

BACKGROUND INFORMATION

Decision on Zions First National Bank Operating Subsidiary to Underwrite and Deal in Municipal Revenue Bonds

December 11, 1997

Summary of Application and Conditional Approval

On December 10, 1997, the OCC conditionally approved the application of Zions First National Bank, Salt Lake City, Utah to expand the activities of its operating subsidiary, Zions Investment Securities, Inc., to underwrite and deal in municipal revenue bonds. The subsidiary currently provides brokerage and investment advisory services to its customers. The bank itself is an experienced primary dealer in government securities and is the only primary dealer located between Chicago and California.

The decision is the first of its type under the OCC's revised regulation governing operating subsidiaries, known as Part 5. Part 5 established procedures for reviewing a national bank's application for an op sub to engage in an activity different from that permitted for its parent bank provided the activity is deemed part of the business of banking.

Under the national banking laws, a national bank may underwrite, deal and invest in general obligation bonds and certain specified revenue bonds (e.g., revenue bonds issued for housing, university, or dormitory purposes), and it may invest in revenue bonds for its own account. But, with the exception of those specified revenue bonds, national banks may not directly underwrite or deal in revenue bonds.

In reaching its decision, the OCC concluded that the proposed revenue bond underwriting and dealing is part of the business of banking and that the Glass-Steagall Act restriction that prohibits national banks from underwriting and dealing in municipal revenue bonds does not apply to their "affiliates" and, accordingly, does not apply to bank subsidiaries.

Municipal Revenue Bond Underwriting and Dealing is Part of the Business of Banking

There is a long history of bank involvement in investment banking activities:
Investment banking was considered a customary part of the business of banking by the time the national banking system was created. As Congress noted in the 1920s, "it is a matter of common knowledge that national banks have been engaged in the investment securities business" Although the Glass-Steagall Act later limited the types of securities that a national bank could underwrite and deal in, banks continued to underwrite and deal in a wide range of government securities.

Municipal revenue bond underwriting and dealing is part of the business of banking recognized under the National Bank Act: Section 24(Seventh) of the National Bank Act specifically enumerates several activities as part of the business of banking. One of these specified activities is the power to "discount and negotiate promissory notes and other evidences of debt." Underwriting and dealing in revenue bonds involves exactly that function.

Municipal revenue bond underwriting and dealing is part of the general business of banking: Revenue bond underwriting is also part of the business of banking because of the financial nature of the activity and its similarity to other traditional banking functions.

It involves the bank in its primary function as financial intermediary -- facilitating the flow of money and credit among different parts of the economy.

Functionally, it is similar to underwriting and dealing activities already conducted safely and soundly by national banks, such as underwriting and dealing in housing, university and dormitory bonds and general obligation bonds (GOs).

Municipal revenue bonds, like housing, university, dormitory revenue bonds and GOs, are debt obligations of a state, city, or municipal authority issued for a public purpose. In most cases, interest from the bonds is exempt from federal and state income taxation. And all of these bonds are subject to similar risks.

The only significant difference between these types of bonds is the

source of repayment. A GO is backed by the full, faith and credit and taxing authority of the issuer. Municipal revenue bonds, such as housing, university, and dormitory bonds, are repaid from the revenues of the project financed by the bonds -- e.g., tolls from a toll road.

Municipal Revenue Bond Underwriting and Dealing is Allowed for Subsidiaries under Section 20 of the Glass-Steagall Act

Section 20 allows limited underwriting by both holding company affiliates and subsidiaries of banks: The Glass-Steagall Act does not prohibit the proposed revenue bond underwriting and dealing. Under the plain language of the Act, the limitation in the Glass-Steagall Act (Section 16) restricting national banks from underwriting municipal revenue bonds does not apply to a subsidiary of a national bank. Both bank subsidiaries and holding company affiliates are governed, instead, by section 20 of the Glass-Steagall Act, which allows "affiliates" of national banks, a term that includes bank subsidiaries, to underwrite and deal in all types of securities as long as they are not "principally engaged" in the activity.

The operating subsidiary will not be principally engaged in underwriting: The Zions subsidiary will not be principally engaged in underwriting and dealing activities. The subsidiary has committed that the revenues derived from its proposed underwriting and dealing activities will not exceed 25 percent of its total revenues. The Federal Reserve Board has previously determined that an affiliate is not principally engaged in underwriting and dealing if it does not exceed that threshold.

The Federal Reserve Board has approved municipal revenue bond underwriting for subsidiaries of bank holding companies: Under the standards of section 20 of the Glass-Steagall Act, the Federal Reserve has allowed holding company affiliates to underwrite and deal in municipal revenue bonds since 1987. Bank holding companies with section 20 subsidiaries currently are actively and profitably involved in the types of activities proposed by Zions.

Benefits of Underwriting Municipal Revenue Bonds

Bank underwriting of municipal revenue bonds benefits local government and taxpayers: Permitting op subs to underwrite and deal in municipal revenue bonds is also expected to produce substantial benefits for local governments and taxpayers by providing communities with greater access to the municipal bond market and increasing competition in municipal bond underwriting. The number of firms involved in municipal financing has sharply declined over the last decade, decreasing competition for revenue bond underwritings. Since 1995, four major securities firms have eliminated their municipal financing businesses. Three other major firms had previously left the business or substantially reduced their operations. As several local governments commenting on the application noted, this reduction in competition has led to higher financing costs for many public issuers, particularly smaller communities. Indeed, many communities, particularly smaller communities, no longer have access to the municipal bond market to finance small issuances. Increased competition from having additional participants in municipal bond underwriting should serve to reduce interest rates and underwriting costs for local governments. And taxpayers would benefit from the lower taxes and improved services that lower financing costs and increased access to public financing should yield.

Municipal revenue bond underwriting strengthens national banks: Permitting operating subsidiaries to underwrite and deal in municipal revenue bonds will enable national banks to generate new sources of revenue. The fees and income from the subsidiaries may enable banks to offset the effects of cyclical downturns in other sectors of the economy. As a result, bank earnings would be less volatile, reducing risks to the banking system as a whole. Stronger institutions with increased profits and asset growth will be better positioned to meet the credit needs in their communities and support the economy as a whole.

Municipal revenue bond underwriting advances CRA objectives: The proposed underwriting activity also can provide an income stream to support the bank's

traditional banking activities, including community development and CRA efforts. As Zions stated in its application, permitting revenue bond underwriting will "advance the objectives of the Community Reinvestment Act

by enabling banks to provide substantial additional sources of financing for local communities."

Risks of Underwriting Municipal Revenue Bonds

Underwriting municipal revenue bonds poses the same risks as underwriting the bank currently conducts: Underwriting municipal revenue bonds through a subsidiary is no more risky to the bank than the revenue bond underwriting the bank itself currently conducts. As the Federal Reserve has noted, "the risks associated with underwriting and dealing in any revenue bond, whether eligible or not, are generally a function of the price volatility of the security, as well as the cash flow and viability of the project being financed. These risks are not . . . significantly greater for ineligible revenue bonds than for eligible bonds, given the very close functional similarity between the two kinds of obligations."

Underwriting municipal revenue bonds through the operating subsidiary will not increase the risk to the Federal Deposit Insurance Fund: Because the bank will be insulated, both structurally and operationally, from the sub, there is no reason to believe that the insurance fund is at any greater risk than when underwriting is conducted in a company owned by the bank's parent company. As former FDIC Chairman L. William Seidman testified nearly a decade ago, "[i]f banks are adequately insulated . . . then from a safety and soundness viewpoint, it is irrelevant whether nonbanking activities are conducted through affiliates or subsidiaries of banks." In fact, according to a recent statement by former FDIC Chairman Ricki Helfer, allowing a bank to put new activities in a bank subsidiary "lowers the probability of failure and provides greater protection to the insurance funds."

Safety and Soundness Considerations

The bank is insulated from the subsidiary: The regulation includes many requirements to ensure that the subsidiary is separate from the bank and that the bank is insulated, both structurally and operationally, from the

subsidiary. For example, under the op sub regulation, the subsidiary is required to be physically separate from the bank, must maintain separate accounting and corporate records and have its own board of directors (at least one-third of whom cannot be directors of the bank). In addition, it must disclose that the obligations of the subsidiary are not obligations of the bank.

The OCC decision includes Fed firewall protections: Several of the conditions in the OCC's decision are patterned after the Federal Reserve's new operating standards applicable to section 20 subsidiaries engaged in underwriting and dealing in securities. For example, the bank is generally prohibited from extending credit to a customer for the purpose of purchasing bonds underwritten by the subsidiary. These standards replaced the firewalls formerly applicable to section 20 subsidiaries.

The SEC supervises the subsidiary's activities: The subsidiary will be subject to comprehensive supervision and functional regulation by securities regulatory authorities. As a registered broker-dealer, the sub's underwriting and brokerage activities are fully subject to the regulation and supervision of the SEC, the National Association of Securities Dealers (NASD), and the Municipal Securities Rulemaking Board (MSRB). The subsidiary must comply with the SEC's net capital rule, which imposes capital requirements on broker-dealers that vary with the degree to which a broker-dealer acts as a principal. In its application, the bank represents that the subsidiary will maintain capital in excess of these requirements. The subsidiary also will be subject to the rules and regulations of the NASD and MSRB. These requirements provide further protection against financial losses as a result of the proposed activities.

The bank is subject to comprehensive supervision by the OCC: The OCC, as the primary federal banking regulator, will be responsible for ensuring the safe and sound operation of the bank and the subsidiary and full compliance with the regulatory and supervisory conditions applicable to the bank and the subsidiary. The OCC has extensive experience and expertise in supervising

national banks involved in underwriting, dealing and investing in government securities. Moreover, it is uniquely qualified to assess whether the activities are conducted in a safe and sound manner without undue risk to the bank.

Bank Customers Are Protected Against Potential Abuses

The bank will only sell bonds underwritten by the sub to its institutional customers: Because the bank is already registered as a municipal securities dealer under the Exchange Act, any sales of securities through the bank will be subject to the same comprehensive regulatory scheme as sales by other registered municipal securities dealers, including the MSRB rules. These rules include extensive consumer protection provisions, such as suitability requirements, price and commission limits, disclosures in connection with new issues, employee qualification requirements, and record keeping requirements. In addition, the bank's securities activities are subject to federal securities law antifraud provisions.

All retail sales to consumers will be conducted by the subsidiary: As a registered broker-dealer under the Exchange Act, the sub's underwriting and brokerage activities are fully subject to the federal securities laws, including the recently adopted NASD rules. In addition, the subsidiary is required to make the disclosures required under the Interagency Statement on Nondeposit Investment Products to ensure that customers of the subsidiary do not confuse the subsidiary with the bank. Bank employees, officers and directors are also prohibited from expressing opinions about securities underwritten by the subsidiary unless the customer is notified that the subsidiary is the underwriter.

Comments Received on the Application

The OCC published the application for public comment on April 18, 1997.

The OCC received 13 comments on the Application, including three from national banks, three from trade associations (including bank and securities trade associations), one from a consumer advocacy group (Consumers Union), four from local governments in Utah, one from a federal bank regulatory agency (FRB) and one from a federal securities regulatory agency (SEC).

The majority of the 13 comments supported the application. Four commenters objected to approval and one, the SIA, requested a public hearing on the application.

The OCC considered all comments in making its decision. In addition, the OCC staff conferred with supervisory staff of the NASD, the SEC, the Federal Reserve Board and the Federal Reserve Bank of New York regarding their supervision of nonbank subsidiaries of bank holding companies -- section 20 subs -- engaged in revenue bond underwriting and dealing. None of the agencies identified any unique compliance or supervisory problems relating to underwriting and dealing in revenue bonds in the section 20 subs.

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