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United States Senate

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

August 11, 1988

The Honorable Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System
Washington, D.C. 20551

Dear Chairman Greenspan:

The Competitive Equality Banking Act of 1987 became law one year ago, culminating a long and bitter struggle in which the nonbank banks resisted every effort to close the nonbank bank loophole and impose grandfather restrictions.

Having been decisively defeated in Congress last year, the nonbank banks now seek to persuade the Board to vitiate CEBA's grandfather restrictions by administrative "interpretation." They offer the Board a hodgepodge of fanciful statutory construction, misinterpreted legislative history, warmed-over policy arguments, and wishful thinking -- whatever suits them at the moment -- as they attempt to turn a legislative Waterloo into a regulatory triumph.

After making some general observations about the grandfather restrictions, I will comment on the Board's proposed regulations as they relate to the restrictions on new activities, cross-marketing, and asset growth.

For the reasons explained below, I believe that the regulations are faithful to the language, structure, and intent of CEBA. I am particularly concerned that the nonbank banks are misinterpreting and misapplying my own statements in an effort to gut the restrictions.

I. General Observations

A. Congressional Hostility Toward Nonbank Banks

Congressional debate on CEBA demonstrated marked hostility toward nonbank banks controlled by diversified companies (which, in the interest of brevity, I will simply call "nonbank banks"). For example, when the Senate debated CEBA in March 1987, nonbank banks were denounced by me and by Senators Boren, Danforth, Durenberger, Glenn, Graham, Heinz, Kassebaum, Leahy, and Pryor.

133 Cong. Rec. S3800-01, 3810, 3816-17, 3951, 3952-53, 4032-33, 4057, 4058, 4059-60 (daily ed. March 25-27, 1987). Not a single Senator argued that nonbank banks were desirable or beneficial. This broad pattern better reflects the thrust of CEBA than the snippets of legislative history touted by the nonbank banks.

B. Construing the Grandfather Restrictions in Accordance with Their Purpose

In closing the nonbank bank loophole, Congress had to decide what to do with existing nonbank banks. Previous legislation (e.g., S. 2851 of 1984 and H.R. 20 of 1985) would have required the divestiture of most nonbank banks. As the price of not requiring such massive divestiture, CEBA imposed stringent restrictions on grandfathered nonbank banks.

Congress declared that nonbank banks "may, because of relationships with affiliates, be involved in conflicts of interest, concentration of resources, or other effects adverse to bank safety and soundness, and may also be able to compete unfairly against bank holding companies by combining banking services with financial services not permissible for bank holding companies." Accordingly, Congress narrowly circumscribed the activities of nonbank banks so as to "minimize any such potential adverse effects or inequities." 12 U.S.C. § 1843(f)(3)(A). Congress intended for the Board to interpret and apply the grandfather restrictions so as to effectuate that objective.

Eliminating the unfair competitive advantages of nonbank banks was central to CEBA -- so central that the entire legislation was called the Competitive Equality Banking Act. Nonbank banks have tremendous competitive advantages over bank holding companies. There are virtually no limits on the activities permissible for companies affiliated with nonbank banks, whereas the activities of bank holding companies are rigidly confined. Thus nonbank banks and their affiliates can, except as constrained by CEBA's grandfather restrictions, offer many products and services that bank holding companies are prohibited from offering. CEBA reflects Congressional concern that this competitive inequality, if left unchecked, would undermine the vitality of bank holding companies and the banking system as a whole, as well as the separation of banking and commerce.

The grandfather restrictions were not designed for the comfort or convenience of nonbank banks; they were designed to carry out the policy of minimizing potential adverse effects, even at the risk of making nonbank banks less viable. The restrictions were well understood to be stringent, which is why the nonbank banks so vociferously opposed them. The change in the nonbank banks' position during the past year is remarkable: while CEBA was pending, they told Congress that the sky would fall on them if the grandfather restrictions were enacted; now they tell the Board that those same restrictions must be construed so that they restrict very little.

C. Narrowly Construing the Nonbank Banks' Grandfather Rights

The Board has long maintained that "grandfather rights under section 4 of the BHC Act are to be narrowly construed." Trustcorp, Inc., 73 Fed. Res. Bull. 827, 829 (1987). The grandfather restrictions of CEBA -- which define the grandfather rights of nonbank banks -- were drafted and enacted against the background of the Board's longstanding policy, and should be construed so as to tightly circumscribe those rights.

D. Rejecting Warmed-Over Policy Arguments

The nonbank banks argue that the grandfather restrictions in the Board's proposed regulations are unworkable, imprudent, irrational, and otherwise objectionable. That should come as no surprise: they made the same arguments to Congress last year about the statutory provisions on which the regulations are based. For example, they argued that the grandfather restrictions were unprecedented, and would impair competition, injure consumers, impede desirable innovation, weaken the international competitive position of the United States, jeopardize the safety and soundness of nonbank banks, and increase risk to the FDIC. Congress weighed such arguments and decisively rejected them.

Yet the same arguments are now being dredged up in an attempt to weaken the grandfather restrictions. The Board should decline the nonbank banks' invitation to bend the statute in deference to the very policy arguments Congress found unpersuasive.

E. The Grandfather Restrictions as Permanent Law

The nonbank banks argue that the Board should adopt lenient regulations because the grandfather restrictions might be only temporary. They harp on CEBA's reference to "temporarily restricting the activities of [nonbank banks] until such time as the Congress has enacted proposals to allow . . . all banks or bank holding companies to compete on a more equal basis with [nonbank banks]." But they ignore the remainder of the quoted sentence, which refers to Congress enacting "proposals to permanently restrict the activities of [nonbank banks]" (i.e., yet more stringent restrictions). The Board is not free to make assumptions about what the next step by Congress will be.

If Congress had wished to adopt the sort of comprehensive reform desired by the nonbank banks, it could have done so. But that approach, embodied in bills such as S. 1905 and H.R. 3799, has been soundly rejected.

In any event, the grandfather restrictions are as permanent as any Act of Congress: they will remain in effect until Congress modifies or repeals them. Leading opponents of CEBA emphasized the permanence of the restrictions:

> [V]irtually all the provisions in Title I effect changes that are both _substantial_ and _permanent_. The nonbank bank loophole is closed permanently. Current nonbank banks are grandfathered permanently with permanent restrictions.
>
> . . .
>
> [T]his legislation _itself_ finally resolves the issue. The bill is not a "temporary freeze"; it is a deep freeze that is unlikely to thaw soon.

S. Rep. No. 19, 100th Cong., 1st Sess. 86 (1987) (additional views of Senator Garn and other dissenting Republicans) (italics in original). The grandfather restrictions are entitled to the same respect as any other statute, and the Board should not be slack in interpreting and applying them.

II. Definition of "Activity"

CEBA prohibits a nonbank bank from "engag[ing] in any activity in which such bank was not lawfully engaged as of March 5, 1987." This restriction was intended to prevent nonbank banks from expanding into new lines of business.

The activity restriction is crucial to the integrity of CEBA. It is the only thing that prevents nonbank banks from becoming more like full-service banks. Indeed, without the restriction, nonbank banks could actually become full-service banks, which they were prohibited from doing even before CEBA. But the restriction was intended to be much more stringent than the pre-CEBA definition of a "bank" (under which a nonbank bank could not both accept demand deposits and engage in the business of making commercial loans).

CEBA was enacted because Congress believed that the restraint imposed by the old definition of a "bank" was not worth a plugged nickel. Congress intended to prohibit the creation of new nonbank banks and to tightly restrict nonbank banks that were in existence on March 5, 1987. If a nonbank bank was not accepting demand deposits as of that date, it could not do so after the enactment of CEBA. If it did not engage in mortgage banking, it could not begin to do so. And likewise with offering NOW accounts, accepting time deposits, making agricultural, commercial real-estate, or securities loans, leasing, discount brokerage, or acting as an investment adviser or futures commission merchant -- to name only a few examples. Any interpretation that would permit nonbank banks to expand their deposit-taking, lending, or nonbanking activities beyond those in which they were engaged as of the grandfather date would be a gross subversion of what Congress intended to accomplish.

I agree with the Board that "activity" means any discrete line of banking or nonbanking business. I believe that the Board correctly differentiates (1) among demand deposits, other transaction accounts, and time and savings deposits; (2) among commercial lending, consumer lending, loans secured by the borrower's residence, and credit-card lending; (3) among other banking activities, such as loans to depository institutions, various trust services, various clearing and payment services, consumer and business transaction services, clearing and custody of securities, and correspondent banking services; and (4) among various lines of nonbanking business, such as those listed in the Board's Regulation Y.

I believe that the Board should, if anything, further differentiate among various activities, as it did in the Statement of Guidance issued on August 21, 1987 (which used the same categories as the reports of condition routinely filed by banks). I am concerned that the Board's current proposal tends to lump together discrete lines of business (e.g., by failing to differentiate among various types of commercial lending, such as agricultural lending, commercial real-estate lending, and broker call loans).

But the Board's agglomerations pale before those now proposed by the nonbank banks -- which would define "activity" so broadly as to gut the restriction (e.g., by concocting mega-categories such as "accepting insured deposits").

In CEBA, Congress envisioned accepting demand deposits, accepting other transaction accounts, and accepting savings deposits as distinct activities. Demand deposits and transaction accounts were repeatedly mentioned separately. See, e.g., 12 U.S.C. § 1841(c)(1)(B)(i) (definition of "bank"); (c)(2)(D)(iii) (trust company exception); (c)(2)(F)(ii) (credit-card bank exception). Moreover, without such a distinction, the nonbank banks that avoided the old definition of a "bank" by not accepting demand deposits would be free to become full-service banks; for those institutions, the activity restriction would be a complete nullity -- which is the last thing Congress intended.

Some nonbank banks cite a colloquy between me and Senator Cranston for the proposition that accepting various types of insured deposits is a single activity for purposes of the activity restriction (and that the various types of insured deposits are a single product for purposes of the cross-marketing restrictions). 133 Cong. Rec. S11208 (Aug. 4, 1987). I had nothing of the sort in mind, and never imagined the use to which the colloquy is now put. I understood the colloquy to be providing reassurance that the activity restriction was not a growth limit, and that a nonbank bank could accept additional insured deposits of the same type as it was accepting as of the grandfather date ("additional such deposits").

Commercial lending activities are distinct from consumer lending activities under CEBA. That understanding is reflected in CEBA's specific references to "commercial loans." See, e.g., 12 U.S.C. § 1841(c)(1)(B)(ii) (definition of "bank"); (c)(2)(D)(iii) (trust company exemption); (c)(2)(I)(iv) (Investors Fiduciary Trust Company). Without such a distinction, nonbank banks would be free to become much more like full-service banks -- and nonbank banks that had avoided the old definition of a "bank" by limiting their commercial activities could become full-service banks if they had engaged in other lending. This would go against the whole thrust of CEBA.

Although leasing can under some circumstances be functionally equivalent to lending, I regard leasing as a separate activity for purposes of the restriction. I note that section 108 of CEBA specifically authorized leasing as a new activity for national banks.

Much lawyerly fiction has been written in an attempt to broaden the word "activity." Ingenious schemes have been concocted under which "activity" is given some broad meaning derived from other statutes, such as the so-called core banking functions exempted from the 1970 anti-tying legislation. These schemes are completely unrelated to the intent of the activity restriction, and demonstrate nothing except the creativity of their authors.

Some nonbank banks argue that the activity restriction means only that nonbank banks may not both accept demand deposits and make commercial loans. This is nonsense on stilts. If Congress had merely intended to perpetuate the old definition, it would have said so -- as it did very precisely in the case of nonbank banks controlled by bank holding companies. 12 U.S.C. § 1841(g)-

(1)(A). Congress used different language because it intended a different result.

This point is underscored by noting how the activity restriction was made more stringent while CEBA was pending in the Senate Banking Committee. Committee Print No. 1 (Feb. 17, 1987), used the same language for diversified companies' nonbank banks as it did for bank holding companies' nonbank banks: "engages in activities that would have made it a bank under the definition of bank in this Act in effect immediately prior to the date of enactment of [CEBA]." But Committee Print No. 2 (March 2, 1987) rewrote the activity restriction in substantially its current form ("engage in any activity in which it was not lawfully engaged as of March 5, 1987"). The activity restriction was intended to be much more stringent than either the pre-CEBA definition of a "bank" or the restrictions on nonbank banks controlled by bank holding companies.

The Senate Committee report noted that the activity restriction "prevent[s] the nonbank bank from, for example, both offering demand deposits and engaging in the business of making commercial loans." S. Rep. No. 19, 100th Cong., 1st Sess. 32 (1987). My statement that "the meaning stated in the report is what was intended" (133 Cong. Rec. S4054-55 (daily ed. March 27, 1987)) notes that the example (which I pointedly identified as just an "example") means what it says, but that is hardly the limit of what the activity restriction does.

The nonbank banks erroneously suggest that the proposed regulation is inconsistent with my statement that "no effort to measure activity _unduly_ narrowly on a product-by-product, customer-by-customer basis is intended, so that if a nonbank bank were engaged in offering any type of loans on March 5, it may offer _that same type of loans_ thereafter." _Id._ S4054-55 (emphasis added). This statement was inserted into the _Record_ in response to widespread fears that the Board would construe "activity" with virtually infinite specificity, so as to eliminate (rather than just closely circumscribe) the activities in question. The reference to defining activities "customer-by-customer" shows how tightly people thought the restriction could be read; "product-by-product" was likewise intended to be extremely specific (e.g., distinguishing between selling gold and selling silver). The reference to "type[s] of loans" reflects the general understanding that each of the various types of lending (e.g., credit-card loans to consumers) would be an activity for purposes of the activity restriction, and that a nonbank bank could engage after CEBA only in the particular types of lending in which it was engaged as of the grandfather date.

Although "activity" should not be defined "unduly narrowly on a product-by-product, customer-by-customer basis," such a statement should not be turned into a negative litmus test (from which "unduly narrowly" is conveniently omitted). The nonbank banks err in suggesting that nothing that can be characterized as a product (e.g., making home mortgage loans) can ever be a distinct "activity," and that no activity (e.g., lending to other depository institutions or to securities broker/dealers) can be defined with reference to the customers involved.

I think the differentiation of various activities in the proposed regulation is more than fair to the nonbank banks, and could have been considerably stricter.

III. Cross-Marketing

Under CEBA's cross-marketing restrictions, a nonbank bank may not:

> offer or market products or services of an affiliate that are not permissible for bank holding companies to provide under subsection (c)(8), or permit its products or services to be offered or marketed by or through an affiliate, . . . unless such products or services were being so offered or marketed as of March 5, 1987, and then only in the same manner in which they were being offered or marketed as of that date[.]

Grandfather rights to continue otherwise-impermissible cross-marketing are very specific: they apply product-by-product and service-by-service, and permit the product or service in question to be cross-marketed "only in the same manner" as it was being cross-marketed as of the grandfather date. It is difficult to see how one could have been more specific than "products or services" or "only in the same manner." As Governor Heller has noted, the cross-marketing restrictions are "clearly some of the most restrictive language . . . in the legislation."

The cross-marketing restrictions do not lock into place the specific terms or conditions of a grandfathered product or service. The product or service may evolve "to reflect general changes in the . . . service's or product's character and design generated by competition, market innovation or technology." 133 Cong. Rec. S3957 (daily ed. March 26, 1987) (colloquy with Senator Dodd). Thus, for example, the restrictions do not prohibit a nonbank bank from using new technology to improve a grandfathered product (just as automated teller machines were used to improve customers' access to various types of deposit accounts). But the restrictions do not permit a different product or service to be substituted for the one that is grandfathered (e.g., substituting a savings account for a certificate of deposit, or a home equity loan for an unsecured line of consumer credit). The Senate debate gives the following specific example of the sort of changes permissible: "if a nonbank bank was jointly marketing on March 5, 1987, a 3 year, $5,000 certificate of deposit, the bill would not prohibit offering in the same manner a 1 year, $2,000 certificate of deposit with a different interest rate." Id. S3959 (colloquy with Senator Cranston). CEBA was drafted in the awareness that some nonbank banks were cross-marketing only a few products (such as credit cards), and Congress did not intend to permit such banks to begin cross-marketing different products (such as such as automobile loans, home mortgages, or securities margin accounts).

To effectuate the intent of CEBA, it is crucial that the Board apply the statute as written to limit the unfair competitive advantages of nonbank banks and their affiliates.

The Board should reject the loophole lawyers' attempts to reduce "only in the same manner" to a few all-inclusive categories (e.g., direct marketing and mass marketing). As used in the cross-marketing restrictions, "the same manner" was intended to be very specific (e.g., distinguishing among newspaper advertising, radio advertising, and television advertising). It was not derived from, or in any way influenced by, abstract theories about there being only a few types of marketing. The loophole lawyers' categories would practically read the restriction out of the statute book, as most nonbank banks could claim to have done some cross-marketing in each category.

I believe that the proposed cross-marketing regulations are faithful to the language and intent of CEBA.

IV. Limitations on Asset Growth

CEBA prohibits a nonbank bank from "increas[ing] its assets at an annual rate of more than 7 percent during any 12-month period beginning after" August 10, 1988.

The Board correctly understands this language as providing for a rolling average, under which a bank's average assets during a given period (e.g., a calendar quarter) are compared with the bank's average assets during the corresponding period twelve months before. CEBA deliberately said "any 12-month period" (rather than "any year" or "any calendar year") in order specify the use of rolling measurement.

The practical and policy arguments now made by the nonbank banks are irrelevant to construing the growth restriction. These same arguments were made to Congress last year -- and rejected. Consider, for example, the arguments raised in amendments filed by Senator Cranston for the Senate Banking Committee's mark-up of CEBA. Amendment No. 19 asserted that the growth restriction "is a poorly disguised effort to reduce the viability of these institutions in the marketplace" and "plays havoc with business plans." Amendment No. 61 argued as follows:

> The asset growth restriction is simply unworkable and ends up being anti-consumer. The valuation of assets in a bank's portfolio can be affected by inflation, geographic changes in market conditions for certain assets such as real estate, consumer acceptance of valuable products and services as well as other variables. Those variables are extremely difficult to predict and in all likelihood this provision would result in lessening choices for the consumer.

More elaborate arguments were made in Conference in support of amendments to weaken the growth limit offered by Congressman Barnard and Congresswoman Oakar, both of which failed. The Board should give this sort of argument no more weight than Congress did.

In defending the 7 percent growth restriction, I stated that "[t]he average bank is growing at a rate of 8 percent. 133 Cong. Rec. S3954 (March 26, 1987). Some nonbank banks now argue that the restriction must be construed so that it conforms to the methodology of FDIC statistics, from which the 8 percent figure was supposedly drawn. This argument is as misguided as it is contrived. The growth restriction was not derived from statistics. Indeed, the relevant language of the restriction was in substantially its current form by the time of Committee Print No. 2 (March 2, 1987), which provided for a 3 percent limit ("increase its assets at an annual rate of more than 3 percent during any 12-month period beginning on or after one year after the date of enactment").

There are several references in the legislative history to how a nonbank bank "may sell assets to remain within the statutory [growth] limit." *See, e.g.*, H. Rep. No. 261, 100th Cong., 2d Sess. 125 (1987). This is now touted as showing that measurement of asset growth was intended to be so infrequent that nonbank banks could make unhurried decisions about whether to sell assets. Nothing could be further from the truth. Asset sales were mentioned to show that compliance was *possible*, however inconvenient or unremunerative it might be.

By its terms, the growth restriction involves a one-way ratchet, a use-it-or-lose-it standard: a nonbank bank cannot grow faster than 7 percent during a given measuring period, even if it grew slower than 7 percent during some previous period. Seven percent is a strict upper limit, not an average annual entitlement.

V. Conclusion

I believe that the proposed regulations are sound and judicious. The Board would have had discretion to take a considerably more restrictive view than it did, and it should not back down from what it proposed.

I trust that the Board will not make a mockery of itself by forming a task force to bargain with the nonbank banks about what regulations might suit their convenience.

I urge the Board to reject the sophistries of the nonbank banks and to promulgate final regulations without further delay.

Sincerely,

William Proxmire
Chairman