dealing activities for that quarter, when added to the adjusted revenue from ineligible securities activities for

the seven previous quarters, do not exceed 10 percent of adjusted total gross revenues of the subsidiary for that quarter and the previous seven quarters.

Under the indexing method, current revenue will be adjusted by a series of factors supplied by the Board that vary according to the average duration of the securities portfolio of the section 20 subsidiary. For each category of average duration the adjustment 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 will then be applied to current interest and dividend revenue.

To use the indexing method in conjunction with the tables to be provided for any given quarter, a section 20 subsidiary must adhere to the following procedure.

1. The subsidiary calculates the average duration of its eligible assets and of its ineligible assets.^{12/}
2. The subsidiary determines the appropriate adjustment factor corresponding to the duration of the eligible and ineligible assets from the table of adjustment factors published by the Board for that quarter.

^{12/} In the proposal for modifications of the 10 percent revenue limit, the Board noted that computation of duration on a daily basis appeared to be the most appropriate method, since interest and dividends are earned on securities held as of the end of the day. Several commenters said that daily computation of duration would be unduly burdensome and suggested monthly or quarterly computation. After considering the comments as well as other facts of record, the Board is requiring that section 20 subsidiaries that choose to use the indexing method compute duration on a weekly basis.

3. The subsidiary adjusts its current interest and dividend revenue from its eligible and its ineligible activities by the appropriate adjustment factors.

4. The subsidiary adds the adjusted eligible and ineligible interest and dividend revenue to the other types of revenue earned by the subsidiary to calculate an adjusted ratio of ineligible to total revenue for that quarter.

Several commenters have raised various technical questions with regard to the method for computing average duration of assets for purposes of this formula. Specifically, the Board is aware that there may be diversity of opinion with respect to calculating duration of certain securities, such as obligations containing explicit options (e. g., callable securities) and those with imbedded options (e. g., collateralized mortgage obligations ("CMOs") with prepayment options). To ensure uniformity, the Board's staff will attempt to address these issues in revising the FR Y-20 and in responding to specific inquiries.

To reduce burden and ensure uniform treatment, the staff has been directed, to the extent possible, to rely on regulatory precedent in addressing these types of issues. For example, callable bonds would be considered to have a maturity equivalent to the first call date.^{13/} Alternatively, it would be proper, where feasible, to use the methodology contained in

^{13/} See Municipal Securities Rulemaking Board Rule G-15, Customer Confirmations.

the Federal Financial Institutions Examination Council policy statement on investments (i. e., the so-called "stress test") to calculate appropriate duration for CMOs and similar products.^{14/}

With regard to the timing of the Board's publication of the table of adjustment factors, the Board intends to publish the table applicable to each quarter at the beginning of that quarter based on average interest rates prevailing during the immediately prior quarter. Although the use of prior quarter rates will not necessarily produce adjustments that directly mirror the interest rate conditions likely to be faced by section 20 subsidiaries in the coming quarter, the differences in rates from quarter to quarter are unlikely to be highly significant, and publication of the applicable adjustment factors at the beginning of the quarter should provide for greater predictability in meeting the limits. A table of the factors that will be used to adjust revenue earned during the first quarter of 1993 is attached to this Order.

The Board recognizes that some section 20 subsidiaries do not currently have available sufficient prior data related to the duration of their assets to initially measure compliance with an indexed revenue test over past quarters. Accordingly, while the Board will retain the eight-quarter rolling average method of measuring compliance with the "engaged principally" test, the indexed revenue test will be implemented on a prospective basis

^{14/} See Federal Reserve Regulatory Service, pages 3-484.8 through 3-484.11.

only. Accordingly, to determine compliance with the indexed revenue test during the first two-year period after election of this test, adjusted revenues from ineligible securities activities for each quarter during this two-year period, when added to the adjusted revenues from ineligible securities activities for each previous quarter during the period, may not exceed 10 percent of the section 20 subsidiary's adjusted total gross revenues for that quarter and all previous quarters during the initial two-year period. After the end of the initial two-year period, compliance would be measured on the rolling eight-quarter average basis described above.

The Board is in the process of modifying the FR Y-20 (Financial Statements for a Bank Holding Company Subsidiary Engaged in Ineligible Securities Underwriting and Dealing) instructions and reporting form to take into account the adoption of an indexed revenue test. The FR Y-20 is used by the Board to collect data for off-site monitoring of compliance with the Board's revenue test and certain Board conditions, and monitoring of general financial condition.

Other comments

Two commenters cite recent allegations that some banking organizations unlawfully tied credit services with investment banking services offered by their section 20 subsidiaries and assert that adoption of the proposed adjustment would increase the possibility for illegal tying. However, as explained above, this proposal is not designed to expand

ineligible activities and allegations of illegal tying are currently under review by Board staff.

Procedural issues

The SIA, in initially commenting on the Board's proposal, requested that the Board extend the original comment period by 90 days and hold a public hearing to discuss the proposal. The SIA also requested that the Board disclose the data on operations of section 20 subsidiaries upon which the Board relied in proposing the alternative tests. The SIA believed that access to such data is essential in order to allow it to adequately assess the proposal.

The Board does not believe that it is necessary to extend the comment period or hold a public hearing on this proposal. The Board previously held a public hearing on defining the term "engaged principally" in section 20 of the Glass-Steagall Act in connection with the Board's first section 20 order in Citicorp. This interpretation is only a modest procedural adjustment, however, and does not involve the major^a policy issues the Board faced in initially allowing bank holding companies to engage in ineligible securities underwriting and dealing. In addition, the Board has generally only held public hearings on matters when written submissions are an inadequate means for the public to express an opinion on a proposal. The Board believes that in this case, written submissions have been an adequate means for the public to comment on the proposal.

As for the data to which the SIA requested access, it appears that the release of data on the level of ineligible securities activities for a specific section 20 subsidiary would not be warranted. The Board and other federal agencies generally do not disclose to the public commercial or financial information about a person that could harm that person's competitive position in the marketplace.^{15/} In this case, data about the composition of the portfolios of various section 20 subsidiaries could be potentially harmful to the competitive position of these subsidiaries, since their competitors could learn the relative mix of their eligible and ineligible activities and whether the ineligible activities might have to be curtailed because of the 10 percent limit. The Board notes that the factual circumstances that prompted the decision to modify the current revenue test, the current unusual interest rate conditions, are a matter of public record. In addition, in order to assist the section 20 subsidiaries and the public in assessing how the indexed revenue test would operate in practice, the Board has published a sample table of adjustment factors, based on historic interest rate data, that could be used in applying the indexed revenue test.

A final procedural issue relates to the process under which a section 20 subsidiary may change its method of compliance with the "engaged principally" test. The Board's Regulation Y requires a notice to be filed with the Board to alter a nonbanking activity in any material respect from that considered

^{15/} See, e.g., 5 U.S.C. § 552(b)(4).

by the Board in acting on the application to engage in the activity.^{16/} As noted above, the Board views the changes adopted to the revenue test as procedural adjustments to account for distortion caused by changes in interest rates. It is not the Board's intention, and the Board does not believe, that its action will materially alter the activity of engaging in ineligible securities underwriting and dealing for those section 20 subsidiaries that choose to adopt an indexed revenue test. Accordingly, the Board will not require a section 20 subsidiary that adopts the indexed revenue test to file a formal notice pursuant to Regulation Y before making this change, but merely to notify the relevant Federal Reserve Bank of the test it is choosing to measure its compliance with the "engaged principally" standard.

III. RAISING THE PERCENTAGE LIMITATION

A large number of commenters who favored adjusting the current revenue test also suggested that the Board raise the current percentage limitation from 10 percent to as high as 25 percent. Because this suggestion goes beyond the scope of the Board's current proposal, no action is now being taken with respect to the 10 percent limit.

IV. CONCLUSION

Accordingly, for the reasons and subject to the conditions set forth in this Order, the Board concludes that the proposed indexed revenue test, as an alternative to the existing

^{16/} 12 CFR 225.23(b)(3).

10 percent revenue limit on the ineligible securities activities of section 20 subsidiaries, is consistent with section 20 of the Glass-Steagall Act. Accordingly, the Board modifies its prior section 20 orders to permit section 20 subsidiaries to use this indexed revenue test under the conditions prescribed in this Order. This modification applies to all section 20 subsidiaries and is effective immediately. This modification does not effect in any other way the authorizations to engage in securities underwriting and dealing granted by the Board in its prior section 20 Orders and is subject to the Board's continuing authority to reexamine limitations on such activities established on section 20 subsidiaries in these prior Orders.

By order of the Board of Governors,^{17/} effective
January 26, 1993.



William W. Wiles
Secretary of the Board

^{17/} Voting for this action: Chairman Greenspan and Governors Kelley, LaWare, Lindsey and Phillips. Voting against this action: Governors Mullins and Angell.

Dissenting Statement of Governors Mullins and Angell

We believe that the indexed revenue test is an unduly complex and burdensome solution to the problem it is intended to address, i.e., the unreliability of the current 10 percent revenue limit on the ineligible securities activities of section 20 subsidiaries due to the unusual structure of interest rates at the present. As indicated by many of the comments on this proposal, the indexed revenue test will impose extensive new recordkeeping and reporting obligations.

Rather than merely fine-tuning the current test, we believe that a more fundamental and efficient approach to this problem is appropriate. In light of the unreliability of the current revenue test, the Board should directly consider an increase in the 10 percent level. As the Board's Order recognizes, the specific limits of the statutory directive that a section 20 subsidiary not be engaged principally, or substantially, in ineligible securities activities are by no means precise. Therefore, the Board has, in our judgment, a considerable degree of latitude in selecting the appropriate quantitative level for applying the engaged principally standard.

The Board selected the 10 percent level without the benefit of the recent experience with unanticipated interest rate relationships, which have now shown the unreliability of the current test. Moreover, the Board has now had considerable experience in reviewing the overall operations of the section 20 subsidiaries, and in light of this experience we believe that it is now appropriate to revisit the issue of the proper measure for

determining whether a section 20 subsidiary is engaged principally in ineligible securities activities. In our view, addressing the issue of whether an increase in the quantitative level of activity should be permitted to take into account this recent experience would be consistent with the basic objectives of the Glass-Steagall Act.

January 26, 1993

Factors to Adjust Interest Income

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

Duration

Months

1	2.70
3	2.52
6	2.42
12	2.30

Years

2	1.83
3	1.62
4	1.43
5	1.35
6	1.28
7	1.25
10	1.14
20	1.03
30	0.97

Note: Adjustment factors were calculated using 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 two years and greater. Data are averages of Wednesday observations.