

**Communication between Federal Reserve Staff and
Representatives of JP Morgan Chase (JPMC)
December 8, 2010**

Participants: Molly Mahar (Federal Reserve Board)

Kate Childress (JPMC)

Summary: A representative from JPMC participated in a telephonic discussion Federal Reserve staff. During the discussion, JPMC's representatives raised the concern that Section 622 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the financial sector concentration limit) creates a competitive disadvantage for U.S.-based institutions. JPMC's concerns and recommendations are outlined in the attached memo.

Proposed Modifications to Section 622 of the Dodd-Frank Act

Section 622 of the Dodd-Frank Act creates a new section 14 of the Bank Holding Company Act, which limits the ability of a financial company to make acquisitions if it exceeds more than 10 percent of the aggregate consolidated liabilities of all financial companies.¹ Section 14 grants authority to the Financial Stability Oversight Council to make modifications to the statute, with such modifications to be executed by the Federal Reserve Board through rulemaking.

This paper urges a modification of the statute to correct an anomaly in the treatment of foreign bank assets for purposes of calculating the 10 percent ratio, which results in a significant discrimination against U.S. banks versus their overseas competitors.

Background

Section 622 was part of the Volcker Rule legislative language adopted by the Senate Banking Committee. Section 622 does not define its purpose, and the legislative history provides no explanation.

Congress was quite specific, however, in granting the Council authority to modify section 14, and identifying factors to consider in exercising that authority: “the extent to which the concentration limit... would affect financial stability, moral hazard in the financial system, the efficiency and competitiveness of United States financial firms and financial markets, and the cost and availability of credit and other financial services to households and business in the United States.”

Proposed Modification to Calculation of 10 Percent Limit

In order to determine whether a given financial company exceeds the 10 percent limit, section 14 divides that company’s liabilities by the total liabilities of all financial companies. Liabilities are defined (somewhat oddly) as the total risk-weighted *assets* of a company, less its total regulatory capital. For foreign banks, liabilities include only the risk-weighted assets of their U.S. operations. This structure presents an anomaly that creates a significant, and perhaps unintended, advantage for foreign banks.

¹ Section 622 provides that a financial company may not merge or acquire another company if: (x) the total consolidated liabilities of the acquiring financial company upon consummation of the transaction (the “numerator”), would exceed (y) 10 percent of the aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction (the “denominator”).

“Liabilities” for U.S. financial companies is defined as total risk-weighted assets, less total regulatory capital.

“Financial company” is defined as: (1) an insured depository institution; (2) a bank holding company; (3) a savings and loan holding company; (4) a company that controls an insured depository institution; (5) a foreign bank or company that is treated as a bank holding company; and (6) a nonbank financial company that has been designated as systemically important.

Inequitable Treatment of U.S. Banks

As section 14 is currently constructed, a foreign bank would include in its numerators the risk-weighted assets of its U.S. operations (but not its overseas assets), and in the denominator the assets of all U.S. financial companies, *including their overseas assets*. Thus, a foreign bank could grow to hold significantly more than 10 percent of the U.S. market without violating the limit.

A parallel problem arises when the test is applied to a U.S. bank. The U.S. bank must include in the numerator all of its risk-weighted assets – *including assets held overseas* – and can include in the denominator both the domestic and overseas assets of U.S. financial companies, but cannot include in the denominator the overseas assets of foreign banks operating in the United States.

Thus, for example, if on a given day a U.S. bank were to acquire a foreign company with say, \$2 billion in assets, and a foreign bank were to acquire a foreign company with \$5 billion in assets, the U.S. bank's ratio under the concentration limit would rise, but the foreign bank's ration would fall. (This is because the U.S. bank would have to include \$2 billion in both its numerator and denominator, for an effective ratio of 100%, whereas the foreign bank would add nothing to its numerator and \$2 billion to its denominator.) Thus, as U.S. banks and their major foreign competitors grow abroad, the U.S. banks will eventually be prohibited from further growth, while the foreign banks will get more and more latitude to grow in the United States. And foreign banks have no limit on their ability to grow outside the United States, as no other country in the world has adopted a concentration limit akin to section 14, even though the U.S. financial services system is the least concentrated in the world.

If the purpose of the test is to consider concentration on a global scale, then overseas assets should be included in both the numerator and the denominator. If the purpose of the test is to consider concentration in the U.S. market, then only U.S. assets should be considered in both the numerator and the denominator. The current treatment of Section 14 works significantly to the detriment of a U.S. bank by including its overseas assets in the numerator but excluding the overseas assets of its major foreign competitors from the denominator; a foreign bank, conversely, can exclude its overseas assets from the numerator but include the overseas assets of U.S. banks in its denominator. It is difficult to imagine any possible rationale for such an approach.

Authority of the Council to Correct this Anomaly

Section 14 explicitly allows the Council to consider “the efficiency and competitiveness of U.S. financial firms” in deciding whether to recommend a modification to the statute. The clear competitive inequity of the calculation, which may well have been inadvertent, clearly mandates modification under this standard.

As suggested above, fair treatment for U.S. banks could be achieved through either of two modifications to how the test is calculated: (1) including the overseas assets of foreign banks operating in the United States, basically making the test a global one; (2) excluding the overseas assets of U.S. financial companies, basically making the test a U.S. one. Because section 14 specifically limits coverage of foreign banks to their U.S. operations, we believe that Congress envisioned section 14 through a U.S. lens, and therefore believe that option (2) is more consistent with the purpose of the statute.

One potential objection to this modification is that it could give U.S. companies, particularly those already at the 10 percent limit, an incentive to grow abroad rather than expanding in the United States. This concern would be misplaced, for three reasons. First, the statute governs growth only by acquisition; with or without the proposed modifications, large U.S. banks at the 10 percent limit will be free to grow organically in the United States – for example, by expanding their lending. All of the largest U.S. banks have a nationwide footprint, and are able to branch nationwide without making an acquisition subject to section 14. And acquisitions in the failed bank context are already exempt under section 14 (with the approval of the Federal Reserve Board). So, U.S. banks at the limit could and would continue to grow in the United States with or without the proposed modification. Second, U.S. banks are already subject to a 10% deposit cap, which limits their ability to acquire U.S. banks. Third, the greater risk comes if the statute is not modified. Absent a modification, foreign banks will grow unabated both in the United States and overseas; the largest U.S. banks will have an incentive to move their headquarters abroad, thereby receiving an exclusion from section 14 for their overseas (or, at that point, domestic) assets.

Another potential objection is that the current test focuses only on assets that the U.S. government could be expected to bail out, and excludes those it is unlikely to bail out. There are three major problems with this argument. First, if the assumption is that systemic risk is correlated with bailout risk, one cannot consider the systemic risk of the overseas assets of U.S. companies without considering them in relation to the assets of their overseas competitors; in other words, if the overseas assets of U.S. financial companies end up representing a smaller rather than larger percentage of global assets, then they should be resolvable without imposing systemic risk. Second, the Dodd-Frank Act has taken considerable efforts to eliminate “too big to fail,” including significantly higher capital and margin requirements and a resolution scheme. This objection presumes that Congress has failed. Third, the Federal Reserve has recently released data on the liquidity programs that it offered during the recent financial crisis, and it is readily apparent that the participation by foreign banks dwarfed the size of their U.S. operations. Thus, any contention that their overseas assets are irrelevant for purposes of this test is untenable.