Board of Governors of the Federal Reserve System
U.S. Department of the Treasury

Report to the Congress on Financial Holding Companies under the Gramm–Leach–Bliley Act

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Submitted to the Congress by the Board of Governors of the Federal Reserve System and the Secretary of the Treasury as required by section 103(d) of the Gramm–Leach–Bliley Act

Contents □

Introduction and Executive Summary

Background

The Gramm-Leach-Bliley Act significantly altered the legal framework governing the permissible affiliations and activities of banking organizations in the United States.[1] Enacted on November 12, 1999, it repealed the provisions of the Glass-Steagall Act and the Bank Holding Company Act of 1956 (BHC Act)[2] that previously had constrained the ability of banking organizations, securities firms, and insurance companies to affiliate and compete with each other. By removing these legal barriers, the Gramm-Leach-Bliley Act (GLB Act or Act) created a two-way street that permits banks, securities firms, and insurance companies to affiliate with each other through the financial holding company (FHC) structure when, or if, the organization believes such action is appropriate in light of the organization's competitive strategy or market developments. In other words, the Act allows existing bank holding companies to acquire full-service securities firms and insurance companies, and it allows securities firms and insurance companies to acquire a bank (and thereby become a bank holding company).

Specifically, the GLB Act permits a bank holding company or a foreign banking organization that is subject to the BHC Act to elect to become an FHC.[3] The Act permits FHCs to engage in, or affiliate with a company engaged in, any activity that has been determined to be financial in nature or incidental to a financial activity under the Act. The Act itself declares that several activities are financial in nature and thus permissible for FHCs, including, most importantly, the following four: securities underwriting and dealing, insurance underwriting, insurance agency activities, and merchant banking. In addition, the GLB Act authorizes the Board of Governors of the Federal Reserve System (Board), in consultation with the Secretary of the Treasury (Secretary), to determine that additional activities are financial in nature or incidental to a financial activity and thus permissible for FHCs. Moreover, the Act permits an FHC to engage, to a limited extent, in a nonfinancial activity if the Board determines that the activity is complementary to a financial activity and does not pose a substantial risk to depository institutions or the financial system generally. The authority for FHCs to engage in these new activities is in section 4(k) of the BHC Act.

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[1] Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[2] 12 U.S.C. §§ 1841 *et seq*.

[3] Under Federal law, a foreign bank and any company controlling a foreign bank is treated as a bank holding company for purposes of the BHC Act if the foreign bank operates a branch or agency in the United States or if the foreign bank or company controls a commercial lending company in the United States. *See* 12 U.S.C. § 3106. Unless the context otherwise requires, the terms "bank holding company" and "financial holding company" used in this report include any foreign bank or company controlling a foreign bank that is subject to the requirements of the BHC Act.

For a bank holding company to be an FHC and take advantage of the new powers granted by the GLB Act, all of its depository institution subsidiaries must be well capitalized and well managed, and all of the company's insured depository institution subsidiaries must have at least a "satisfactory" rating under the Community Reinvestment Act of 1977 (12 U.S.C. §§ 2901 *et seq*.).[4] As required by the GLB Act, the Board has established comparable capital and managerial requirements for foreign banks that are subject to the BHC Act because they maintain a branch or agency in the United States or control a commercial lending company in the United States.[5]

Report

Section 103(d) of the GLB Act requires the Board and the Secretary to submit a joint report to the Congress within four years after the date of enactment of the GLB Act concerning the new activities conducted by FHCs under the Act, the actions the Board and the Secretary have taken to determine the activities permissible for FHCs, the risks posed by any commercial activities conducted by FHCs, and the effect that any mergers and acquisitions by FHCs under the Act have had on market concentration in the financial services industry.[6] This report is submitted in fulfillment of section 103(d) of the GLB Act.

The report is in four parts. Part I provides background information concerning FHCs and analyzes the extent to which FHCs are engaged in securities underwriting and dealing, insurance underwriting, insurance agency activities, and merchant banking under the GLB Act. Part I also highlights some of the most significant inter-industry transactions enabled or facilitated by the GLB Act. Part II discusses the actions that the Board and the Secretary have taken to identify, clarify or expand the range of nonbanking activities permissible for FHCs under the GLB Act. Part III contains an analysis of the risks posed by the commercial activities of FHCs to the safety and soundness of affiliated depository institutions. Part IV analyzes the effects that the formation of, and acquisitions by, FHCs have had on market concentration in the markets for securities underwriting and dealing, insurance underwriting, insurance agency services, and merchant banking.

Summary of Findings

Here are the principal findings of the report.

● Financial Holding Companies. More than 600 companies now operate as FHCs under the GLB Act. FHCs represent a broad spectrum of banking organizations, including 49 of the 71 U.S.-based bank holding companies with assets of

[4] The criteria a bank holding company must meet in order to be an FHC are specified in section 4(*l*) of the BHC Act. 12 U.S.C. § 1843(*l*).

[5] *See id*. at § 1843(*l*)(3); 12 C.F.R. §§ 225.81 and 225.90.

[6] The complete text of section 103(d) is in Appendix A.

$10 billion or more and 473 U.S.-based bank holding companies with assets of less than $1 billion. In the aggregate, FHCs represent 78 percent of the total assets of all bank holding companies. Several firms that were not affiliated with a commercial bank before passage of the GLB Act have acquired a bank and become an FHC under the Act. These firms include Charles Schwab & Co., MetLife, and Franklin Resources.

● Financial Activities. More than 50 FHCs report being engaged in securities underwriting and dealing activities under the GLB Act. Twenty-six FHCs report being engaged in insurance underwriting activities and 26 report being engaged in merchant banking activities under the Act. Of the four major new or expanded activities analyzed in this report, insurance agency activities are the most common, particularly among smaller banking organizations, with more than 160 FHCs reporting being engaged in insurance agency activities under section 4(k) of the BHC Act.

The assets attributable to these expanded activities of FHCs have grown significantly since the end of 2000. In particular, the assets of the securities underwriting and dealing subsidiaries of FHCs have grown by two-thirds since 2000, and the reported insurance underwriting assets of FHCs have tripled in that period. The reported merchant banking assets of FHCs, however, have declined modestly since year-end 2000, in large part because of the decline in equity prices from record highs.

● Board and Secretary Actions Involving New Activities. The Board, jointly or in consultation with the Secretary when appropriate, has taken several actions to identify, clarify, or expand the activities permissible for FHCs under the GLB Act. These actions include:

- Adopting rules to implement the Act's merchant banking authority;

- Determining, by rule, that "finder" activities are incidental to financial activities and thus permissible for FHCs;

- Adopting a rule that permits all bank holding companies, including FHCs, to engage in an expanded range of commodity derivative activities;

- Seeking public comment on a proposed rule that would determine that real estate brokerage and real estate management are activities that are financial in nature or incidental to a financial activity.

● Commercial Activities of FHCs. Virtually all domestic FHCs engage only in financial activities. One domestic FHC—Citigroup—currently is engaged in trading activities involving nonfinancial commodities (for example, oil and gas). These commercial activities, however, represent a de minimis portion of Citigroup's total consolidated assets and are conducted pursuant to conditions,

imposed by the Board, that are designed to ensure that the activities are conducted in a safe and sound manner. Accordingly, the existing commercial activities of FHCs pose little risk to the safety and soundness of the depository institution subsidiaries of FHCs.

● Effect of FHCs on Market Concentration. The formation of FHCs and the mergers and acquisitions involving FHCs under section 4(k) of the BHC Act have not resulted in any substantial changes in concentration in the markets for securities underwriting and dealing, insurance underwriting, insurance agency services, or merchant banking. However, some firms providing these services have gained market share and others have lost market share.

I. Financial Activities Conducted by Financial Holding Companies

More than 600 companies have elected to become an FHC under the GLB Act. While most of these companies already were bank holding companies, several securities, insurance and other financial firms that were not affiliated with banks before passage of the Act have acquired a bank and become a bank holding company and an FHC in reliance on the Act.

FHC status provides several benefits to bank holding companies. For example, FHCs are permitted to engage in some activities—such as insurance underwriting—that are, as a general matter, not permissible for bank holding companies that are not FHCs. In addition, the GLB Act permits FHCs to conduct certain activities—such as securities underwriting and dealing—without being subject to the restrictions that govern the conduct of these activities by bank holding companies that are not FHCs. Moreover, the GLB Act permits an FHC to commence any activity that has been determined to be financial in nature or incidental to a financial activity under the Act, or acquire a company engaged solely in such activities, *without* the Board's prior approval, so long as the FHC notifies the Board within thirty days after commencing the activity or consummating the acquisition. This streamlined process enables FHCs to respond more quickly to market developments and opportunities.

This part of the report provides information concerning the number and characteristics of FHCs. This part also discusses the extent to which FHCs are engaged in securities underwriting and dealing, insurance underwriting, insurance agency activities, and merchant banking under section 4(k) of the BHC Act as added by the GLB Act.[7] The report focuses on these activities because they represent the most important and significant activities authorized for FHCs by the GLB Act. Moreover, as directed by the GLB Act, the Board has focused its supervisory efforts, including reporting requirements, on those activities of bank holding companies that present the greatest potential risk to the bank holding company, its depository institution subsidiaries, and the deposit insurance funds. Accordingly, the Board does not collect extensive data on all types of financial activities conducted by FHCs.[8]

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[7] This report does not discuss the activities of "financial subsidiaries" of national and state banks. Besides authorizing the creation of FHCs, the GLB Act also authorized national and state banks to own or control a "financial subsidiary," which may engage in certain financial activities authorized for FHCs, including securities underwriting and dealing. *See* 12 U.S.C. §§ 24a, 335 and 1831w. Financial subsidiaries of banks, however, may not engage in insurance underwriting, merchant banking activities permitted under the Act for FHCs, or real estate development or investment (unless otherwise authorized by law), although the Act permits the Board and the Secretary to remove the prohibition on merchant banking after November 12, 2004. Figures in this report on the number of banking organizations engaged in expanded activities pursuant to the GLB Act refer to FHCs that conduct the activity under section 4(k) of the BHC Act.

[8] Section 103(d) of the GLB Act also requires this joint report to discuss any commercial activities conducted by FHCs under the "grandfather" provisions of section 4(n) of the BHC Act. *See* 12 U.S.C. § 1843(n). As discussed in part III, no FHCs have engaged in commercial activities under section 4(n) of the BHC Act.

A. Number and Characteristics of Financial Holding Companies

On March 13, 2000, the first business day after the effective date of the GLB Act's FHC provisions, the Board approved the elections of 117 bank holding companies to become FHCs. The number of FHCs subsequently has grown to 630 as of March 31, 2003.

Table 1.1 provides information on the number of bank holding companies and the number of such organizations that have elected to become FHCs. To avoid double-counting, only the top-tier bank holding company in a multi-tier organization is included in the data. The information is divided into bank holding companies whose ultimate parent is incorporated in the United States (domestic organizations) and those whose ultimate parent is a foreign bank or other organization chartered outside the United States (foreign organizations).[9]

TABLE 1.1: Aggregate Number of Bank Holding Companies and Financial Holding Companies

	12/31/00	12/31/01	12/31/02	3/31/03
Number of domestic BHCs	5,072	5,090	5,094	5,093
Number of foreign BHCs	220	208	193	191
Total number of BHCs	5,292	5,298	5,287	5,284
Number of domestic FHCs	457	565	603	600
Number of foreign FHCs	20	23	30	30
Total number of FHCs	477	588	633	630
FHCs as a percentage of all bank holding companies	9%	11%	12%	12%

Although the number of FHCs currently represents a relatively small percentage of all bank holding companies, FHCs held approximately 78 percent of the aggregate consolidated assets of all bank holding companies as of March 31, 2003 (table 1.2).[10] Moreover, this percentage has increased each year since 2000.

[9] For example, a U.S.-incorporated bank holding company that is ultimately owned by a foreign parent is considered a "foreign" organization and is reported as such in the tables throughout this report.

[10] The asset data in this report are based on the consolidated total assets of the relevant organizations and thus do not reflect assets under management or other off-balance-sheet assets.

TABLE 1.2: Aggregate Assets of Bank Holding Companies and Financial Holding Companies
(Billions)

	12/31/00	12/31/01	12/31/02	3/31/03
Assets of domestic BHCs	$6,330	$6,970	$7,603	$7,673
U.S. assets of foreign BHCs[11]	$2,676	$2,676	$2,789	$2,942
Total assets	$9,006	$9,646	$10,392	$10,615
Assets of domestic FHCs	$4,512	$5,469	$5,938	$6,083
U.S. assets of foreign FHCs	$1,545	$1,900	$2,091	$2,240
Total assets	$6,057	$7,369	$8,029	$8,323
FHC total assets/BHC total assets	67%	76%	77%	78%

As the asset data suggest, a significant number of the largest bank holding companies have chosen to become FHCs. In fact, 49 of the 71 U.S.-based bank holding companies with assets of $10 billion or more are FHCs (table 1.3).[12] In addition, 473 U.S.-based bank holding companies with assets of less than $1 billion, including 153 with assets of less than $150 million, also have elected to become FHCs, which suggests that FHC status also provides benefits to smaller banking organizations in many cases. It should be noted that some of the larger FHCs (that is, those with assets of more than $1 billion)—including MetLife and Franklin Resources—were formed through the acquisition of small banks by financial service firms that were not bank holding companies before passage of the GLB Act.

TABLE 1.3: Number of U.S.-Based FHCs by Asset Size as of March 31, 2003

Asset Size	BHCs that are FHCs	Total Number of BHCs
Over $10 billion	49	71
Greater than $1 billion to $10 billion	86	261
$150 million to $1 billion	320	1688
Less than $150 million	153	3117

B. Securities Underwriting and Dealing

The GLB Act repealed the legal restriction that had limited the securities activities of bank holding companies, and created a "two-way street" between securities firms and banking organizations, allowing full-service securities firms to acquire a bank and permitting banking organizations to acquire a full-service securities firm through the FHC structure.

[11] Asset figures for foreign organizations include only third-party assets of the U.S. branches, agencies, offices, and subsidiaries of the organization.

[12] The term "U.S.-based bank holding company" refers to domestic bank holding companies and the U.S.-incorporated bank holding company subsidiaries of foreign organizations.

Before adoption of the GLB Act, bank holding companies were permitted to underwrite and deal in corporate debt and equity securities in the United States only to a limited extent through a "section 20 subsidiary." The name refers to section 20 of the Glass-Steagall Act, which prohibited a bank that was a member of the Federal Reserve System (hereafter a member bank) from being affiliated with a company "engaged principally" in underwriting or dealing in securities that a member bank may not underwrite or deal in directly (bank-ineligible securities). In light of this restriction, a section 20 subsidiary of a bank holding company may not derive more than 25 percent of its gross revenues from underwriting and dealing in bank-ineligible securities, such as corporate debt and equity securities. Moreover, a section 20 subsidiary of a bank holding company may not acquire voting securities of a company in a dealer capacity if the section 20 subsidiary and its affiliates, in the aggregate, would own or control more than 5 percent of any class of voting securities of the company.

The GLB Act significantly expanded the ability of bank holding companies to engage in securities underwriting and dealing and, thus, also the ability of securities firms to affiliate with banks through the FHC structure. Specifically, the Act repealed section 20 of the Glass-Steagall Act and expressly authorized the broker-dealer subsidiaries of an FHC to underwrite and deal in all types of securities, including corporate debt and equity securities, without limit as to the amount of revenue the subsidiary may derive from underwriting and dealing in bank-ineligible securities.[13] In addition, the GLB Act permits the broker-dealer subsidiaries of an FHC to engage in dealing activities without complying with the 5 percent ownership restriction applicable to section 20 subsidiaries.

These changes allow the broker-dealer subsidiaries of FHCs to compete more effectively with securities firms that are not affiliated with a bank and to structure their operations more efficiently.[14] In light of the benefits conferred on FHCs, forty of the forty-five bank holding companies that operated a section 20 subsidiary before the GLB Act have become an FHC and now operate the subsidiary under the expanded, less-restrictive GLB Act provisions.[15]

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[13] *See* 12 U.S.C. § 1843(k)(4)(E); GLB Act, § 101.

[14] Because the 25 percent revenue limit applies to *each* section 20 subsidiary controlled by a bank holding company, bank holding companies that are not FHCs typically must conduct their securities underwriting and dealing activities through a single subsidiary in order to facilitate compliance with the 25 percent revenue test. On the other hand, FHCs generally have the flexibility to establish as many or as few securities subsidiaries as they deem appropriate to accommodate the organization's business needs.

[15] Three foreign banking organizations that are not FHCs continue to operate section 20 subsidiaries in the United States. These subsidiaries remain subject to the revenue and other limits applicable to section 20 subsidiaries. The remaining two bank holding companies now operate their section 20 subsidiaries under the GLB Act's financial subsidiary provisions.

TABLE 1.4: Securities Underwriting and Dealing Activities of FHCs

Number of FHCs Engaged in Securities Underwriting and Dealing Under the GLB Act	**12/31/00**	**12/31/01**	**12/31/02**	**3/31/03**
Domestic FHCs	27	32	36	38
Foreign FHCs	10	15	17	19
Total	37	47	53	57
Total Assets (billions)				
Assets of GLB Act Securities Subsidiaries of Domestic FHCs	$403	$482	$501	$545
Assets of GLB Act Securities Subsidiaries of Foreign FHCs	$559	$967	$918	$1,075
Total Assets	$962	$1,449	$1,419	$1,620

There has been significant growth in both the number of FHCs involved in securities underwriting and dealing activities and in the aggregate assets of the securities underwriting and dealing subsidiaries of FHCs (table 1.4).[16] Asset growth is even more pronounced when compared with data as of December 31, 1999, the end of the last quarter before bank holding companies became eligible for FHC status. As of December 31, 1999, twenty-six domestic bank holding companies and nineteen foreign banking organizations operated section 20 subsidiaries, and these subsidiaries had total assets of $877 billion.

By March 31, 2003, fifty-seven FHCs operated securities underwriting and dealing subsidiaries under the GLB Act's expanded authority. Of these organizations, thirty-eight were domestic and nineteen foreign. The total assets of FHC-affiliated broker-dealers engaged in underwriting and dealing activities pursuant to the GLB Act totaled $1,620 billion as of March 31, 2003. Interestingly, the assets of the securities underwriting and dealing subsidiaries controlled by foreign FHCs was roughly twice as large as the assets of the securities subsidiaries controlled by domestic FHCs.

The growth in the securities underwriting and dealing assets of FHCs is partially attributable to several major transactions since passage of the GLB Act.

- Charles Schwab & Co., a securities firm that controlled the thirteenth largest broker-dealer in the United States in terms of capital, purchased a commercial bank and became an FHC.

[16] The Board relies, when possible, on reports obtained from a functionally regulated subsidiary of an FHC (for example, a securities broker-dealer) by the subsidiary's appropriate functional regulator. The information in this report on the assets of the securities broker-dealer subsidiaries of FHCs is based on information obtained by the Board from the Securities and Exchange Commission (SEC) pursuant to an interagency information-sharing agreement.

- UBS AG, Zurich, Switzerland, acquired the Paine Webber Group.[17]

- Credit Suisse, Zurich, Switzerland, acquired Donaldson, Lufkin & Jenrette, which was ultimately merged into Credit Suisse's existing securities arm, Credit Suisse First Boston.[18]

- Royal Bank of Canada, Montreal, acquired Tucker Anthony Sutro.[19]

Other notable acquisitions of securities firms by FHCs include

- Morgan Keegan, Inc., Memphis, Tenn., by Regions Financial Corporation, Birmingham, Ala.[20]

- First Albany Companies, Albany, N.Y.,[21] by First Union Corporation, Charlotte, N.C. (now Wachovia Corporation).[22]

In fact, four of the ten largest securities broker-dealers and thirteen of the largest twenty-five broker-dealers in terms of capital are now affiliated with an FHC.[23] Some large securities firms have chosen not to acquire or become affiliated with a bank, but this fact is not surprising. The ultimate decision of whether to acquire or become affiliated with a bank remains a complex one that the individual organization must evaluate in light of its particular competitive strategy and other factors. Furthermore, some of the large securities firms that have not become FHCs already conduct a significant amount of banking activities through the ownership of bank and bank-like entities that technically are not considered "banks" for purposes of the BHC Act.

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[17] At the time of the acquisition, UBS Warburg was ranked the 13th largest broker-dealer and Paine Webber the 12th in terms of capitalization among member firms of the Securities Industry Association (SIA).

[18] In the year before the acquisition, the SIA ranked Credit Suisse First Boston and Donaldson, Lufkin & Jenrette as 9th and 8th, respectively, in terms of capitalization.

[19] The SIA ranked Tucker Anthony Sutro as 83rd in terms of capitalization.

[20] The SIA ranked Morgan Keegan 67th in terms of capitalization, and the firm was among the top fifteen underwriters of municipal securities at the time of acquisition.

[21] The SIA ranked First Albany 114th in terms of capitalization at the time of acquisition.

[22] Friedman, Billings, Ramsey & Co., Inc., a securities firm based in Arlington, Va., also acquired a bank and became an FHC in 2001. The firm recently engaged in a reorganization through which the firm divested its bank subsidiary. Accordingly, the firm ceased to be a bank holding company and an FHC.

[23] *See Securities Industry Yearbook* (2003).

C. Insurance Underwriting and Agency Activities

Before the GLB Act, the ability of bank holding companies to underwrite insurance as principal or sell insurance as agent in the United States was strictly constrained by the Garn–St Germain Depository Institutions Act of 1982 (Garn–St Germain Act).[24] The Garn–St Germain Act prohibited bank holding companies, with some exceptions, from underwriting or selling any type of insurance. The most important of the act's exceptions permitted bank holding companies to underwrite and sell certain types of credit-related insurance and to sell insurance as agent in places that have a population of 5,000 or less. In addition, the Garn–St Germain Act allowed a limited number of bank holding companies to engage in insurance sales activities that the Board had approved for the company prior to 1982.[25]

The GLB Act freed FHCs from these restrictions. The Act permits FHCs to underwrite or sell any type of insurance without geographic limit.[26] Thus, the Act permits an FHC to acquire any type of insurance company or insurance agency, and it permits insurance companies and insurance agencies to acquire or affiliate with a bank through the FHC structure.

1. Insurance Underwriting Activities

Seventeen domestic FHCs and nine foreign FHCs reported that they were engaged in insurance underwriting activities under the GLB Act as of March 31, 2003 (table 1.5). These numbers represent an increase from the number of domestic FHCs (seven) and foreign FHCs (four) that reported being engaged in insurance underwriting activities under the GLB Act as of year-end 2000. The reported insurance underwriting assets of FHCs totaled $356 billion at March 31, 2003, up from $116 billion as of year-end 2000.

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[24] *See* Pub. L. No. 97-320, 96 Stat. 1469 (1982).

[25] Section 225.28(b)(11) of the Board's Regulation Y describes the limited types of insurance activities permissible under the Garn–St Germain Act for bank holding companies that are not FHCs. *See* 12 C.F.R. § 225.28(b)(11).

[26] *See* 12 U.S.C. § 1843(k)(4)(B). The Act also authorizes an insurance underwriting subsidiary of an FHC to invest the company's assets in accordance with State law governing such investments. *See* 12 U.S.C. § 1843(k)(4)(I). The Act, however, prohibits an FHC and its insurance company subsidiary from routinely managing or operating any company acquired under such authority except as may be necessary or required to obtain a reasonable return on the investment.

TABLE 1.5: Number of Financial Holding Companies Engaged in Insurance Underwriting Activities

	12/31/00	12/31/01	12/31/02	3/31/03
FHCs Engaged in GLB Act Insurance Underwriting Activities				
Domestic FHCs	7	16	20	17
Foreign FHCs	4	8	9	9
Total	11	22	29	26
Reported Insurance Underwriting Assets[27] (billions)	$116.1	$340.7	$347.1	$356.2

Two FHCs—Citigroup and MetLife—currently account for the preponderance of the reported insurance underwriting assets of all FHCs. Citigroup was formed in 1998 through the acquisition of Citicorp, Inc., by Travelers Group, Inc.[28] At the time of this transaction, Travelers Group was a significant underwriter of property-casualty and life insurance, although the combined entity subsequently has spun off its largest property-casualty underwriting subsidiary (Travelers Property Casualty Corporation). MetLife, a company that is primarily engaged in underwriting life and property-casualty insurance, acquired a small commercial bank and became an FHC in 2001.

The reported insurance underwriting assets of FHCs likely will grow further before year-end. Bank One Corporation, Chicago, recently acquired various U.S. life insurance operations from affiliates of Zurich Financial Services Group (Europe's third largest insurance group), Zurich, Switzerland. These transactions are not reflected in table 1.5.

Several foreign FHCs also engage in significant insurance underwriting operations in the United States in reliance on the GLB Act's expanded insurance authority. These include Fortis, of Belgium and the Netherlands; Dexia, Brussels, Belgium; and

[27] Asset figures include the U.S. insurance underwriting assets reported by domestic FHCs and by foreign FHCs that control an insurance company through a U.S.-based bank holding company. The Board does not collect data on the insurance underwriting assets of foreign banking organizations that do not engage in insurance underwriting activities in the United States through a U.S.-based bank holding company.

[28] Citigroup initially retained the insurance underwriting and agency operations of Travelers Group under section 4(a)(2) of the BHC Act, which allows a company that becomes a bank holding company up to five years to divest any nonbanking activities that do not conform to the requirements of the BHC Act. *See* 12 U.S.C. § 1843(a)(2). After passage of the GLB Act, Citigroup elected to become an FHC and now operates its insurance underwriting and agency activities under the expanded insurance authority granted by the GLB Act.

Royal Bank of Canada, Toronto. In 2000, Dexia expanded its U.S. insurance presence through the acquisition of Financial Security Assurance, a major underwriter of credit enhancements in the U.S. and international markets for municipal obligations and structured finance. Since passage of the GLB Act, Royal Bank of Canada also has acquired the insurance operations of Liberty Corporation, Greenville, S.C., including Liberty Life Insurance Company, a life and health insurance carrier and fixed annuity underwriter, as well as Business Men's Assurance Company of America, a life insurance and variable annuity underwriter. The U.S. underwriting assets of these foreign FHCs are not reflected in table 1.5, as the Board does not collect such information from foreign banking organizations, such as those discussed above, that do not engage in insurance underwriting activities through a U.S.-based bank holding company. Available industry data indicates that the U.S. insurance underwriting affiliates of Fortis, Royal Bank of Canada, and Dexia have total assets of approximately $15.1 billion, $4.3 billion, and $3.3 billion, respectively.[29]

2. Insurance Agency Activities

The number of FHCs, both foreign and domestic, reporting that they engage in insurance agency activities under the GLB Act has grown significantly, from 86 at the end of 2000 to 165 as of March 31, 2003 (table 1.6).[30] Not surprisingly, of the four new or expanded activities analyzed in this report, the Act's insurance agency powers appear to be of the greatest interest to smaller banking organizations. In this regard, approximately 65 percent of the FHCs that report being engaged in insurance agency activities under the GLB Act have assets of less than $1 billion.

TABLE 1.6: Number of Financial Holding Companies Engaged in Insurance Agency Activities

	12/31/00	12/31/01	12/31/02	3/31/03
FHCs Engaged in Insurance Agency Activities under the GLB Act				
Domestic FHCs	82	128	150	155
Foreign FHCs	4	5	9	10
Total	86	133	159	165

Significant transactions in this area include the May 2001 acquisition by Wells Fargo & Co., San Francisco, of ACO Brokerage Holdings Corporation, Chicago, one of the largest property-casualty insurance agencies in the country. The insurance brokering

[29] Data were obtained from A.M. Best Company and Thomson Financial Insurance Solutions. Insurance financial data are prepared in accordance with statutory financial principles.

[30] The asset size of an insurance agency is not a meaningful measure of the agency's insurance activities and is therefore not discussed in this report.

subsidiaries of an additional twelve FHCs now rank among the largest 100 U.S. insurance brokers.[31]

Table 1.6 *understates* the extent to which FHCs are engaged in insurance agency activities. Although the table reports activity under the GLB Act's expanded insurance agency authority for FHCs,[32] many bank holding companies, both before and after enactment of the GLB Act, have conducted insurance sales through a subsidiary bank of the holding company under other legal authorities. For many years, state-chartered banks have generally been able to sell insurance as agent, either directly or through a subsidiary, to the extent permitted by the law of the bank's chartering state. The GLB Act also expanded the ability of national and state member banks to sell any type of insurance nationwide through a financial subsidiary of the bank. Supervisory experience indicates that many FHCs conduct their insurance agency activities through their subsidiary banks in reliance on these other authorities. The GLB Act, however, does provide FHCs the flexibility to restructure their insurance agency operations and to conduct these operations through a nonbank affiliate of the holding company if the FHC believes such action is more consistent with its business plans.

D. Merchant Banking

Merchant banking is a form of equity financing through which an investor acquires an equity or other ownership position in another company for investment purposes. Typically, merchant banking investments are made in nonpublic companies and thus are less liquid and more difficult to value than investments in public companies.

Before the GLB Act, bank holding companies had only limited authority to make equity investments in nonfinancial companies. Although section 4(c)(6) of the BHC Act, the Small Business Investment Act of 1958 (Small Business Act), and the Board's Regulation K permitted bank holding companies to make certain types of equity investments, investments under these provisions were subject to several restrictions.[33] For example, section 4(c)(6) of the BHC Act does not allow a bank holding company to acquire more than 5 percent of any class of voting securities, or more than 24.9 percent of the total equity, of a nonfinancial company. Investments made under the Small Business Act are limited to less than 50 percent of the ownership of the target company and are subject to other restraints that limit the range of potential investments, especially for new entrants. Investments made under Regulation K must be made overseas and also are subject to various investment limits.

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[31] Statistical information on insurance agency activities is based on information from an annual survey contained in the July 21, 2003, issue of *Business Insurance* magazine.

[32] 12 U.S.C. § 1843(k)(4)(B).

[33] *See* 12 U.S.C. § 1843(c)(6); 15 U.S.C. § 682(b); 12 C.F.R. Part 211.

The GLB Act significantly expanded the ability of FHCs to compete in the market for providing equity financing to commercial companies. In particular, the Act's merchant banking authority permits a qualifying FHC to acquire any amount—including up to 100 percent—of the equity securities or other ownership interests of a nonfinancial company as part of a bona fide underwriting, merchant banking, or investment banking activity.[34] The Act does, however, place limits on the period of time that an FHC may hold a merchant banking investment and generally prohibits an FHC from routinely managing or operating a nonfinancial company held as a merchant banking investment.

As authorized by the GLB Act, the Board and the Secretary jointly issued regulations in 2000 implementing the Act's merchant banking authority and the associated restrictions on holding periods and routine management. These regulations are described in greater detail in part II.B. of this report. In light of the potential volatility of merchant banking investments, the regulations require an FHC engaged in merchant banking activities to establish and maintain appropriate policies, procedures, and systems to monitor and manage the risks associated with these activities.[35]

As of March 31, 2003, twenty-six FHCs reported holding investments under the GLB Act's merchant banking authority, up from twenty FHCs as of December 31, 2000 (table 1.7). The value of investments held by FHCs under the Act's merchant banking authority as of March 31, 2003, was $9.2 billion, a figure that is slightly less than the $9.5 billion reported as of the end of 2000. The lack of growth of reported merchant banking investments from 2000 to 2003 likely is largely attributable to the overall decline in both the public and private equity markets during this period.

[34] *See* 12 U.S.C. § 1843(k)(4)(H).

[35] In 2002, the Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation also modified their risk-based capital guidelines for banks and bank holding companies to better reflect the risks presented by the merchant banking activities of FHCs and the similar equity investment activities of banks and bank holding companies. *See* 67 *Federal Register* 3784 (Jan. 25, 2002).

TABLE 1.7: Merchant Banking Activities of Financial Holding Companies

	12/31/00	12/31/01	12/31/02	3/31/03
Number of FHCs Engaged in Merchant Banking				
Domestic FHCs	11	19	12	12
Foreign FHCs	9	10	14	14
Total	20	29	26	26
Reported Assets (billions)				
Merchant banking assets of FHCs[36]	$9.5	$8.3	$9.1	$9.2

The asset figures reported in table 1.7 do not reflect the merchant banking investments of foreign FHCs that do not engage in merchant banking in the United States through a U.S.-based bank holding company, as the Board does not collect such data from these organizations. Indeed, because most foreign banking organizations operate in the United States through a branch, agency, or representative office and do not control a U.S.-based bank holding company, these figures largely exclude the investments held by foreign FHCs. Industry data and supervisory information indicate that certain foreign FHCs have significant merchant banking holdings in the United States. In addition, the Board does not require a domestic FHC to report the value of its investments held under the merchant banking authority unless the value of the FHC's aggregate equity investments in nonfinancial entities exceeds the lesser of $200 million or 5 percent of the FHC's tier 1 capital.

II. ACTIONS BY THE BOARD AND THE SECRETARY TO EXPAND OR CLARIFY THE TYPES OF ACTIVITIES PERMISSIBLE FOR FHCS

The GLB Act itself defines a number of important activities—including securities underwriting and dealing, insurance underwriting, insurance agency activities, and merchant banking—to be financial in nature.[37] In addition, the Act allows the Board (in consultation with the Secretary when appropriate) to expand the types of activities permissible for FHCs in several ways.

First, the GLB Act authorizes the Board, in consultation with the Secretary, to determine (by regulation or order) that additional activities not specified in the statute are financial in nature or incidental to a financial activity.[38] The financial in nature or incidental to a

[36] Asset figures include merchant banking assets reported by domestic FHCs and by foreign FHCs that engage in merchant banking through a U.S.-based bank holding company.

[37] *See* 12 U.S.C. § 1843(k)(4). Appendix B provides a complete list of the activities that the GLB Act defines as being financial in nature.

[38] *See id*. at § 1843(k)(1) and (2). The Act requires the Board to consult with the Secretary concerning any request, proposal, or application for a determination that an activity is financial in nature or incidental to a financial activity. The Board may not determine that an activity is

financial activity standard embodied in the Act is significantly broader and more flexible than the "closely related to banking" standard that previously governed the ability of bank holding companies to engage in nonbanking activities under section 4(c)(8) of the BHC Act. For example, the GLB Act directs the Board to consider a wide variety of factors in determining whether an activity is financial in nature or incidental to a financial activity. These factors include the following:

- The purposes of the GLB Act and of the BHC Act;
- Changes or reasonably expected changes in the marketplace in which FHCs compete;
- Changes or reasonably expected changes in the technology for delivering financial services;
- Whether authorizing the activity is necessary or appropriate to allow an FHC and its affiliates to
    - Compete effectively with any company seeking to provide financial services in the United States;
    - Efficiently deliver information and services that are financial in nature through the use of technological means, including any application necessary to protect the security or efficacy of systems for the transmission of data or financial transactions;
    - Offer customers any available or emerging technological means for using financial services or for the document imaging of data.[39]

These factors are not exclusive and the Board may consider other factors or information that it considers relevant in determining whether an activity is financial in nature or incidental to a financial activity.

Second, the GLB Act directs the Board, in consultation with the Secretary, to define (by regulation or order) the extent to which the following three generally described activities are financial in nature or incidental to a financial activity:

- Lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities;

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financial in nature or incidental to a financial activity if the Secretary informs the Board in writing that the Secretary believes the activity is not financial in nature, incidental to a financial activity or otherwise permissible under section 4 of the BHC Act.

[39] *See id.* at § 1843(k)(3).

- Providing any device or other instrumentality for transferring money or other financial assets;

- Arranging, effecting, or facilitating financial transactions for the account of third parties.[40]

Third, the GLB Act permits an FHC to engage in other activities if the Board determines (by regulation or order) that the activity is "complementary" to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.[41] The Act's "complementary" provisions were intended to give the Board some flexibility to permit an FHC to engage, to a limited extent, in a *commercial* activity so long as there is some meaningful connection between the proposed activity and the FHC's financial activities and so long as the proposed activity would not pose undue risks to the safety and soundness of depository institutions or the financial system.

The GLB Act also retains the current provision of the BHC Act that permits all bank holding companies, including FHCs, to engage in any nonbanking activity that the Board had determined (by regulation or order) before November 12, 1999, to be "so closely related to banking as to be a proper incident thereto" under section 4(c)(8) of the BHC Act.[42] A bank holding company, including an FHC, must conduct these activities in accordance with any terms or conditions imposed by the Board in authorizing the activity under section 4(c)(8). The GLB Act permits the Board to *modify* the terms and conditions that govern the conduct of these previously approved activities. However, the GLB Act repeals the Board's authority to authorize new activities for all bank holding companies under the "closely related to banking" provision.

This part of the report describes the actions that the Board, in consultation with the Secretary when appropriate, has taken by regulation, order, interpretation or guideline, or by approval or disapproval of an application, to expand, identify, or clarify the range of nonbanking activities permissible for FHCs.

A. Rule Identifying the Activities Permissible Under the "Closely Related to Banking" and Foreign Activity "Carryover" Provisions

Among the activities that the GLB Act defines to be financial in nature and thus permissible for FHCs are:

- Activities that the Board had determined (by regulation or order) before November 12, 1999, to be "so closely related to banking as to be a proper incident thereto" under section 4(c)(8) of the BHC Act;

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[40] *See id.* at § 1843(k)(5).

[41] *See id.* at § 1843(k)(1)(B).

[42] *See id.* at § 1843(c)(8) and (k)(4)(F).

- Activities in which a bank holding company may engage outside the United States and that the Board had determined, under regulations prescribed or interpretations issued under section 4(c)(13) of the BHC Act (12 U.S.C. § 1843(c)(13)) and in effect on November 11, 1999, to be usual in connection with the transaction of banking or other financial services abroad.[43]

The GLB Act, however, does not identify the particular activities that an FHC may conduct under these "carryover" provisions.

Accordingly, the Board in March 2000 adopted an interim rule to provide guidance to FHCs concerning the scope of activities considered to be financial in nature under these authorities.[44] In particular, the rule identifies for FHCs (through a cross-reference to the relevant section of the Board's Regulation Y) those activities that, before November 12, 1999, the Board had determined *by regulation* to be "closely related to banking." The rule also provides FHCs with a convenient list of activities that, before November 12, 1999, the Board had determined *only by order* to be "closely related to banking" under section 4(c)(8). These activities, which now also are considered to be financial in nature under section 4(k)(4)(F), include:

- Providing administrative and other services to mutual funds;

- Owning shares of a securities exchange;

- Acting as a certification authority for digital signatures and authenticating the identity of persons conducting financial and nonfinancial transactions;

- Providing employment histories to third parties for use in making credit decisions and to depository institutions and their affiliates for use in the ordinary course of business;

- Providing check cashing and wire transmission services;

- Providing notary public services, selling postage stamps and postage-paid envelopes, providing vehicle registration services, and selling public transportation tickets and tokens in connection with offering banking services;

- Real estate title abstracting.[45]

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[43] *See id.* at § 1843(k)(4)(F) and (G).

[44] *See* 65 *Federal Register* 14,433 (March 17, 2000) (codified in pertinent part at 12 C.F.R. § 225.86(a) and (b)). After reviewing the public comments received on the interim rule, the Board adopted a final rule in December 2000. *See* 66 *Federal Register* 400 (Jan. 3, 2001).

[45] This list does not include activities that the Board had authorized under section 4(c)(8) on a limited basis (for example, underwriting and dealing in bank-ineligible securities) and that other provisions of the GLB Act authorize FHCs to conduct on a broader basis.

In addition, the rule provides FHCs with a list of the activities that the Board had determined, by regulation in effect as of November 11, 1999, to be usual in connection with the transaction of banking or other financial operations abroad. These activities, which now also are considered to be financial in nature under section 4(k)(4)(G), are:

- Providing management consulting services, including to any person with respect to nonfinancial matters, so long as the management consulting services are advisory and do not allow the FHC to control the person to which the services are provided;

- Operating a travel agency in connection with financial services offered by the FHC or others;

- Organizing, sponsoring, and managing a mutual fund so long as (1) the fund does not exercise managerial control over the entities in which the fund invests, and (2) the FHC reduces its ownership interest in the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund or such additional period as the Board permits.

B. Rule Implementing the GLB Act's Merchant Banking Provisions

Section 4(k)(4)(H) of the BHC Act permits an FHC that meets certain criteria to make investments in *nonfinancial* companies as part of a bona fide securities underwriting or merchant or investment banking activity.[46] The Act, however, also limits the period of time that an FHC may hold a merchant banking investment and generally prohibits an FHC from routinely managing or operating a nonfinancial company held as a merchant banking investment (referred to as a portfolio company). Merchant banking investment activities conducted within the Act's parameters are considered by the Act to be financial in nature.

In March 2000, the Board and the Secretary jointly adopted a rule to implement the Act's merchant banking provisions.[47] The Board and Secretary initially adopted the rule on an interim basis to provide FHCs immediate and effective guidance concerning the types of investments permitted by the Act's merchant banking authority and the limits imposed on such

[46] *See* 12 U.S.C. § 1843(k)(4)(H).

[47] *See* 65 *Federal Register* 16460 (March 28, 2000). The GLB Act expressly authorizes the Board and the Secretary to issue regulations implementing the Act's merchant banking authority, including limitations on transactions between depository institutions and companies controlled under the Act's merchant banking authority, that the Board and Secretary jointly deem appropriate to assure compliance with the purposes and prevent evasions of the BHC Act and GLB Act and to protect depository institutions. *See* 12 U.S.C. § 1843(k)(7).

investments by the Act. After reviewing the public comments received on the interim rule, the Board and Secretary adopted a final rule in January 2001.[48]

The rule permits a qualifying FHC to acquire any amount (including up to 100 percent) of the shares of a nonfinancial company under the Act's merchant banking authority. In addition, the rule broadly defines the term "securities affiliate"—which is used by the Act to identify the types of FHCs qualified to make merchant banking investments[49]—to mean any securities broker-dealer or municipal securities dealer (including a separately identifiable division or department of a bank) registered under the Securities Exchange Act of 1934 (15 U.S.C. §§ 78a *et seq*.). This broad definition of a securities affiliate permits a wide range of FHCs to engage in merchant banking activities in accordance with the Act and the rule.

The rule also implements the holding period and routine management restrictions imposed by the Congress on the merchant banking investments of FHCs. In this regard, the rule generally permits an FHC to own or control any merchant banking investment for up to ten years and allows FHCs to own or control merchant banking investments in (or held through) a qualifying "private equity fund" for up to fifteen years. The Board and the Secretary believe that these holding periods are consistent with industry norms. Nevertheless, the rule also permits an FHC to seek the Board's approval to hold a merchant banking investment beyond the normal ten- or fifteen-year holding period in appropriate circumstances.

The rule also allows an FHC to have a wide range of relationships with a portfolio company *without* being deemed to "routinely manage or operate" the company in violation of the Act. For example, the rule expressly permits an FHC to have any number of director interlocks with a portfolio company held under the merchant banking authority and to have covenants with a portfolio company that restrict the ability of the portfolio company to take actions outside the ordinary course of business without the FHC's approval.[50] In addition, the rule permits an FHC to provide financial, investment, and management consulting advice to a portfolio company; act as underwriter or private placement agent for the securities of a portfolio company; and meet with officers or employees of a portfolio company to monitor the company's financial performance or activities.

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[48] *See* 66 *Federal Register* 8466 (Jan. 31, 2001) (codified at 12 C.F.R. §§ 225.170 *et seq*.). All references to the rule in this part of the report are to the joint final rule.

[49] The GLB Act permits an FHC to make merchant banking investments only if the FHC controls either (1) a "securities affiliate" or (2) an insurance company and an investment adviser that provides advice to the insurance company and is registered under the Investment Advisers Act of 1940 (15 U.S.C. §§ 80b-1 *et seq*.).

[50] The rule provides several examples of the types of permissible covenants that an FHC may have with a portfolio company, and the Board's general counsel has issued a letter providing additional examples of permissible covenants. *See* Letter from J. Virgil Mattingly, Jr., General Counsel of the Board, to Peter T. Grauer, dated Dec. 21, 2001.

On the other hand, the rule provides that an FHC will be deemed to "routinely manage or operate" a portfolio company if any director, officer, or employee of the FHC serves as (or has the responsibilities of) an executive officer of the portfolio company; if any executive officer of a significant subsidiary of the FHC serves as an officer or employee of the portfolio company;[51] or if the FHC restricts, through contractual covenants or otherwise, the ability of the portfolio company to make routine business decisions. The rule also creates a presumption that an FHC routinely manages a portfolio company if the FHC has a non-executive officer or employee interlock with the portfolio company, but this presumption may be rebutted by the FHC upon application to the Board.

The rule also permits an FHC to routinely manage or operate a portfolio company when, and for the period, necessary or required to obtain a reasonable return on the FHC's investment in the portfolio company. Thus, for example, the rule would allow an FHC to assume day-to-day operational or managerial control of a portfolio company for the period of time necessary to address a significant operating loss at the portfolio company or the resignation or termination of the portfolio company's senior management. However, to ensure that an FHC does not routinely manage or operate a portfolio company for an extended period time, the rule requires that an FHC notify the Board if it routinely manages or operates a portfolio company for more than nine months.

Finally, the rule contains several provisions designed to ensure that an FHC conducts its merchant banking activities in a safe and sound manner and to implement the special cross-marketing and lending restrictions imposed by the GLB Act on companies held by an FHC under the merchant banking authority.

C. Rule Authorizing FHCs to Engage in "Finder" Activities

In December 2000, the Board, in consultation with the Secretary, determined by rule that acting as a finder is incidental to a financial activity and therefore permissible for FHCs.[52] The rule permits FHCs to act as an intermediary in bringing together buyers and sellers of *any type of financial or nonfinancial product or service* so long as the buyers and sellers themselves negotiate and consummate the transaction. Permissible intermediary services that an FHC may provide as a finder include identifying potential parties that may be interested in engaging in a transaction between themselves; making inquiries of third parties as to their interest in engaging in a transaction with another party; introducing and referring potential parties to a transaction to each other; arranging contacts and meetings between interested parties;

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[51] For these purposes, a "significant subsidiary" means any subsidiary of an FHC that is a depository institution, broker-dealer, or small business investment company, as well as any subsidiary of an FHC engaged in merchant banking or insurance company investment activities under section 4(k)(4)(H) or (I) of the BHC Act.

[52] *See* 65 *Federal Register* 80735 (Dec. 20, 2000) (codified at 12 C.F.R. 225.86(d)(1)). The Board initially proposed to determine that finder activities are incidental to a financial activity in July 2000. *See* 65 *Federal Register* 47696 (Aug. 3, 2000).

conveying expressions of interest, bids, offers, orders, and confirmations relating to a transaction between third parties; and transmitting information concerning products and services to potential parties in connection with the activities described above.

The Board's rule permits an FHC to act as a finder through any available technological means, including the Internet or other electronic networks (whether shared or proprietary). Accordingly, the rule permits FHCs, among other things, to:

- Host an electronic marketplace on the Internet that provides links to the websites of third-party buyers or sellers;

- Host the Internet website of a seller that provides information concerning the seller and the products or services it seeks to sell and allows buyers to submit orders, bids, and confirmations relating to such products or services;

- Host the Internet website of a government agency that provides information concerning the services or benefits made available by the agency and assists persons in applying for such services or benefits;

- Operate an Internet website that allows multiple buyers and sellers to exchange information concerning the products and services that they are willing to purchase or sell, locate potential counterparties for transactions, aggregate orders for goods or services with those made by other parties, and enter into transactions between themselves;

- Operate a telephone call center that provides permissible finder services (for example, providing information about the products or services of a seller and accepting orders from customers for such products or services).

The Board's rule also contains several restrictions that are designed to ensure that an FHC acting as a finder serves only as an intermediary between a buyer and seller and does not become impermissibly involved in the commercial activities or transactions of a buyer or seller.[53] These restrictions prevent an FHC from, for example, owning or operating a physical shopping mall, a retail store, a manufacturing plant, or a trucking company under the guise of acting as a finder. The rule also does not authorize an FHC to engage in any activity that would require the FHC to register or obtain a license as a real estate broker or agent. As discussed below, the Board and the Secretary have separately requested comment on a proposal concerning real estate brokerage.

[53] *See* 12 C.F.R. § 225.86(d)(1)(iii).

D. Proposal to Expand the Ability of All Bank Holding Companies to Engage in Nonfinancial Data Processing and Allow FHCs to Make Additional Data Processing Investments as a "Complementary" Activity

The Board requested comment in December 2000 on a proposed rule that would expand the ability of all bank holding companies, including FHCs, to process, store, and transmit *nonfinancial* data in connection with their financial data processing, storage, and transmission activities.[54] The proposed rule would permit bank holding companies to compete more effectively with nonbank providers of data processing and to achieve additional economies of scale in data processing.

In particular, before November 12, 1999, the Board had authorized bank holding companies under section 4(c)(8) of the BHC Act to provide a wide range of data processing services to any entity so long as the data involved are financial, banking, or economic in nature.[55] The Board also had authorized a bank holding company or nonbank subsidiary engaged in financial data processing activities to process nonfinancial data so long as the annual revenue derived by the company from its nonfinancial data processing activities does not exceed 30 percent of the company's total annual data processing revenue.

The proposed rule would raise, from 30 percent to 49 percent, the proportion of revenue a bank holding company or subsidiary may derive from processing data that are not financial, banking, or economic in nature. As permitted by the GLB Act, the Board proposed to make this change through an amendment to the regulatory limitations governing the conduct of data processing activities previously approved under section 4(c)(8) of the BHC Act. Accordingly, all bank holding companies, including FHCs, would be able to take advantage of the expanded data processing authority proposed.

At the time the Board requested comment on the proposal, the Board also requested comment on whether the Board should permit FHCs to invest, as a complementary activity, in companies that provide (1) data storage services for *any* type of data, so long as the company also provided data storage services for some financial data; (2) data processing services for *any* type of data, so long as the company derived at least 20 percent of its total revenues from providing data processing services to depository institutions and their affiliates, processing financial data, or selling other financial products and services; or (3) information-portal services over electronic networks. The Board also requested comment on whether the Board should develop an additional proposal that would permit FHCs to invest in companies that engage in developing new technologies that might in the future support the sale or provision of financial

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[54] *See* 65 *Federal Register* 80384 (Dec. 21, 2000).

[55] *See* 12 C.F.R. § 225.28(b)(14). Permissible activities may include providing data processing and data transmission services, facilities (including data processing and data transmission hardware, software, documentation, or operating personnel), data bases, advice and access to such services, facilities or data bases by any technological means. *Id.*

products and services; own and operate communication linkages; or engage in the sale of financial and nonfinancial products or services over electronic networks.

E. Proposal to Define Real Estate Brokerage and Real Estate Management as Financial in Nature or Incidental to Financial Activities

In response to requests from trade associations representing the financial services industry, the Board, in consultation with the Secretary, requested comment in December 2000 on a proposed rule that would determine that real estate brokerage is financial in nature or incidental to a financial activity and therefore permissible for FHCs. The proposal also requested comment on whether real estate management activities should be considered financial in nature or incidental to a financial activity.[56]

In issuing the proposal for public comment, the Board noted that the requestors had cited several factors that would appear to support a finding that real estate brokerage and real estate management are financial in nature or incidental to a financial activity for purposes of the BHC Act.[57] For example, federal savings associations and state-chartered banks chartered in more than twenty states currently are permitted to engage in real estate brokerage.[58] In addition, bank trust departments have long been involved in brokering and managing real estate assets that are part of trust estates. Banks and bank holding companies also currently engage in a wide variety of other activities related to real estate, including owning and managing the real estate premises of the bank or bank holding company, making real estate investments that have as their primary purpose community development, providing real estate appraisal services, arranging commercial real estate equity financing, engaging in real estate lending and leasing activities, providing real estate settlement and escrow services, and providing real estate advisory services.

The proposal also noted that many aspects of real estate brokerage are permissible finder activities for banks and FHCs and that real estate brokerage activities more generally may be viewed as a natural extension of permissible finder activities. The proposal also noted that several diversified financial companies provide real estate brokerage services and that allowing

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[56] *See* 66 *Federal Register* 307 (Jan. 3, 2001). The proposal generally defines real estate brokerage as the business of bringing together parties interested in consummating a real estate purchase, sale, exchange, lease, or rental transaction and negotiating on behalf of such parties a contract relating to the transaction. The proposal also generally defines real estate management as the business of providing for others day-to-day management of real estate.

[57] At the time the Board issued the proposal for public comment, the Secretary issued a parallel proposal for financial subsidiaries of national banks. *See id*. The Treasury's fiscal 2003 appropriation legislation prohibits the Treasury from using appropriated funds to finalize this rule.

[58] Thrift holding companies and thrift service corporations also are permitted to maintain and manage real estate.

FHCs to engage in these activities may help FHCs compete effectively with other financial service providers in the United States—a factor the GLB Act directs the Board to consider in determining whether an activity is financial in nature or incidental to a financial activity. For these reasons, the Board requested comment on whether real estate brokerage and real estate management should be found to be financial in nature.[59]

The Board also requested comment on whether permitting FHCs to engage in real estate brokerage and management as agent would raise any material safety and soundness issues or have other significant, adverse effects. In this regard, the proposal included several limits designed to ensure that an FHC would *not* become involved as principal in real estate investment and development activities, which involve significantly more risk than the agency activities of real estate brokerage and real estate management. For example, the proposal would *not* authorize any FHC to (1) invest in or develop real estate as principal; (2) take title to, acquire, or hold any ownership interest in any real estate brokered or managed by the FHC; or (3) maintain or repair, directly or indirectly, any real estate managed by the FHC.[60] In addition, the proposal noted that an FHC would have to conduct any authorized real estate brokerage or management activities in accordance with applicable federal and state laws, including state licensing requirements, the Real Estate Settlement Procedures Act (12 U.S.C. §§ 2601 *et seq*.) and the anti-tying restrictions in section 106 of the BHC Act Amendments of 1970 (12 U.S.C. §§ 1971 *et seq.*).

The Board has received approximately 50,000 public comments on the real estate brokerage and management proposal. Comments were submitted by members of the Congress, state officials, trade associations, financial institutions, and real estate brokers. The Board has not taken final action on the proposal.

F. Rule Implementing Section 4(k)(5)

Section 4(k)(5) of the BHC Act requires the Board, in consultation with the Secretary, to define the extent to which three categories of activities generally described in the Act are financial in nature or incidental to a financial activity.[61] As discussed above, these three general categories of activities are (1) lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities; (2) providing any device or other

[59] In the proposal, the Board also requested comment on whether FHCs should be permitted to provide employee relocation services to businesses in connection with real estate brokerage or otherwise, and, if so, whether an FHC providing employee relocation services also should be permitted to purchase an employee's unsold real estate, assist a transferred employee in moving his or her household goods, or assist the spouse of a transferred employee in finding new employment.

[60] The proposal, however, would allow an FHC to arrange for a third party to maintain or repair the real estate managed by the FHC.

[61] *See* 12 U.S.C. § 1843(k)(5).

instrumentality for transferring money or other financial assets; and (3) arranging, effecting, or facilitating financial transactions for the account of third parties.

These categories are quite broad and encompass some activities that FHCs are permitted to conduct under other provisions of the GLB Act or the Board's rules including, for example, safe deposit services, and electronic funds transfer, credit and stored-value card, securities brokerage, and finder activities. In light of these facts, the Board, in consultation with the Secretary, adopted a rule in December 2000 that permits an FHC to engage in an activity pursuant to section 4(k)(5) if the FHC obtains a determination from the Board that the proposed activity is within one of the three categories of activities specified in that section of the Act. To allow FHCs to take immediate advantage of this procedure and the authority granted by section 4(k)(5), the Board adopted the rule on an interim basis effective January 2, 2001.[62]

The rule provides that the Board will promptly respond in writing to any request from an FHC for a determination that an activity is within the scope of the three activities generally described in section 4(k)(5) and establishes the procedure to be used by FHCs for making such requests. The rule also provides that, in considering whether a particular proposed activity is permissible under section 4(k)(5), the Board will consider the same factors that it is required to consider generally when evaluating whether an activity is financial in nature or incidental to a financial activity.

If the Board determines that a specific activity is within the scope of the three activities generally described in section 4(k)(5), the activity is then considered to be financial in nature or incidental to a financial activity for purposes of the BHC Act. Accordingly, other FHCs may then commence the approved activity (or acquire a company engaged in the activity) simply by filing a notice with the Board within thirty days *after* the FHC commences the activity (or acquires the company).[63]

The Board has not received any requests from an FHC under the rule for a determination that a specific activity is within the scope of section 4(k)(5). During the public comment process on the interim rule, however, commenters requested that the Board determine that real estate brokerage, real estate management, investment counseling, and estate planning are within the scope of section 4(k)(5). As discussed above, the Board, in consultation with the Secretary, has separately requested comment on a proposed rule that would determine that real estate brokerage and real estate management are financial in nature or incidental to a financial activity under section 4(k)(1) of the BHC Act, and the Board has requested comment on whether real estate brokerage and real estate management should be considered permissible under section 4(k)(5) in connection with that proposal. In addition, investment counseling and estate planning are already permissible activities for all bank holding companies, including FHCs,

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[62] *See* 65 *Federal Register* 257 (Jan. 3, 2001) (codified at 12 C.F.R. § 225.86(e)). At the time the Board adopted the interim rule, the Secretary adopted a parallel interim rule for financial subsidiaries of national banks.

[63] *See* 12 C.F.R. § 225.87.

under other provisions of the BHC Act and the Board's regulations.[64] Accordingly, the Board has not acted on these requests at this time.

G. Final Rule Permitting All Bank Holding Companies to Engage in a Wider Array of Commodity Derivative Activities

In June 2003, the Board adopted a final rule that permits all bank holding companies, including FHCs, to engage in an expanded range of commodity derivative activities.[65] Specifically, the rule permits all bank holding companies to:

- Take and make delivery of title, on an instantaneous, pass-through basis, to any commodity that underlies a permissible commodity derivative contract entered into by the bank holding company;

- Enter into commodity derivative contracts that do not require cash settlement, or allow the bank holding company to assign, terminate, or offset the contract prior to delivery, if the derivative contract is based on an asset for which futures or options on futures contracts have been approved for exchange trading by the Commodity Futures Trading Commission (CFTC), and the bank holding company takes all reasonable steps to avoid delivery or makes and takes delivery only on an instantaneous, pass-through basis.

The Board adopted the rule pursuant to its authority to modify the conditions under which all bank holding companies may conduct activities that, before November 12, 1999, the Board had determined were "closely related to banking" under section 4(c)(8) of the BHC Act.

In this regard, prior to enactment of the GLB Act, the Board had authorized bank holding companies to buy and sell as principal commodity derivative contracts under section 4(c)(8) of the BHC Act, subject to certain restrictions.[66] These restrictions generally permitted a bank holding company to enter into a commodity derivative contract that did not require cash settlement only if (1) the commodity underlying the contract is eligible for purchase by a state member bank (for example, gold, silver, or palladium), *or* (2) the contract allows the bank holding company to assign, terminate, or offset the contract before delivery (the contractual

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[64] *See* 12 C.F.R. §§ 225.86(b)(6) (financial and investment advisory activities) and (b)(4) (performing activities of a fiduciary nature that may be performed by a trust company under federal or state law).

[65] *See* 68 *Federal Register* 39807 (July 3, 2003). The Board initially proposed to take this action in March 2003. *See* 68 *Federal Register* 12316 (March 14, 2003).

[66] *See* 12 C.F.R. § 225.28(b)(8)(ii)(B). A "commodity derivative contract" for these purposes is generally defined to include forward contracts, options, futures, options on futures, swaps, and similar contracts (whether traded on an exchange or not) that are based on a rate, price, financial asset, nonfinancial asset, or group of assets (other than a bank-ineligible security).

offset requirement) *and* the bank holding company makes every reasonable effort to avoid taking or making delivery of the underlying commodity (the delivery avoidance requirement).[67] The contractual offset requirement and the delivery avoidance requirement generally were intended to reduce the potential that bank holding companies would become involved in, and bear the risks of, physical possession, transport, storage, delivery, and sale of bank-ineligible commodities.

These requirements, however, impeded the ability of bank holding companies to participate substantially in certain derivative markets. For example, in some over-the-counter forward markets (for example, U.S. energy markets), the physically settled derivative contracts traded by market participants do not specifically provide for assignment, termination, or offset before delivery and thus do not conform to the contractual offset requirement. In addition, financial intermediary participants in commodity derivative markets often enter into back-to-back derivative contracts with third parties that effectively offset each other and, in connection with these arrangements, make and take delivery of title to the underlying commodity on an instantaneous, pass-through basis—action that does not conform with the delivery avoidance requirement.[68]

In light of these facts, the Board modified the restrictions in Regulation Y governing the commodity derivative activities of bank holding companies in the manner described above. These modifications permit bank holding companies, including FHCs, to make and take delivery of title to (but not physical possession of) the commodities underlying a permissible commodity derivative contract on an instantaneous, pass-through basis. In addition, these modifications permit bank holding companies, including FHCs, to enter into commodity derivative contracts that do not require cash settlement or specifically allow for assignment, termination, or offset before delivery so long as the contracts involve commodities for which futures contracts have been approved for trading on a U.S. futures exchange by the CFTC (and the bank holding company complies with the rule's modified delivery avoidance requirement).

The Board concluded that permitting bank holding companies to take title to a commodity on an instantaneous, pass-through basis would not expose bank holding companies to significantly greater or different risks than they currently face as a holder of a commodity derivative contract. The Board also found that, because derivative contracts based on commodities approved by the CFTC for exchange trading are more likely to have reasonably

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[67] *See* 12 C.F.R. § 225.28(b)(8)(ii)(B).

[68] These market practices typically result in the creation of a chain of contractual relationships that begins with a commodity producer, continues with a number of intermediaries who have entered into matched contracts both to buy and sell the same commodity at the same future time, and ends with a purchaser that intends to take physical delivery of the commodity. On the maturity date of the derivative contract, the producer will be responsible for making physical delivery, and the ultimate buyer will be responsible for accepting physical delivery, and each intermediate participant in the chain will be deemed, by operation of contract, to have instantaneously received and transferred legal title to the commodity.

liquid markets, the modified contractual offset requirement should continue to provide some assurance that bank holding companies would be able to avoid physical delivery of commodities even if the contract does not expressly provide for assignment, termination, or offset before delivery.

H. Order Authorizing Citigroup to Engage, to a Limited Extent, in Physical Commodity Transactions as an Activity That is Complementary to its Financial Derivative Activities

The Board has found that one activity is complementary to a financial activity conducted by an FHC. On October 2, 2003, the Board, by order, authorized Citigroup (an FHC) to engage, to a limited extent, in purchasing and selling nonfinancial commodities in the spot market and receiving and making physical delivery of nonfinancial commodities to settle permissible commodity derivative contracts entered into by Citigroup (commodity trading activities).[69] The order permits Citigroup to engage in these commodity trading activities only with respect to commodities on which (1) Citigroup regularly buys and sells permissible derivative contracts and (2) futures have been approved by the CFTC for trading on a U.S. futures exchange (such as oil, natural gas, and various agricultural commodities). The order also provides that the total market value of all nonfinancial commodities held by Citigroup at any one time pursuant to the order may not exceed 5 percent of Citigroup's consolidated tier 1 capital.

The Board determined that Citigroup's conduct of these limited, nonfinancial commodity trading activities would be complementary to one of Citigroup's existing financial activities—namely, the business of buying and selling, as principal, permissible commodity *derivative* contracts. In this regard, the Board found that the approved commodity trading activities flow from, and are meaningfully connected to, Citigroup's existing financial derivatives business. For example, the approved commodity trading activities would provide Citigroup with an alternative method of fulfilling its obligations under otherwise permissible commodity derivative contracts and would enable Citigroup to acquire more experience in the physical markets for commodities and thereby improve its understanding of the commodity derivatives markets and the profitability of its existing commodity derivatives business. The Board also found that permitting Citigroup to engage in commodity trading activities would enable Citigroup to offer services that are provided by a number of other financial intermediaries in the commodity derivatives markets.

The Board also found, as required by the GLB Act, that Citigroup's conduct of commodity trading activities, on the limited basis authorized by the order, would not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally and could reasonably be expected to produce benefits to the public that outweighed any potential adverse effects.[70] For example, the Board noted that approval likely would benefit

[69] *See* Citigroup Inc., Order dated Oct. 2, 2003. The Board's order does *not* authorize Citigroup to own or operate storage, transportation, or distribution facilities for any commodities or to refine or otherwise process any commodities.

[70] *See* 12 U.S.C. §§ 1843(k)(1)(B), (j)(1)(A) and (j)(2)(A).

customers by enabling Citigroup to transact more efficiently with customers in a wider variety of commodity markets and in a wider variety of transaction formats. The Board's order also requires Citigroup to maintain appropriate internal policies and procedures to address the risks associated with the purchase and sale of physical commodities. For example, the order requires Citigroup to have policies that are designed to ensure that Citigroup maintains adequate insurance coverage to mitigate the risks associated with the ownership of environmentally sensitive commodities, such as oil.

III. Risks Posed by the Commercial Activities of FHCs

A. Overview.

The GLB Act maintains the general separation of banking and commerce by permitting FHCs, as a general matter, to engage in only those activities that are determined to be financial in nature or incidental to a financial activity. The GLB and BHC Acts, however, do contain certain "grandfather" provisions that allow a company that acquires a bank and becomes a bank holding company to conduct, for a limited period, any commercial activities conducted by the company before its acquisition of a bank. In addition, as noted above, the GLB Act permits the Board to allow an FHC to engage in a commercial activity if the Board determines that the activity is complementary to the financial activities of the FHC and would not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Virtually all domestic FHCs currently engage in only financial activities and do *not* engage in commercial activities.[71] In fact, Board data and supervisory experience indicate that only one FHC (Citigroup) currently engages in commercial activities to any extent. These commercial activities are conducted by a nonbank subsidiary of the parent holding company and represent a de minimis percentage of Citigroup's consolidated total capital and assets. As discussed in part II.H, the Board has authorized Citigroup to continue engaging in these commercial activities subject to limitations designed to ensure that the activities would not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. In light of the very limited scope of the commercial activities of FHCs both individually and in the aggregate, the Board and the Secretary do not believe these activities

[71] Some foreign banking organizations are permitted under the laws of their home country to affiliate with a commercial company. In light of this fact, and to avoid unduly interfering with overseas commercial affiliations of foreign banking organizations, the BHC Act allows the foreign commercial affiliates of a qualifying foreign banking organization to engage in commercial activities in the United States under certain limited circumstances. *See* 12 U.S.C. § 1841(h)(2). Moreover, most foreign banking organizations that have a banking presence in the United States do so through a branch or agency of the foreign bank and do not own a separately chartered depository institution in the United States. In light of these facts, and the fact that section 103(d) of the GLB Act directs the Board and the Secretary to discuss the risks of commercial activities to the depository institution affiliates of FHCs, this part of the report focuses on the commercial activities of domestic FHCs and all references to FHCs in this part of the report are to domestic FHCs.

have posed any material risks to the safety and soundness of the depository institution subsidiaries of FHCs.

B. Existing Commercial Activities of FHCs

Section 4(n) of the BHC Act, as amended by the GLB Act, permits a company (other than a bank holding company or foreign bank) that becomes an FHC after November 12, 1999, to continue to engage in any commercial activity that the company lawfully was engaged in on September 30, 1999, provided that the company is and remains "predominantly engaged" in financial activities.[72] The GLB Act requires an FHC to terminate any commercial activities conducted under this special grandfather authority no later than November 12, 2009, although the Board may extend the divestiture date for an FHC for up to an additional five years (that is, until November 12, 2014) if the Board finds that the extension would not be detrimental to the public interest. Board data and supervisory experience indicate that, to date, no FHC has engaged in commercial activities under the authority of section 4(n) of the BHC Act.

Section 4(a)(2) of the BHC Act also permits any company that becomes a bank holding company to continue to engage in any commercial activity that the company was engaged in on the date it becomes a bank holding company for up to two years from that date.[73] The Board is permitted to grant up to three one-year extensions of this divestiture period (for a total of up to five years) if the Board determines that the extension would not be detrimental to the public interest.

Citigroup, which was formed in October 1998 through the acquisition of Citicorp (a bank holding company) by Travelers Group, has engaged in a limited amount of commercial activities pursuant to section 4(a)(2).[74] In particular, after October 1998, Citigroup continued to engage in certain commercial activities previously conducted by Travelers Group including trading in nonfinancial commodities, real estate management and investment, oil and gas exploration and investment, and ship chartering. In the aggregate, these commercial activities represented less than 2 percent of Citigroup's total assets, and Citigroup derived less than 2 percent of its total revenues from these commercial activities.

[72] *See* 12 U.S.C. § 1843(n). An FHC is considered to be "predominantly engaged" in financial activities if the FHC derives at least 85 percent of its annual gross revenues, on a consolidated basis, from engaging in activities that are financial in nature or incidental to a financial activity.

[73] *See id.* at § 1843(a)(2).

[74] Because Citigroup was a bank holding company on the date of enactment of the GLB Act (November 12, 1999), it does not qualify for the special ten-year grandfather rights in section 4(n) of the BHC Act.

Citigroup's authority to conduct these commercial activities under section 4(a)(2) terminated on October 8, 2003.[75] Accordingly, Citigroup has divested or terminated all of these commercial activities and investments other than its trading in nonfinancial commodities. As discussed in part II.H. of this report, the Board authorized Citigroup to continue to engage in nonfinancial commodity trading activities after October 8, 2003, as an activity that is complementary to Citigroup's financial derivatives business.[76] The Board's order limits the total market value of nonfinancial commodities that Citigroup may hold at any one time to no more than 5 percent of Citigroup's consolidated tier 1 capital. In addition, the Board's order requires Citigroup to establish and maintain appropriate policies and procedures to address the risks associated with the purchase and sale of nonfinancial physical commodities. Based on these and other factors discussed in the Board's order, the Board concluded that permitting Citigroup to continue to engage in the purchase and sale of nonfinancial commodities, to a limited extent, would not pose a substantial risk to the safety and soundness of Citigroup's depository institution subsidiaries or the financial system generally.

IV. The Effect of Mergers and Acquisitions Under Section 4(k) on Concentration in the Financial Services Industry

This part of the report examines the extent to which the formation of FHCs and mergers and acquisitions by FHCs under section 4(k) of the BHC Act have affected concentration in the financial services industry.[77] As with the earlier parts of this report, the analysis focuses on the four most important nonbanking activities authorized by section 4(k) of the BHC Act—securities underwriting and dealing, insurance underwriting, insurance agency activities, and merchant banking.

The national presence of FHCs is examined for each of these services. This focus on broad product categories at the national level does not reflect any judgment regarding the scope of product markets or of geographic markets that would be relevant in a particular antitrust context. Rather, it reflects an attempt to use the available information to paint a meaningful picture of the structural changes that may have resulted from passage of the GLB Act.

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[75] In October 2000, 2001, and 2002, the Board granted Citigroup one-year extensions of the section 4(a)(2) divestiture period.

[76] *See* 12 U.S.C. § 1843(k)(1)(B). To date, the Board has not authorized any other FHC to engage in a commercial activity under the GLB Act's "complementary" provisions.

[77] The GLB Act permits an FHC to acquire a nonbanking company (other than a savings association) under section 4(k) without the Board's prior approval. Accordingly, the Board does not analyze the effects that a particular nonbank acquisition by an FHC under section 4(k) may have on competition in the relevant market. However, nonbanking acquisitions made by FHCs under section 4(k) of the BHC Act are subject to review by the Department of Justice or the Federal Trade Commission in accordance with the Hart-Scott-Rodino Antitrust Improvements Act of 1976, Pub. L. No. 94-435.

Where adequate data exists, concentration levels are calculated for the selected markets before passage of the GLB Act and compared with concentration levels in those markets calculated with data from the most recent year available. This study uses *n*-firm concentration indexes as the measure of market concentration. An *n*-firm concentration index reports the combined market share of the *n* largest firms in that market. For example, a 4-firm concentration index is the sum of the market shares of the 4 largest firms. As a market becomes more concentrated, the index numbers will increase as a greater share of the market is served by the *n* largest firms. For each of the selected activities and product lines, this study calculates the 4-firm, 10-firm, and 25-firm concentration indexes.

In contrast to showing how mergers or acquisitions have affected the market shares of FHCs, the concentration-index approach shows how the whole industry has changed. It also allows for any changes in FHC market share to be examined in the context of how non-FHC competitors of similar size have fared over the same period. The portion of these industry changes that are explainable as the result of FHC activity can then be identified. This approach also provides a broader picture of how section 4(k) may have affected competition in these markets by reflecting any changes in the market share of FHCs that may have occurred through internal growth—growth that may have been sparked by the removal of barriers previously applicable to the activities in question—as well as changes in the market share of FHCs that may have occurred through mergers and acquisitions.

A. Securities Underwriting and Dealing

As of March 2003, a total of 38 domestic and 19 foreign FHCs report being engaged in securities underwriting and dealing under the GLB Act's expanded securities underwriting and dealing authority. As a measure of each firm's involvement in the spectrum of underwriting and dealing activities, data were collected from the June 1999 issue of *Securities and Investments Quarterly* and the 2003-04 *Securities Industry Yearbook* on the capital levels of broker-dealer firms.[78] These capital levels, which are used as approximations of the volume of business of each firm in underwriting and dealing activities, are used to construct measures of concentration in the market for securities underwriting and dealing.

The three concentration indexes for securities underwriting and dealing tell a mixed story (table 4.1).[79] The 4-firm index shows that the market share of the top 4 firms has

[78] This section uses the same definition of capital used in these two publications, namely as the sum of ownership equity and subordinated liabilities, except for companies reporting as nonregulated parent holding companies, for which capital is defined as the sum of long-term borrowings and ownership equity.

[79] The numbers presented in table 4.1 differ from the raw data published in the *Securities and Investments Quarterly* and *Securities Industry Yearbook.* In those publications, separate subsidiaries of a corporation are listed as separate entities. In conformance with standard procedure in calculating market concentrations, firms that are subsidiaries of the same corporation were identified using the Corporate Affiliations databases for 2003 and 1999, and the capital levels of affiliated firms were aggregated. As a result of this aggregation, the numbers

decreased slightly, but the 10-firm and 25-firm concentration indexes have increased by 3.8 percentage points and 2.6 percentage points respectively.

TABLE 4.1: Concentration Indexes for Securities Underwriting and Dealing, 1999 and 2003

Concentration Index	1999 (%)	2003 (%)
4-firm	60.5	59.8
10-firm	83.5	87.3
25-firm	92.2	94.8

The different trends exhibited by the concentration indexes may be attributable to the growth of the securities underwriting and dealing activities of FHCs. In this regard, the top 4 firms in 2003 were not affiliated with an FHC. Twelve of the remaining 21 firms within the top 25 broker-dealers in 2003, however, are affiliated with FHCs. Five of these are affiliated with domestic FHCs and 7 are affiliated with foreign FHCs. The combined market share of these FHCs increased 5.7 percentage points from 1999 to 2003.

The FHCs' increase in market share was entirely attributable to the foreign FHCs. Between 1999 and 2003, the combined market share of the 5 domestic FHCs that are among the top 25 broker-dealers in 2003 decreased 1 percentage point (table 4.2). The decrease in market share was a result of Citigroup's decrease of 2.4 percentage points. The market shares of each of the remaining 4 domestic FHCs increased slightly over the period.

TABLE 4.2: U.S. Market Shares of the Largest Domestic FHCs Engaged in Underwriting and Dealing, 1999 and 2003

Financial Holding Company	Rank in 2003	1999	2003
Citigroup	5	11.9	9.5
Bank of America	11	0.8	1.1
Charles Schwab	12	0.6	1.0
J.P. Morgan Chase	13	0.6	1.0
Wachovia	15	0.1	0.5
Total		14.0	13.0

Table 4.3 provides similar market share information for the foreign FHCs that are among the top 25 broker-dealers in 2003. Combined, the market shares of these firms based upon their capital more than doubled over the 1999-2003 period. Of the seven foreign FHCs, five gained market share. Most of these firms' increase in market share can be attributed

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and rankings presented here will differ from those presented in the corresponding issues of *Securities and Investments Quarterly* and *Securities Industry Yearkbook*.

to Credit Suisse (whose market share increased 4.9 percentage points) and UBS (whose market share increased 1 percentage point).

TABLE 4.3: U.S. Market Shares of the Largest Foreign FHCs Engaged in Underwriting and Dealing, 1999 and 2003

Financial Holding Company	Rank in 2003	1999	2003
Credit Suisse Group	6	1.6	6.5
UBS	8	1.5	2.5
Deutsche Bank	10	0.6	1.2
Toronto-Dominion Bank	14	0.3	0.7
ABN-AMRO Bank	19	0.2	0.3
Canadian Imperial Bank of Commerce	20	0.6	0.3
Société Générale	23	0.4	0.3
Total		5.1	11.8

Several acquisitions contributed substantially to the capital growth of the FHCs. For example, the large share growth of Credit Suisse can be explained partially by its acquisition of Donaldson, Lufkin & Jennrette, which had a market share in 1999 of 2.1 percent. Several of the other FHCs that experienced increases in their capital share also were involved in mergers since passage of the GLB Act. Notable mergers involving these FHCs include the acquisition of Paine Webber (1999 market share of 2.5 percent) by UBS, the merger of Chase (0.8 percent) into JP Morgan, and the combination of Wachovia and First Union (0.1 percent).

To further analyze how the formation of FHCs and acquisitions and mergers by FHCs under section 4(k) may have affected concentration in the market for securities underwriting and dealing, data were collected from Securities Data Corporation on the dollar volume of public debt underwriting to nonfinancial U.S. corporations in 1999 and 2002.[80]

TABLE 4.4: Concentration Indexes for Debt Underwriting Services, 1999 and 2002

Concentration Index	1999 (%)	2002 (%)
4-firm	53.8	52.5
10-firm	88.6	90.6
25-firm	98.2	99.5

The concentration indexes for debt underwriting (table 4.4) show a pattern similar to that of the concentration indexes based on capital levels. The 4-firm concentration index decreased slightly (1.3 percentage points), while the 10-firm and 25-firm indexes increased by similarly small amounts, 2 percentage points and 1.3 percentage points respectively.

[80] These data include debt transactions placed with institutional buyers under SEC Rule 144A, but exclude all mortgage- and asset-backed issues.

On balance, mergers involving FHCs in securities underwriting and dealing services appear to have led to an increase in the capital share of the FHCs. Although these mergers likely helped to increase the 10-firm and 25-firm concentration indexes, they did not affect concentration among the 4 largest firms, as none of these 4 firms were subsidiaries of FHCs. Although mergers under section 4(k) appear to have increased concentration in the market for securities underwriting and dealing services, this increase has been relatively small.

B. Insurance Underwriting

As of March 2003, a total of seventeen domestic and nine foreign FHCs reported engaging in insurance underwriting activities under section 4(k) of the GLB Act. Data were collected from A.M. Best Company on the volume of net premiums written by firms in two product lines: (1) property-casualty and (2) life-health. Each product line is examined in this part as a distinct and separate product market.

1. Property-Casualty

Data were collected on the volume of net premiums written by insurance groups and insurance companies from the 2000 and 2003 editions of *Best's Aggregates & Averages: Property-Casualty* and *Best's Insurance Reports Property-Casualty*. These numbers are used to construct firm-level market shares for insurance underwriters in the property-casualty lines of insurance in the United States for 1999 and 2002.

TABLE 4.5: Concentration Indexes for Property-Casualty Insurance, 1999 and 2002

Concentration Index	1999 (%)	2002 (%)
4-firm	26.7	28.2
10-firm	43.9	46.3
25-firm	64.0	65.6

According to these data, the top 4 firms ranked by net premiums written in the property-casualty market had a combined market share of 28.2 percent in 2002 (table 4.5). This share represented an increase of 1.5 percentage points from the share of the top 4 firms in 1999. Similarly, although the 10-firm and 25-firm concentration indexes also indicate an increase in market concentration, these increases were also relatively modest (increases of 2.4 percentage points and 1.6 percentage points respectively). These data indicate a small increase in national market concentration in property-casualty insurance underwriting.

Of the top 25 firms involved in underwriting property-casualty insurance in 2002, only one, Metropolitan Property and Casualty Insurance Company (Metropolitan Property), was a subsidiary of an FHC (MetLife). Metropolitan Property's market share over the 1999-2002 period fell slightly, from around 1 percent to 0.8 percent. In 1999, a second top-25 property-casualty insurer, Travelers Property Casualty Group, was affiliated with Citigroup, which is now an FHC. However, in 2002, Citigroup distributed the stock of Travelers Property Casualty Group to Citigroup's shareholders. Since this insurer contained almost all of the property-

casualty underwriting business of Citigroup, this transaction had very little effect on concentration in the property-casualty insurance market.

On balance, these data suggest that market concentration in property-casualty insurance has been largely unchanged since passage of the GLB Act. Furthermore, there is no evidence that the formation of FHCs or mergers and acquisitions by FHCs under section 4(k) of the GLB Act have had any discernable effect on market concentration in the property-casualty insurance industry.

2. Life-Health

Data also were collected on the volume of net premiums written by insurance groups and insurance companies from the 2000 and 2003 editions of *Best's Aggregates & Averages: Life-Health* and *Best's Insurance Reports: Life-Health*. As with the property-casualty lines, these data were used to construct firm-level national market shares for insurance underwriting in the life-health lines in the United States for 1999 and 2002.

TABLE 4.6: Concentration Indexes for Life-Health Insurance, 1999 and 2002

Concentration Index	1999 (%)	2002 (%)
4-firm	17.8	21.1
10-firm	36.0	38.0
25-firm	64.6	63.7

According to these data, the top 4 firms ranked by net premiums written in the life-health market had a combined market share of 21.1 percent in 2002, an increase of 3.3 percentage points since 1999 (table 4.6). The market share of the 10 largest firms was also notably higher, having increased 2 percentage points over the period. Finally, the 25-firm concentration index was little changed, having decreased by a modest 0.9 percentage points.

Of the top 25 life-health insurance underwriting firms in 2002, two are subsidiaries of FHCs (MetLife and Citigroup). MetLife had a lower market share in 2002 (5.5 percent) than in 1999 (5.7 percent). Citigroup's market share also declined a minor amount, from 1.8 percent to 1.6 percent, over this period. The merger of Citicorp and Travelers, which occurred just before passage of the GLB Act and led to the creation of Citigroup, also did not have a substantial effect on concentration in this market. In 1998, the year before the merger, Travelers had a significant share of the life-health market (1.3 percent), whereas Citicorp's share was substantially smaller at less than 0.1 percent. The combination of these two firms into Citigroup, therefore, did not have a noticeable effect on concentration.

The data suggest that market concentration has risen in the life-health insurance industry when measured by the 4-firm or 10-firm indexes. However, the data do not suggest that the formation of FHCs or mergers and acquisitions by FHCs under section 4(k) contributed to this trend.

C. Insurance Agency Activities

As of March 2003, a total of 155 domestic and 10 foreign FHCs report engaging in insurance agency activities under the expanded insurance agency authority for FHCs in section 4(k) of the BHC Act. While more FHCs report engaging in insurance agency activities than any of the other activities covered in this part, FHCs represent only a small fraction of the number of insurance agents currently operating in the United States. For example, the Independent Insurance Agents & Brokers of America represent over 300,000 independent insurance agents.[81] These numbers suggest that FHC insurance agents are a small fraction of the total number of insurance agents operating in the United States. Accordingly, the formation of FHCs and acquisitions by FHCs under section 4(k) has almost certainly had a negligible impact on market concentration in insurance agency services.

D. Merchant Banking

As of March 2003, a total of 12 domestic and 14 foreign FHCs reported holding assets under the GLB Act's merchant banking investment authority. These 26 organizations combined reported total assets of $9.2 billion in merchant banking investments. The assets include those held by domestic FHCs and the assets held by foreign FHCs that engage in merchant banking through a U.S.-based bank holding company. The assets exclude those held by foreign banking organizations operating without a U.S. bank holding company subsidiary because the Board does not collect data on such activity. As noted in part I, industry data and supervisory information indicate that certain nonreporting foreign FHCs have significant merchant banking holdings in the United States. In addition, total merchant banking assets are slightly understated for domestic FHCs because of Board reporting requirements designed to minimize burden.

These data limitations constrain estimation of how concentration in the private equity market has been affected by the passage of the GLB Act. However, a comparison of the reported value of merchant banking investments held by FHCs with estimates of the total value of private equity commitments suggests that FHCs account for a small share of private equity activity. This in turn suggests that the formation of FHCs and mergers and acquisitions by FHCs under section 4(k) should not have had a substantial effect on concentration in the private equity market.

[81] While estimates of the number of independent insurance agents vary, this number clearly underestimates the total number of independent insurance agents currently operating in the United States. Even with 300,000 agents, this market is very unconcentrated.

Appendix A: Section 103(d) of the GLB Act

(d) REPORT-

(1) IN GENERAL- By the end of the 4-year period beginning on the date of the enactment of this Act, the Board of Governors of the Federal Reserve System and the Secretary of the Treasury shall submit a joint report to the Congress containing a summary of new activities, including grandfathered commercial activities, in which any financial holding company is engaged pursuant to subsection (k)(1) or (n) of section 4 of the Bank Holding Company Act of 1956 (as added by subsection (a)).

(2) OTHER CONTENTS- The report submitted to the Congress pursuant to paragraph (1) shall also contain the following:

(A) A discussion of actions by the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, whether by regulation, order, interpretation, or guideline or by approval or disapproval of an application, with regard to activities of financial holding companies that are incidental to activities that are financial in nature or complementary to such financial activities.

(B) An analysis and discussion of the risks posed by commercial activities of financial holding companies to the safety and soundness of affiliate depository institutions.

(C) An analysis and discussion of the effect of mergers and acquisitions under section 4(k) of the Bank Holding Company Act of 1956 on market concentration in the financial services industry.

Appendix B: Activities Defined To Be Financial in Nature by the GLB Act

Section 4(k)(4) of the GLB Act defines the following activities to be financial in nature:

(A) Lending, exchanging, transferring, investing for others, or safeguarding money or securities.

(B) Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State.

(C) Providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940).

(D) Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly.

(E) Underwriting, dealing in, or making a market in securities.

(F) Engaging in any activity that the Board has determined, by order or regulation that is in effect on the date of the enactment of the Gramm-Leach-Bliley Act, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto (subject to the same terms and conditions contained in such order or regulation, unless modified by the Board).

(G) Engaging, in the United States, in any activity that –

(i) a bank holding company may engage in outside of the United States; and

(ii) the Board has determined, under regulations prescribed or interpretations issued pursuant to subsection (c)(13) (as in effect on the day before the date of the enactment of the Gramm-Leach-Bliley Act) to be usual in connection with the transaction of banking or other financial operations abroad.

(H) Directly, or indirectly acquiring or controlling, whether as principal, on behalf of 1 or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls), or otherwise, shares, assets, or ownership interests (include debt or equity securities, partnership interests, trust certificates, or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if—

(i) the shares, assets, or ownership interests are not acquired or held by a depository institution or subsidiary of a depository institution;

(ii) such shares, assets, or ownership interests are acquired and held by-

(I) a securities affiliate or an affiliate thereof; or

(II) an affiliate of an insurance company described in subparagraph [(9)(ii)] that provides investment advice to an insurance company and is registered pursuant to the Investment Advisers Act of 1940, or an affiliate of such investment adviser;

as part of a bona fide underwriting or merchant or investment banking activity, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment;

(iii) such shares, assets, or ownership interests are held for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the activities described in clause [(8)(ii)]; and

(iv) during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.

(I) Directly or indirectly acquiring or controlling, whether as principal, on behalf of 1 or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls) or otherwise, shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if--

(i) the shares, assets, or ownership interests are not acquired or held by a depository institution or a subsidiary of a depository institution;

(ii) such shares, assets, or ownership interests are acquired and held by an insurance company that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities;

(iii) such shares, assets, or ownership interests represent an investment made in the ordinary course of business of such insurance company in accordance with relevant State law governing such investments; and

(iv) during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company except as