FEDERAL RESERVE APPROVES MERGER OF TRAVELERS AND CITICORP

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On September 23, 1998, the Board of Governors of the Federal Reserve System (the "Board") approved an application by Travelers Group Inc. ("Travelers") to become a bank holding company by acquiring Citicorp. The Board's order approving the transaction gives the impression that there is nothing extraordinary about the transaction and that the approval was "consistent with the Board's longstanding precedent and practice". The order goes so far as to state that Travelers' retention of its insurance business while acquiring one of the nation's largest banking organizations was a "matter of right" and did not require the approval of the Board. Notwithstanding the tone of the Board's order, the merger of Travelers and Citicorp obviously is extraordinary, creating the largest financial services firm in the world and the first combination of a large insurance underwriter with a large commercial bank. There are a variety of ways in which the Board could have prevented or impeded the transaction if that had been its desire. Instead, the Board exercised its discretion in a number of ways to facilitate the transaction, using the application as an opportunity to stake its claim as the "umbrella" regulator for all financial services businesses.

A. *Retention of Insurance Businesses*

As a result of the proposed transaction, Travelers will acquire control of Citicorp's bank subsidiaries and will become a bank holding company for purposes of the Bank Holding Company Act of 1956, as amended (the "BHC Act"). As a general matter, Section 4(c)(8) of the BHC Act prohibits bank holding companies from controlling subsidiaries that are engaged in insurance underwriting or agency activities (with certain exceptions, such as underwriting credit life insurance, that are not relevant to the proposed transaction). However, Section 4(a)(2) of the BHC Act provides that a company that becomes a bank holding company may retain for two years shares of nonbank companies that would otherwise be impermissible for a bank holding company to own. The Board may provide up to three one-year extensions of the two-year holding period if, "in its judgment, such extensions would not be detrimental to the public interest".

In approving the Travelers application to acquire Citicorp, the Board stated that providing Travelers with the two-year holding period referred to in Section 4(a)(2) "is consistent with the Board's longstanding precedent and practice." Although other companies have relied upon Section 4(a)(2), none of the precedents cited by the Board involved cross-industry acquisitions that were even remotely comparable in size to the Citigroup transaction;

nor were any of the precedents cases in which the parties fully expected to hold the nonconforming activities beyond the two-year period contemplated by Section 4(a)(2).

The Board also stated in the order that the "two-year period is provided to bank holding companies as a matter of right and does not require the approval of the Board," adding that Section 4(a)(2) "does not distinguish among different types of [nonconforming] activities". Although it is true that Travelers was entitled to retain its nonconforming insurance activities for two years after becoming a bank holding company, it was for the Board to decide whether Travelers met the criteria for approval as a bank holding company. In every case in which a company applies to become a bank holding company the Board is required to consider "the financial and managerial resources and future prospects of the company and the banks concerned". [1] The Board could have denied the application on the grounds (for example) that the financial risks associated with underwriting property and casualty insurance or the difficulty of managing such a vast and diverse institution posed undue risks to the insured bank subsidiaries of Citicorp. The Board previously denied an application by Citibank to engage, through an indirect non-U.S. subsidiary, in property and casualty insurance underwriting outside the United States. Although the Board had the authority to approve the application, it denied it on the grounds that

> the risks inherent in underwriting property and casualty insurance are not of the type traditionally associated with banking. Recent experience of both U.S. and foreign casualty insurance underwriters demonstrates that these risks, and consequent losses and potential losses, can be substantial. . . . Engaging in a generalized property and casualty underwriting business, even initially on a modest scale, would nonetheless constitute entry into an inherently risky business. . . . Based on the foregoing and other considerations reflected in the record, the Board has determined that approval of the application by COIC would not be consistent with the purposes of the Federal Reserve Act or the Bank Holding Company Act and would not be in the public interest. [2]

The Board order approving the acquisition of Citicorp by Travelers does not describe the property and casualty insurance business of Travelers as "inherently risky". In fact, there is no discussion of the risks that might be associated with combining such insurance activities with commercial banking. Instead, the Board appears to have taken the functional regulation approach contemplated in H.R. 10, the financial modernization legislation now before Congress. In a functional regulation scheme, a holding company's activities are compartmentalized into insurance, securities, banking and commodities subsidiaries and each such subsidiary is primarily regulated by its "functional" regulator (i.e., the Securities and Exchange Commission, state insurance commissioners, the Comptroller of the Currency, etc.). The Board, as the "umbrella regulator" under H.R. 10, would have the residual authority to take action to protect

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1 12 U.S.C. §1842(c)(2).

2 *Citibank Overseas Investment Corporation*, 71 Fed. Res. Bull. 267 (1985).

an insured bank subsidiary from risks created by its affiliates, but it would not be expected to supplant the day-to-day jurisdiction of the functional regulators.

As if H.R. 10 already had been enacted, the Board's limited its consideration of the risks associated with Travelers insurance underwriting business to a review of the reports filed with the insurance regulators and consultation with such regulators. The Board also stated that the insurance, securities and depository institution subsidiaries of Travelers and Citicorp currently exceed the regulatory capital requirements imposed by the functional regulators of those subsidiaries and that the Board's plan for supervising Citigroup will include regular contacts with such regulators.

The Travelers order is not very clear on how the Board assessed the capital adequacy of Citigroup. The Board stated several times in the order that Citigroup will be a "well capitalized banking organization" on consummation of the transaction, but it did not state what that meant. Normally, a bank holding company is expected to be well capitalized under the Board's risk-based capital rules, but because the Board's risk-based capital guidelines do not include risk weights for the type of off-balance sheet liabilities associated with insurance underwriting, it is unclear how the Board could determine that Citigroup would be "well capitalized" under those guidelines. It seems more likely that "well capitalized banking organization" means that the banking subsidiaries of Citigroup will be "well capitalized" under the Board's guidelines and that the various insurance and securities subsidiaries of Citigroup would each satisfy the regulatory capital guidelines established by its functional regulator. This would be consistent with H.R. 10. Although H.R. 10 would not explicitly prohibit the Board from imposing its current risk-based capital guidelines on financial holding companies on a consolidated basis, such a prohibition is implicit in the H.R. 10 provision that prevents the Board from mandating capital requirements for subsidiaries regulated by other functional regulators.

The Board also glossed over the extent to which it exercised discretion with regard to the Section 4(a)(2) holding period. The Board could have, but chose not to, require Travelers to provide a specific plan for divesting its impermissible insurance businesses within two years. Instead, the Board decided that Travelers' description of the "various alternatives available to Travelers to meet the requirements of the BHC Act" and a commitment to conform its activities within two years "or such extended period as the Board, in its discretion, may grant" provided the Board with a sufficient basis to approve the application. It seems clear that both Travelers and the Board expect the Section 4(a)(2) holding period to be extended to the maximum five years that the Board has the authority to grant unless, prior to the end of the five years, financial reform legislation is passed that makes it unnecessary for Travelers to conform its insurance business to the BHC Act. In exercising its discretion in this manner, the Board channelled the Travelers transaction toward the H.R. 10 model, in which the Board would have jurisdiction as the umbrella regulator, and away from alternative regulatory arrangements, such as operating Citigroup as a unitary savings and loan holding company or placing the insurance underwriting activities in a subsidiary of Citibank,[3] in which the Board would be divested of jurisdiction.

The Board was also accommodating with respect to restrictions on Travelers' insurance businesses during the Section 4(a)(2) holding period. One question that arose during the processing of Travelers application is the treatment of investments by Travelers' insurance underwriting subsidiaries which, under current practice, occasionally exceed 5% of the voting shares of the company in which the investment made. Bank holding companies are generally not permitted to acquire more than 5% of the voting shares of nonfinancial companies. The Travelers' insurance underwriting subsidiaries also have made equity investments in non-U.S. companies that are consistent with the higher equity thresholds applicable to bank holding company investments in non-U.S. companies,[4] but inconsistent with the requirement that such non-U.S. companies not engage in business in the United States. The Fed permitted the insurance subsidiaries of Travelers to continue making investments constituting more than 5% of the voting shares of a U.S. company during the Section 4(a)(2) holding period,[5] provided that such investments do not involve control, constitute a "small" portion of the insurance underwriting subsidiaries' equity investment portfolio, and are conformed to the BHC Act by the end of the Section 4(a)(2) holding period. This is a more generous position than the Board typically takes, which is to provide a period of two years to bring the nonconforming investments into compliance but not to allow additional investments.

The Board was also generous in allowing Travelers and Citicorp to cross-market their products during the Section 4(a)(2) holding period. The Board has prohibited cross-marketing of insurance and banking products in the United States by non-U.S. banks that merged with non-U.S. insurance companies and that have received, pursuant to Section 4(c)(9) of the BHC Act, a four-year exemption period to conform their activities to the BHC Act.[6] The Board distinguished those cases by stating that Section 4(c)(9) requires a Board determination that the requested exemption would be in the public interest while Section 4(a)(2) allows Travelers to retain its insurance operations as a matter of right. This response by the Board seems odd inasmuch as elsewhere in the order it went to great lengths to explain why the proposed arm's

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3 These regulatory alternatives are discussed in our prior memorandum regarding the Travelers transaction, "Travelers Group, Citicorp and the Federal Reserve" (April 14, 1998).

4 As a general matter, bank holding companies are permitted to acquire up to 19.9% of the voting and 40% of the equity of any type on non-U.S. company that does not engage in business in the United States.

5 Travelers will also be permitted to retain, but not add to, its nonconforming investments in non-U.S. companies.

6 *See*, *e.g.*, Letter from Jennifer J. Johnson, Associate Secretary of the Board, regarding the merger of NMB Postbank Groep N.V. and Nationale-Nederleden N.V. (Nov. 21, 1990).

length[7] cross-marketing activities would not result in any adverse effects or in any competitive advantage[8] for Citigroup. Moreover, the Board will be statutorily required to consider the "public interest" if Citigroup requests an extension of the Section 4(a)(2) holding period for an additional year; presumably, the Board does not anticipate requiring Citigroup to terminate the cross-marketing program as a condition of extending the holding period.

B. *Retention of Securities Businesses*

As expected, the securities activities of Travelers were not a significant obstacle to approval of the transaction. Under current regulatory interpretations, a bank holding company may have a broker-dealer subsidiary that derives up to 25% of its gross revenues from underwriting and dealing in equity securities, corporate debt securities and other securities (collectively, "ineligible securities") that a bank itself is not permitted to underwrite or deal in. It is widely believed that few if any of the major investment banks derive more than 25% of their revenues from underwriting and dealing in ineligible securities.

In addition to Salomon Smith Barney Inc. ("SSB"), Travelers holds a number of broker-dealer subsidiaries that are engaged in ineligible securities activities. SSB and all but one of the other subsidiaries currently satisfy the 25% ineligible revenue limit. Travelers has committed that each of the subsidiaries will operate within the ineligible revenue limit in the future. Compliance with the limit will be calculated under the standard method that is used when banking organizations acquire investment banks.[9]

Travelers also engages in various mutual fund activities. The only mutual fund activity that is not permissible for bank holding companies is acting as the distributor for the funds, which is a largely ministerial role. Travelers agreed to find, prior to closing, an independent distributor for the funds for which Travelers currently acts as distributor.

The Board allowed Travelers to continue to engage, during the Section 4(a)(2) holding period, in two activities that are consistent with the Glass-Steagall Act but not permissible

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7 Travelers committed that its insurance products will be offered by Citigroup affiliates on the same terms and conditions as they are offered for sale through third-party providers to similarly-situated customers.

8 The Board stated that the markets for the products and services that Citigroup proposes to cross-market (i.e., annuities, insurance, mutual funds, credit cards, deposit products, mortgage loans and consumer loans) are highly competitive, making it unlikely that Citigroup would have a competitive advantage in being able to cross-market such products.

9 Under this method, each broker-dealer subsidiary is required to comply with the revenue limit on an annual (rather than quarterly) basis for the first year. After the first year, each broker-dealer subsidiary is required to comply with the revenue limit on the standard quarterly rolling average method.

under the BHC Act. One activity relates to SSB's activities as a market maker. As part of that activity, SSB from time to time acquires more than 5 percent of the voting shares of a company. Bank holding companies generally are not permitted to acquire more than 5 percent of the voting shares of a company without obtaining prior Board approval and the Board will grant such approval only for companies that are engaged in activities that are "closely related to banking." SSB represented in these market-making activities it acquires securities "regardless of the prospects for appreciation" and not for investment purposes. The Board determined that it would be consistent with Section 4(a)(2) to allow SSB to continue to engage in these transactions during the Section 4(a)(2) holding period subject to the conditions that: (i) the size of such holdings does not increase as a share of all market-making transactions; (ii) such holdings continue to be for a noninvestment purpose; (iii) such holdings are reduced to 5 percent within thirty days; and (iv) such holdings never exceed 25 percent or involve control of the company in which the investment is made.

Travelers currently controls private investment vehicles that hold investments that are not permissible for bank holding companies. Travelers is required to bring such investments into compliance with the BHC Act within two years. In contrast to the SSB market-making activities, the private investment vehicles that Travelers controls are not permitted to make additional nonconforming investments during this two-year period.

C. *The Improving Prospects for H.R. 10*

Congress is once again attempting to enact financial reform legislation. In very broad terms, the Financial Services Act of 1998, which is commonly referred to by its bill number, H.R. 10, would allow a holding company to engage in banking, securities underwriting and dealing, insurance underwriting and sales, and a limited amount of nonfinancial activities. The legislation contemplates functional regulation of the component parts of such a holding company by banking, securities, insurance and commodities regulators, with the Board as the umbrella regulator over the entire structure. The Board also would be authorized to determine what types of additional "financial" activities such holding companies could undertake. The authority of the Comptroller of the Currency to permit new activities to be conducted through national bank subsidiaries would be terminated and most insurance underwriting and securities activities would be forced out of banks and into nonbank affiliates. The bill would also prevent additional unitary savings and loan holding companies from being established.

On May 13, 1998 the House of Representatives passed H.R. 10 by a vote of 214 to 213. The version of H.R. 10 that passed the House was supported by investment banks, insurance companies, insurance agents and a few large banks. A number of major banking organizations opposed the legislation, primarily because it did not adequately protect banks that sell insurance from discriminatory treatment by state insurance commissioners. The Treasury Department opposed the House version of H.R. 10 because it would prevent the Comptroller of the Currency, which is part of the Treasury Department, from permitting national banks to engage in new activities through bank subsidiaries, as opposed to holding company affiliates regulated by the Board. The Treasury Department argues that financial institutions should be able to choose between a subsidiary or holding company structure and that the executive branch (and not just the Board) should have a role in the future development of the financial services sector.

On September 11, 1998, the Senate Banking Committee approved its own version of H.R. 10 by a 16-2 vote. Prior to voting on the bill, the Senate Banking Committee made changes to several of the controversial provisions in the legislation. The version approved by the Committee provides the Treasury Department with a role in deciding which new financial activities should be permitted for financial holding companies. However, that role is subservient to the Board and the legislation continues to prohibit bank subsidiaries from engaging in most insurance and securities activities as principal. The Treasury Department continues to oppose H.R. 10.

The Senate Banking Committee version of H.R. 10 substantially rewrote the provisions relating to insurance sales. The independent insurance agents have argued insurance agency activities must be regulated by state insurance commissioners to ensure that banks do not force customers to purchase insurance from them as a condition of getting such credit products as mortgages and car loans. The banks believe that vesting such authority in state insurance regulators will result in a complicated patchwork of insurance regulation and discriminatory treatment of banks by state insurance regulators who to date have been hostile to bank involvement in the insurance business.

The insurance agents supported the House version of H.R. 10, which would have preempted state laws that prevent or significantly interfere with insurance sales by banks, but excluded from this preemption state laws that are no more restrictive than an Illinois law on the subject. This exclusion was of concern to banks because it is unclear how the relatively new Illinois law will be interpreted and because the House version further provided that the non-preemption of the Illinois law did not create any inference regarding preemption of laws more restrictive than the Illinois law. The muddled preemption provisions made it more likely that conflicts would erupt between the Comptroller and state insurance regulators over the discriminatory effect of state insurance rules. The House version provided that the Comptroller would not be entitled to the deference from the courts that it currently enjoys in such disputes. Finally, the House version did not expressly protect banks from state insurance laws that are facially neutral but that have a disparate impact on banks.

The Senate Banking Committee version of H.R. 10 is much friendlier to banks. Although the preemption of state insurance laws that prevent or significantly interfere with insurance sales by banks is subject to thirteen exceptions, the exceptions are specifically described and address the practices that the independent insurance agents say they are concerned about. The excepted laws include laws that: prohibit a bank that requires insurance in connection with a loan from preventing an unaffiliated insurer from providing it; prohibit referral fees to bank employees conditioned on the customer purchasing insurance; prohibit a bank from conditioning a loan or other service, or varying the price thereof, based on whether the customer purchases insurance from the bank or an affiliate of the bank; require a bank to provide customers with written disclosure to the effect that the customer's choice of insurance provider will not affect the availability of credit or the terms thereof; require a bank that sells insurance and provides credit to a customer to use separate documents for each part of the transaction. The Senate Banking Committee version retains judicial deference to the Comptroller in the case of disputes between the Comptroller and a state insurance regulator regarding preemption of state insurance laws passed prior to September 3, 1998. The Senate version of H.R. 10 also contains an express anti-discrimination standard, applicable to laws passed on or after September 3, 1998, protecting banks from facially neutral state insurance laws and regulations that, as interpreted or applied, have a disparate impact on them. As amended by the Senate Banking Committee, H.R. 10 is now supported by commercial banks and opposed by the independent insurance agents.

The Senate Banking Committee also revised the H.R. 10 provisions concerning holding companies that own a single savings association (“unitary savings and loan holding companies”), which, under current law, are permitted to be affiliated with any type of company, including commercial and industrial organizations. Recent changes in laws applicable to savings associations have made them much more like banks and dozens of investment banks and insurance companies have filed applications with the Office of Thrift Supervision to become unitary savings and loan holding companies. Commercial banks oppose unitary savings and loan holding companies because such companies are permitted to engage in most banking activities without being subject to restrictions on their nonbanking activities. The House version of H.R. 10 provided that unitary savings and loan holding companies created pursuant to an application filed after March 31, 1998 would be subject to the activity restrictions that apply to financial holding companies. However, under the House version a unitary savings and loan holding company established prior to the grandfather date that is acquired after the grandfather date would continue to be exempt from activity restrictions. Under the Senate version of H.R. 10, unitary savings and loan holding companies established pursuant to an application filed before September 3, 1998 will not be subject to the activity restrictions that apply to financial holding companies, but a company that acquires a unitary savings and loan holding company pursuant to an application filed on or after September 3, 1998 will be subject to such activity restrictions.

With Congress scheduled to adjourn on October 9, 1998, there is little time for the Senate to pass legislation and for the Senate and the House to resolve the differences that exist in their respective versions of the legislation. Legislative leaders in the House of Representatives expressed support for the Senate version of the bill, but have indicated that differences will have to be resolved in a conference rather than by having the House accept the Senate version of the bill. Also, while the dispute over insurance sales is the most important obstacle to approval, there are a number of other issues that remain contentious. Senators Gramm and Shelby have threatened to block the legislation unless the provisions relating to the Community Reinvestment Act are removed or substantially weakened. The extent of the SEC's authority to determine what securities activities may no longer be conducted in commercial banks is a subject of dispute. Finally, the Treasury Department continues to strongly oppose the provisions that require most nonbanking activities engaged in as principal to be conducted in holding company affiliates of banks under the Board's rather than the Comptroller's supervision.

The prospects for enacting the Senate Banking Committee's version of H.R. 10 within the next year certainly have improved. The Senate version of the legislation seems to more accurately reflect the relative political and economic strength of the disputing factions than the House version. Moreover, the Travelers order indicates that the Board intends to proceed as if H.R. 10 had already been enacted and Congress will find it easier to ratify changes implemented by the Board than to break new ground.

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