Boston University School of Law
Class Members of: Government Regulation of Banking
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September 30, 2003

Ms. Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Fax: 202-452-3819
Email: regs.comments@federalreserve.gov

Re: Docket No. OP-1158

Dear Ms. Johnson:

These comments are respectfully submitted on behalf of the members of the Government Regulation of Banking class at Boston University School of Law.

Banks are indeed special. As the main source of credit to the economy, special care and special regulation need to be accorded to the banking industry. Significant changes have taken place since enactment of the Gramm-Leach-Bliley Act (GLB) in 1999 that raise questions about the effectiveness of the anti-tying regulations as enacted in the Bank Holding Company Act (BHCA) of 1970.

Specifically this comment letter will address:

1) Realities of the new financial marketplace create competitive disadvantages for companies that are not allowed to market and sell multiple financial services as a bundled package. The wide variety of choice in the financial marketplace provides sufficient choice to ensure adequate availability of credit
2) Artificially under-priced credit is the result of customers' increased bargaining power
3) Current regulatory reporting mechanisms do little to deter tying
4) Risk management by the banks is impeded by the interpretation

1) Anti-tying prohibitions need to be modified to fall in-line with the realties of the financial services market place after the Gramm-Leach-Bliley Act of 1999.

a. Banks should be able to compete fairly with other financial services providers.

Today, corporations can choose from a vast array of sources to sustain their credit and investment needs. As the walls separating the financial world have fallen, a host of new entrants to the credit marketplace, including insurance companies, investment banks, and brokerages, have eroded commercial banks' once untouchable market power in issuing credit. These new entrants into the marketplace have forced commercial banks to lower the cost of credit to corporations. Commercial banks' have maintained profitability in a more competitive environment by engaging in the activities that were once forbidden to them. For example, once prohibited underwriting services generate the vital fee income that allows commercial banks to continue to compete.

b. GLB supports banks' ability to offer relationship banking to better serve financial services customers.

Relationship banking has become the central operating principle for larger commercial banks now that they are free to offer virtually all types of financial services. Central to being able to meet the total needs of their customers is the ability to market a package of financial services to obtain a greater share of "the customer's wallet." Relationship banking can offer a variety of benefits such as:

- Saving the customer time and transaction costs by integrating delivery of financial services
- Streamlining delivery of financial and other services for customers with complex needs
- Offering sophisticated risk analysis that is tailored to a customer's needs
- Offering the customer a better price for these services by using the bank's knowledge of the services it can provide to create an attractive offer

John C. Dugan, Stuart C. Stock, James A. McLaughlin; Covington & Burlington Memorandum DC: 861242-2.

The current anti-tying provisions prohibit large financial services companies from offering such bundled packages at a discount if the companies include non-traditional banking products. Offering bundled services at a discount which provides cost savings and efficiencies for both parties is not necessarily indicative of the coercion that the anti-tying rules were designed to prevent. Banks, as repeat entrants into the marketplace, have no incentive to offer services that they know their customers do not want. The reaction of the customers would be to select another firm that did not use such practices. With many different choices in the financial marketplace, and barriers to entry limited, there is little chance that one firm can exert dominant market behavior.

c. The definition of "traditional bank services" should be updated to allow for increased competition among financial services providers.

The BHCA should be interpreted so as to foster the benefits of relationship banking. The definition of "traditional bank services" has become outdated. The passage of GLB indicates a

congressional intention to allow banks to compete fairly in a liberalized competitive environment. Clyde Mitchell; "Alter Anti-Tying Laws to Reflect GLB"; American Banker; June 27, 2003. GLB addresses the need for banks to be able to offer the same services and packages as their domestic competition and those financial institutions operating overseas that are not bound by the BHCA. The Board of Governors should interpret the BHCA in light of GLB and allow banks to move forward in terms of customer services offered and price for those services.

If Board of Governors determines that the text of the BHCA in its current form does not allow this type of market liberalization, the Board should take a proactive stance by proposing a legislative solution. By acknowledging that the anti-tying rules imposed on banks should be modified, the Board of Governors can influence Congress to revise the BHCA. Using an interpretation of the BHCA to acknowledge the flaws in the current form of the BHCA is an appropriate and reasonable step for the Board of Governors to take.

2) Artificially under-priced credit is to a greater degree the result of bargaining power exerted by corporate customers than tying efforts of banks.

Coercion in the financial marketplace often works in the reverse direction. During the summer of 2000, large corporations such as Vodaphone Plc and Ford Motor Co. were openly insisting that their banks promise lines of credit in order to be included in underwriting and advisory business, a practice that became known as pay to play. Celarier, Michael The God that Failed: We went too far with this. Investment Dealers Digest: September 9, 2002. While the comments to the proposed guidance say that this is exactly the type of coercion and bargaining power that anti-tying rules are not designed to prevent, this type of activity places as much strain on the soundness of the credit market as does the reverse. With Wall Street enamored by banks generating as much fee income and short term profits as possible, banks will fall prey to making riskier credit decisions that negatively impact the credit market just to be able to get a piece of the lucrative, fee generating underwriting business.

It appears that the overarching purpose of the anti-tying statute, protection of customers from bank coercion, is no longer relevant in the marketplace. Inn the current financial services marketplace, many large corporate customers are in a position to exercise coercion of banks. Thus, there is a safety and soundness aspect to anti-tying that is not reflected in the 1970 amendments.

3) The current regulatory scheme is ineffective at reporting corporate tying attempts and violations and does not address retaliation by financial institutions

A March 2003 survey of senior level financial services executives conducted by the Association for Financial Professionals (AFP) found that violations of tying laws accused but were never reported to regulators. Without monitoring and reporting, the current law and this interpretation lack teeth. Commercial banks are well aware of the anti-tying regulations. Most tying attempts that occur are during informal negotiations between bank and corporate executives. However, the survey indicates that these attempts are never reported.

Corporate executives overwhelmingly stated that fear of retaliation from the bank was the reason

that they did not report the tying activity. Without regulatory protection from retaliation, this regulation can only continue to operate in an ineffective ex post fashion. Under current regulation, by the time that tying violators are identified and caught, the damage to the credit market, from either side of the relationship is likely to have already been done. Establishing an effective way to spot attempts at tying before they are put into practice is the only way to uphold the goals of the regulation.

Banks are currently allowed to avoid tying rules if they offer provision of the desired product contingent upon a meaningful choice of other bank products (which must include enough traditional bank products to make it "meaningful"). Yet, the current regulatory scheme does nothing if the bank offers a meaningful choice of options, but then does not renew credit or provide it in the future if the company does not select the "correct" options. If this becomes the norm, and customers come to expect this norm, then retaliation becomes a less overt form of coercion, yet coercion nonetheless. Without effective discipline for retaliation by banks, then the anti-tying provisions lose almost all of their meaning.

Bank regulators should make it more of a practice to discuss the operations of the bank with its clients and proposed clients during examinations. Clients, both proposed and actual, could participate in an anonymous reporting procedure which would allow for more effective control. Additionally, civil penalties could be assessed for retaliatory behavior by financial institutions.

In dealing with small customers, bank regulators should examine small customer records and speak with those who have multiple products and services to see how such services were acquired. Speaking on condition of anonymity and providing for punishment for retaliation would paint a better picture of the true practices and procedures the bank was following.

4) Banks should be allowed to require borrowers to take risk managing precautions.

Banks should be allowed to require their borrowers to take risk management precautions such as utilizing derivatives offered by the banks. "Banking, Antitrust and Derivatives: Untying the Antitying Restrictions"; Christian A. Johnson; 2000. Banks have the ability to decrease the risk and volatility of a loan by offering a stabilizing derivative. The derivative can be linked to a measure such as an interest rate index. By mirroring this type of index, the interest rates on the loan are kept stable in relation to prevailing market conditions, thus decreasing the vulnerability of both parties to unforeseen shifts in interest rates. Banks, by requiring a derivative for certain transactions, would increase market stability and allow for the type of measured economic growth underlying the motive of both the BHCA and GLB. The Board of Governors should employ an interpretation of the BHCA that allows for this type of risk management, either as an exception to section 106 or as a reading of the BHCA in light of GLB. Again, this is a "safety and soundness" consideration not contemplated in the 1970 amendments.

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Thank you for the opportunity to provide these comments.

Sincerely,

Class Members: Government Regulation of Banking
Boston University School of Law*

*The principal authors of this comment letter were Ian Kaminski and Alex Pederson.