DATE: February 20, 1970.

TO: The Board of Governors

FROM: Division of Supervision and Regulation (Frederic Solomon)

SUBJECT: "Commercial Paper" Issued by Subsidiaries and Other Affiliates of Banks.

SUMMARY

From a supervisory viewpoint, any Board action--or inaction--that encourages banks to transfer portions of their usual banking activities to affiliates, especially nonsubsidiary affiliates, is undesirable. It tends to increase supervisory problems and to blur the distinction between banking and nonbanking activities.

Use of a separate corporate entity as the obligor on commercial paper is unlikely in practice to provide appreciable protection to the bank.

As a means of avoiding undue tightening or relaxation, "grandfathering," which probably would need to be only temporary, would seem to have less disadvantage than would permanent special privileges to affiliates.

DISCUSSION

It has been suggested that the Division of Supervision and Regulation comment on questions regarding the application of Regulations D and Q to commercial paper issued by subsidiaries or other affiliates of banks.

Although reserve requirements (Regulation D) have long since become almost entirely an instrument of monetary policy, and Q-ceilings seem to be moving fairly rapidly in that direction, both requirements originated as aids to banking soundness, that is, as essentially supervisory instruments.

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Use of these requirements for purposes of monetary policy may conflict with their original purposes of protecting banking soundness. For example, current high reserve requirements not only drive many banks from membership in the Federal Reserve System, but also burden bank earnings and thus adversely affect the capital position of banks. With relatively low earnings, banks find it hard to build up capital through either retained earnings or sale of shares.

High reserve requirements have also stimulated banks to resort to such nondeposit sources of funds as Eurodollars and commercial paper. Q-ceilings, since they represent absolute barriers instead of merely items of cost, have added even stronger impetus in that direction.

Any Board action--or inaction--that encourages the moving of activities out of banks and into affiliates (especially non-subsidiary affiliates) would seem to raise questions of banking soundness that deserve careful consideration.

It is true that the System and the Comptroller of the Currency have statutory authority to "make such examinations of the affairs of... affiliates...as shall be necessary to disclose fully the relations between such banks and their affiliates and the effect of such relations upon the affairs of such banks." However, in practice it can become difficult to ascertain the true facts of such relationships when different portions of what is essentially a single activity are divided between bank and affiliate, and especially so when the affiliate also engages in various other activities. Such fragmenting of activities also makes it more difficult to prove the facts regarding unsound practices as well as to apply sanctions (e.g. expulsion from membership, or cease and desist orders). In addition, expanded use of affiliates for banking purposes tends to encourage their use for nonbanking purposes.

So long as bank affiliates are subject to exactly the same rules as the bank itself, these problems can be minimized. However, privileges granted to activities through an affiliate as contrasted with those through the bank itself would intensify the problem and could create precedents that make it harder to draw reasonable lines of distinction with respect to other regulatory standards.

Any method of dealing with the present interest ceilings, commercial paper, etc., will have some undesirable features, but some form of "grandfathering" would seem less undesirable--at least from a supervisory viewpoint--than granting permanent special privileges to operations through affiliates. Such privileges to affiliates would seem to be worse in terms of future precedent and long-run consequences. Such privileges would also seem to inject considerable uncertainty as to how meagerly or extensively the privileges might actually be used; by giving an official stamp of approval to such use of affiliates, such privileges might encourage substantial expansion of commercial paper.

While "grandfathering" includes some element of unfairness, it is a widely used and well recognized practice. Banks not "grandfathered" probably would concede the merit of the practical arguments in favor of some adjustment time for those "grandfathered". Any unfairness would be considerably lessened by making the privilege temporary.

It would seem that Reserve requirements could be applied to outstanding commercial paper fairly promptly, perhaps at the earliest reserve period consistent with monetary policy. The real problem arises with respect to Q--ceilings. Since it is not feasible to call in paper that has already been issued, outstanding paper with a relatively long maturity (for example, about 15 per cent is understood to mature in July or later) already has, in effect, "grandfathered treatment". The problem centers on what to do about paper that matures fairly soon--for example, about 40 per cent matures by March 31. One solution might be to permit one or more exempt rollovers, so long as none had an ultimate maturity beyond, say, September 1.

Although there may be theoretical benefits to a bank in having a separate corporate entity as the obligor on commercial paper (for example, the bank might technically escape legal liability), we believe these would usually be illusory in practice. The bank may have to guarantee the affiliate's obligation to insure ready marketability, or it may have to undertake an obligation to repay the affiliate and include such a maturity as to place the bank under much the same pressure to repay as that facing the affiliate. Furthermore, a bank probably could not afford to permit the failure of an affiliate prominently associated with it. The bank's volatile liabilities would probably make it virtually impossible for the bank to avoid the consequences of the weakened public confidence that would result from failure of the affiliate.