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Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Anti-Tying Restrictions of Section 106 of the Bank Holding Company Act Amendments of 1970, Docket No. OP-1158, 68 Federal Register 52024 (August 29, 2003).

Dear Ms. Johnson:

The ABA Securities Association ("ABASA") is pleased to have the opportunity to comment on the proposed interpretation of the anti-tying restrictions of section 106 of the Bank Holding Company Act Amendments of 1970 and related supervisory guidance recently issued by the Board of Governors of the Federal Reserve System ("Board"). The interpretation describes the scope and purposes of section 106, the elements of a tying arrangement prohibited by section 106, and the statutory and regulatory exceptions to the prohibitions of section 106. The supervisory guidance discusses the types of internal controls that banks should have in place to comply with section 106. The American Bankers Association ("ABA") also endorses the views expressed herein.

The Board's actions are very important to ABASA members. Because the current debate on tying generally has centered on bank credit facilities and the investment banking activities of bank affiliates, ABASA has taken a lead role on this issue reflective of the organization's core mission.[1] To that end, ABASA, earlier this year, commissioned two papers on the subject of tying and the restrictions imposed by section 106 in order to contribute to the public's understanding of tying.

[1] ABASA is a separately chartered trade association and non-profit affiliate of the ABA whose mission is to represent before the Congress, the federal government and the courts the interests of banking organizations engaged in underwriting and dealing securities, proprietary mutual funds and derivatives.

The first paper, "Legality of Relationship Banking Under Bank Antitying Restrictions," prepared by the law firm Covington & Burling (the "Covington Paper"), analyzed the application of section 106 to a variety of relationship banking scenarios and concluded that there are many permissible approaches—consistent with section 106—for banks to expand customer relationships and achieve the benefits of bundled products and services. The second paper, "Tying and Subsidized Loans: A Doubtful Problem" by Donald J. Mullineaux, Dupont Chair in Banking and Financial Services at the University of Kentucky, analyzed whether tying made any sense from an economic perspective and evaluated the so-called evidence of tying. Mullineaux' paper concluded that tying is not a rational strategy in today's financial environment and that no valid inferences about tying can be drawn from simple comparisons of rates on loans with those on bonds or credit default swaps.

DISCUSSION

General Comments

We are pleased that the Board's proposed interpretation supports the position that, under section 106, there are many ways that banks legally can offer products and services to their customers based on their customers' overall relationship with the bank and its affiliates. Further, by describing in detail the targeted scope of section 106, and the statutory and regulatory exceptions, the proposed interpretation will assist all parties with an interest in section 106 in distinguishing between permissible and impermissible tying arrangements.

For example, Section II of the interpretation makes quite clear that a decision by a bank not to extend credit or provide any other product to a customer is not a violation of section 106. The interpretation notes that denials of credit based on a customer's financial condition, financial resources or credit history, or because the bank does not offer (or seeks to exit the market for) the type of credit requested by the customer are perfectly permissible under section 106. To this we would add that denials of credit are also permissible when based on such factors as geographic or industry concentrations, customer limits, and even such intangible matters as perceptions of the customer's management abilities and the bank's potential to develop a relationship of trust and confidence with the customer. In addition, we believe it should be permissible for a banking organization to deny credit based on the bank's general assessment of the customer's ability to be or become a profitable customer for the banking

organization. We encourage the Board, when issuing its final interpretation, to make these latter points quite clear upfront.

We find particularly instructive and helpful the Board's statement that section 106 does not prohibit a bank from cross-marketing the full range of products offered by the bank and its affiliates. There must be a bank-imposed condition or requirement for a violation of section 106 to occur and a condition or requirement will not be inferred when a bank grants credit or provides any other product to a customer based solely on a desire or hope (but not a requirement) that the customer will obtain additional products from the bank or its affiliates in the future. As the Board points out, "[c]ross-marketing and cross-selling activities, whether suggestive or aggressive, are part of the nature of ordinary business dealings and do not, in and of themselves, represent a violation of section 106."

The interpretation discusses, at length, the permissibility of mixed-product arrangements[2] and the necessity to perform further analyses when such arrangements are offered to customers. This explicit confirmation of the permissibility of mixed-product arrangements is welcome. ABASA is deeply concerned, however, that the interpretation and supervisory guidance, as proposed, appear to require individual customer-by-customer analyses, determinations, and documentation. As addressed more fully below, analyses such as these are not required by the statute, its legislative history or Board precedent, create very substantial compliance burdens and greatly increase litigation exposure for our member institutions.

Relationship Banking

We agree wholeheartedly with the Board's position that section 106 does not prohibit a bank from reviewing the overall profitability of customers' aggregate business relationships with the bank and its affiliates to determine whether those relationships meet the internal profitability thresholds or hurdle rates set by the bank and its affiliates for customers, a practice sometimes known as "relationship banking." Congress recognized the validity of relationship banking insofar as it relates to traditional bank products by adopting an amendment to the original section 106 language which permits banks to condition the availability of products and services on customers also obtaining one or more traditional bank products from the bank. The Board also

[2] The Board has defined a "mixed-product arrangement" as an arrangement that allows customers the freedom to choose whether to satisfy a condition imposed by the bank, such as a requirement that a customer's total business with the bank and its affiliates meet certain profitability thresholds, through the purchase of one or more traditional bank products or other non-traditional products.

recognized this when it adopted a regulatory exception to permit banks to condition the availability of products and services on customers obtaining one or more traditional products from affiliates of the bank.

The banking industry has long taken the position that no reason exists to limit the pool of products and services from which customers can choose to meet profitability thresholds. As stated in the Covington paper, so long as customers have a meaningful choice of traditional bank products, that is to say that it is genuinely possible for customers to clear the bank's hurdle rate by selecting only products that qualify for the traditional bank product exception, then an arrangement allowing the customer to choose from the bank's menu of products in order to meet a profitability hurdle is permissible under the plain language of section 106, its legislative history, regulatory guidance, and case law interpreting section 106. We are pleased that the Board, in issuing the proposed interpretation, has recognized that banks can legally offer these mixed-product arrangements without running afoul of the tying restrictions of section 106.

We are strongly opposed, however, to any suggestion that each bank offering mixed-product arrangements is required to analyze each customer's individual ability to meaningfully choose among traditional and non-traditional bank products whenever the customer enters into a transaction with the bank. For example, the interpretation states that "If… **the** customer does not have a meaningful option to satisfy the bank's condition solely through the purchase of traditional bank products included in the arrangement, then the arrangement violates section 106 because the arrangement effectively requires **the** customer to purchase one or more non-traditional products in order to obtain the customer's desired product or discount on the desired product." And, it states that the bank must make a determination whether **each** customer has a meaningful option to satisfy the bank's condition solely through the purchase of traditional bank products. To make that determination, the interpretation appears to require a granular, highly fact specific investigation with respect to each transaction by each customer.

Similarly, while we recognize that the supervisory guidance contains some generalized due diligence requirements at the program level, a close reading of the guidance suggests that any mixed product arrangement requires an individualized, customer-by-customer, transaction-by-transaction review. For example, the guidance requires bank policies, procedures and documentation "to reflect how the bank will and does establish a good faith belief that **a** customer offered a mixed-product arrangement would be able to satisfy the conditions associated with the arrangement solely through the purchase of

traditional bank products." The guidance goes on further to require bank policies to address factors and types of information that the bank will review for **each** individual customer to determine whether **that** customer has been afforded a meaningful choice to purchase only traditional bank products, including:

- The types and amounts of traditional bank products typically required or obtained by companies that are comparable in size, credit quality, and nature, scope and complexity of business operations to **the** customer; and

- Information provided by **the** customer concerning the types and amounts of traditional bank products needed or desired by **the** customer and **the** customer's ability to obtain those products from the bank or its affiliates.

Thus, the interpretation and the supervisory guidance taken together appear to require that a bank offering mixed-product arrangements must **determine, document,** and be prepared to **prove** that **each** customer has a meaningful option to satisfy the bank's profitability thresholds solely through the purchase of traditional bank products.

We are strongly opposed to any requirement to perform such detailed customer-by-customer analyses. Instead, it should be sufficient that the bank have a good faith belief that **customers generally** have meaningful options to satisfy the bank's profitability thresholds solely through the purchase of traditional bank products. In this context, it should be sufficient to demonstrate meaningful choice by testing the program against various fact patterns. For example, analyzing the weighting of the various products to determine that the assigned weightings do not unfairly favor non-traditional bank products over traditional bank products would be one way of testing to ensure meaningful choice. Another method would involve, during development of the program, testing various hypothetical customers against the program to determine whether these hypothetical customers had the ability to satisfy the bank's hurdle rate by selecting exclusively traditional bank products.

Section 106 does not require that mixed product arrangements be conducted on a customer-by-customer basis, nor does any regulatory provision. To the contrary, the Board plainly took the opposite approach in issuing the combined balance discount exception, which is a particular kind of mixed-product arrangement. In this context, the Board did <u>not</u> require banks to analyze whether each individual customer could enjoy the benefits of the combined balance

discount by only choosing traditional bank products. Similarly, the Board should not require a customer-by-customer analysis for mixed-product arrangements more generally.

The burdens in terms of time and money associated with performing these individual analyses are significant. While section 106 always has required a significant legal and compliance infrastructure, the interpretation and guidance would substantially increase the required infrastructure to deal with the customer-by-customer requirement for each mixed product arrangement. Moreover, since legal and compliance personnel cannot be present during each encounter with a customer in which a mixed product arrangement discussion could arise, the responsibility for executing and documenting the required diligence would fall largely to business personnel. Garnering, analyzing and documenting the information provided by the customer as to its traditional bank product requirements and its "ability to obtain" those products from the bank and its affiliates would become a significant responsibility of each business person conducting the discussion with the customer. The recordkeeping required to document this information provided by the customer and compare the individual customer to all other customers of comparable size, credit quality, and nature, scope and complexity of business in order to prove that the mixed-product arrangement afforded that customer meaningful choice would be significant and onerous.

In this connection, we are especially opposed to any requirement to delve into a customer's business agreement with another financial services provider. The interpretation states that a "company would have a meaningful option even though [the] company had a long-standing cash management arrangement with another financial institution so long as [the] company may legally transfer its cash management business to [the] bank and [the] bank is able to satisfy [the] company's cash management needs." (Emphasis added) This language could be read as requiring the bank that hoped to acquire the business to review the customer's cash management service contract to determine whether the customer can void the contract with or without legal penalty. We believe that it is the customer's responsibility to determine whether it can transfer the business, and that it should not be for the bank to investigate whether the business can be transferred or whether the customer can otherwise "reasonably obtain" such business from the bank.[3] Moreover, putting such a burden on the banks would require difficult

[3] These concerns could be avoided if footnote 51 was revised to read, "Company would have a meaningful option even though Company had a long-standing cash management arrangement with another financial institution."

discussions with the borrower as to its commitments with other financial institutions, which is information that the customer may well be unwilling to provide.

In addition, our members believe that the customer-by-customer analyses and recordkeeping requirements greatly increase the potential for litigation and lengthy discovery proceedings even if, in the end, it is proven that the bank has not committed any violation of section 106. We strongly urge the Board to reduce the burdens imposed by its supervisory guidance by making clear that it is sufficient to test mixed-product arrangements at the program level before they are offered to the bank's customer base.

If the Board remains convinced that meaningful choice requires an individualized, customer-by-customer analysis, then we request that the Board permit banks to assume without further inquiry that sophisticated customers are capable of having a meaningful choice when offered a mixed-product arrangement. The Board itself recognizes in the guidance that less detailed analyses of customers' meaningful choice may be appropriate for sophisticated customers.[4] Given the complexity of their individual financial needs, sophisticated customers are in a position, better than a bank, to judge their own needs and whether a particular mixed-product arrangement meets those needs.

Moreover, it is well known that sophisticated customers with traditional and non-traditional product needs are adept at leveraging the power of their financial services "wallet" among providers in the competitive financial products marketplace. It is simply unnecessary in this context for banks to be required to document and substantiate the traditional bank product needs for this sophisticated set of customers that frequently exercises leverage against financial services providers. Such customers do not need protection from the potentially anticompetitive practices that section 106 is intended to address.

Single Product

For a tying violation to occur, two conditions must be met. The first condition or prong of the test requires that the potentially violative tying arrangement must involve two or more separate products, i.e., the customer's desired product or products **and** one or more separately tied products. According to the interpretation, two products will be determined to be separate and distinct for purposes of section 106 only if there is sufficient consumer demand for each of the

[4] See discussion at Part VII.B.

products individually that it would be efficient for a firm to provide the two products separately.

We believe that this standard should permit banks to consider as a single product two or more interrelated products that, if offered together, could be offered at a lower price than if offered separately. For example, a loan that requires an interest rate swap may be priced lower if the swap is provided by the bank as opposed to a third party. If a third party provides the swap, the bank has another credit exposure to consider—that of the swap counterparty, as opposed to the bank itself—and there can be a cost associated with evaluating and accepting that exposure. Similarly, there may be a cost associated with having inter-creditor issues with a swap counterparty. If the bank itself provides the swap, it would not have these issues and may be able to offer the loan at a lower price than it would if the swap were with a third party. The same could be true for an equity derivative, e.g., a loan secured with stock with an associated equity collar.

The Board has asked for specific comment on how interest rate swaps, foreign exchange swaps, and other derivative products that are often connected with lending transactions should be treated under section 106. We believe that derivatives offered in conjunction with lending transactions should be viewed as a single product.

It is quite common for derivative products, such as interest rate, foreign exchange credit and equity derivatives, to be offered by banks in connection with lending transactions. Banks first developed and offered these risk management products as an adjunct to customers' lending needs. While the market for derivatives has developed to the point that derivatives can and frequently are offered to customers as separate products, it is beyond question that the vast majority of derivative instruments are bought and sold as hedges against risks associated with lending transactions. But for the lending transaction, the customer would have no need for risk mitigation provided by derivative instruments.

The products should not have to be offered simultaneously; it should be enough that the products are coterminous. It is not uncommon for an interest rate derivative to be offered to a customer some time after the loan is executed. This will often occur when the borrower opts not to fix an interest rate until long after the loan is executed. While the products are not offered simultaneously, the borrower, often times, views the two products as a single transaction and demands that the business day conventions in the loan and swap documentation conform. Thus, it should be sufficient that the

derivative instrument hedges the loan for it to be viewed as a single product.

Packaged Products

The second condition for a tying violation to occur requires that a condition or requirement exist that ties the customer's desired product to another product and the condition or requirement is imposed or forced on the customer. Clearly, bundled sales of multiple products to a customer do not violate either the general antitrust laws or section 106 if the customer voluntarily decides to purchase the package of products from the seller.

The interpretation states that "…section 106 prohibits banks from granting certain types of price discounts—that is, varying the price of the product on the condition that the customer purchase one or more other products from the bank or an affiliate ….[S]ection 106 may restrict the ability of banks to provide price discounts (including rebates) on bundled products depending on what products are in the bundle and which ones are discounted."[5] We are troubled by this blanket statement suggesting that discounts on bundled products, absent any coercion, can violate section 106.[6] Clearly, discounts on bundled products offer pricing benefits to the customer. So long as the products offered in the bundle are available separately, no coercion of the customer exists because the customer has voluntarily elected to purchase the products bundled over the separate product or products. We urge the Board to make this point clear.

The Board also should make clear that packaged products where the discount is not allocated to a particular product in the package are permissible under section 106. One such example involves guaranteed settlement service packages, such as the Guaranteed Mortgage Package ("GMP") likely to be offered by banks and their mortgage finance subsidiaries pending finalization by the Department of Housing and Urban Development ("HUD") of its RESPA Reform 2002 proposal. As envisioned by HUD, the package would allow lenders and other settlement service providers to offer consumers an all-inclusive, one charge settlement package.[7] The GMP is intended to address criticisms regarding the number of hidden

[5] See Section II.

[6] We note that discounts on bundled products do not violate the antitrust laws.

[7] Real Estate Settlement Procedures Act; Simplifying and Improving the Process of Obtaining Mortgages To Reduce Settlement Costs to Consumers; 67 Federal Register 49133 (July 29, 2002).

service charges associated with purchasing a home and allow customers to better shop for a single cost settlement package.[8]

Specifically, the GMP would require customers to be offered a guaranteed cost for origination which would include the application, origination, underwriting, appraisal, pest inspection, flood determination, tax review, tax service, title insurance, government fees and all other lender required services. To be sure, not all products and services need be offered by a bank and its affiliates but it is quite conceivable that they would be. Any discount involved in the bundled package would not be allocated to any particular product or products.

Where the GMP package involves products and services that the customer must have in order to purchase a home, another variation involves packaging products that a customer can, but is not required, to purchase. One such example involves packaging securities brokerage, trust, insurance and banking services for qualifying customers. The products are available separately but can also be purchased at a discount as a package. The discount is not allocated to any product or combination of products and the customer is free to accept or reject the package. We urge the Board to make clear that packaged products such as we have described are permissible under section 106.

Traditional Bank Products

The statutory and regulatory exceptions to section 106 permit banks to restrict the availability or vary the price of any bank product on the requirement that the customer obtain a "traditional bank product" offered by either the bank or an affiliate. The statute defines these bank products to be either a "loan, discount, deposit, or trust service."[9] The interpretation includes a non-exclusive list of traditional bank products and, while the list is quite helpful, ABASA believes it does not go far enough. For example, the list should be revised to make clear that services customarily provided by trust departments are included within the list of traditional bank products. Trust or fiduciary services for employee benefit accounts as well as trust and fiduciary services for personal trusts and estates, charities and endowments would be included within this designation. In addition, corporate trust services would also be included under our suggested revision. It is

[8] We should note that some banks have already begun offering guaranteed settlement service packages, structured in such a manner as to comply with current RESPA regulations.

[9] 12 U.S.C. Section 1972(1)(A).

beyond question that these services are traditional trust services as banks have been offering many of these services for over 100 years.

The list should include foreign exchange, clearly an adjunct to bank deposit and cash management services. All types of derivatives, not just credit derivatives where the bank is the seller of credit protection, also should be added to the list. Congress, in enacting section 106, clearly intended that traditional banking products evolve. As the Senate Committee Report states:

> Banking is not a static form of activity. Modern bankers are offering a variety of specialized services which would have been entirely unknown to their predecessors of a few generations ago…Innovation in financial fields should be encouraged. It seems particularly desirable to permit banks to enter other financial markets when competition is weak, or where the bank can be expected to offer real efficiencies.[10]

Derivatives are one of those products where banks offer real efficiencies. Derivatives are widely perceived as being classic bank product offerings although they were not developed until well after section 106 was enacted. Nevertheless, as risk mitigation products, they are integral to traditional lending transactions. We urge the Board to take a more flexible approach in defining, for purposes of section 106 only, loan, deposit, discount and trust service and accord the status of traditional bank products to all derivatives. Further, with respect to derivative transactions, it should not matter whether the bank or an affiliate is on the buy or sell side of the transaction.

Alternatively, the Board could exercise its exemptive authority under section 106 to allow packaging of bank products and services with foreign exchange and derivative transactions. Section 106 specifically authorizes the Board by regulation or order to permit exceptions to its statutory restrictions as will not be contrary to the purposes of the statute. And in conferring exemptive authority on the Board, Congress intended to ensure that section 106 did not interfere with appropriate traditional banking practices and that its restrictions could be adjusted or tailored to accommodate market changes.[11]

Congress took a similar approach under the Gramm-Leach-Bliley Act when it directed the Board to take an expansive, forward thinking approach when considering the activities in which bank

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[10] S. Rep. 91-1084, 91st Cong., 2nd Sess., *reprinted in* U.S.C.C.A.N 5519, 5535 (August 10, 1970).

[11] S. Rep. No. 91-1084, at 17.

holding companies are permitted to engage. Specifically, Congress directed the Board, when determining what constitutes a financial-in-nature activity, to take into account changes in the marketplace in which financial services firms compete, as well as changes in the technology for delivering such services. We strongly urge the Board to take a similar approach when called upon to interpret or craft exceptions to a statute that was enacted over 30 years ago.

Other Comments

The interpretation makes clear that the anti-tying restrictions of section 106 do not simply apply to banks, thrifts and U.S. branches, agencies and commercial lending companies of a foreign bank. Rather, section 106 also applies to non-deposit trust companies, credit card banks, and industrial loan companies, as well as their affiliates. We believe this clarification will assist the public debate on section 106.

Finally, ABASA is very supportive of the consultative process put in place by the Board. Specifically, the interpretation makes clear that the Board has consulted extensively with the Office of the Comptroller of the Currency in developing the interpretation and supervisory guidance. As supervision of national banks' compliance with section 106 lies with the OCC, we believe it is very important that there be general agreement among the banking agencies on the appropriate anti-tying policies, procedures and systems for all banks.

CONCLUSION

ABASA applauds the Board's efforts to make clear that relationship banking is permissible under section 106. Clarification, as we have requested, regarding single, packaged and traditional banking products would be most welcome. We are, however, strongly opposed to any suggestion that banks offering mixed-product arrangements are required to analyze and document **each customer's** individual ability to meaningfully choose traditional bank products. We believe it should be sufficient for a bank to have a good faith belief that **customers generally** have meaningful options to choose.

Sincerely yours,

Beth L. Climo