PROMOTION OF CAPITAL AVAILABILITY TO AMERICAN BUSINESSES

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

AND THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT

OF THE

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PROMOTION OF CAPITAL AVAILABILITY TO AMERICAN BUSINESSES

WEDNESDAY, APRIL 4, 2001

U.S. House of Representatives,
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises,
Joint with the
Subcommittee on Financial Institutions
and Consumer Credit,
Committee on Financial Services,
Washington, DC.

The subcommittees met, pursuant to call, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises], presiding.

Present for the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises: Chairman Baker; Representatives Bachus, Biggert, Ose, Toomey, Ferguson, Ryun, Bentsen, J. Maloney of Connecticut, Mascara, Inslee, Ford, Hinojosa, Lucas, Shows and Ross.

Present for the Subcommittee on Financial Institutions and Consumer Credit: Representatives Bachus, Roukema, Baker, Kelly, Ryun, Biggert, Toomey, Grucci, Ferguson, Tiberi, Waters, C. Maloney of New York, Bentsen, Mascara, Moore, Kanjorski, J. Maloney of Connecticut, Ford, Hinojosa, Lucas, and Shows.

Also Present: Representatives LaFalce and Oxley.

Chairman Baker. Good morning. I would like to call this joint hearing of the House Subcommittee on Capital Markets and the House Subcommittee on Financial Institutions of the House Financial Services Committee to order.

This morning Chairman Bachus and myself have joined together for the purpose of again reviewing the rules proposed pursuant to the enactment of Gramm-Leach-Bliley with regard to merchants' banking activities. Chairman Bachus and I both, along with Ranking Member Kanjorski, realize the significance of these proposals and do appreciate the modifications made from the earlier proposals submitted last summer to the status of the proposals currently. Certainly all Members perceive Gramm-Leach-Bliley to be a significant step toward unleashing the power of markets to facilitate economic development, utilize new technologies and create market opportunity heretofore not possible.

It would appear to me and I am perhaps aware that others still have remaining concerns with regard to certain aspects of the implementation of the proposed regulations. Certainly we should not preclude activities which are currently authorized by law under the name of modernization and make managerial and cross-marketing decisions more difficult which are customarily utilized in the marketplace today.

In the course of the hearing today we will hear not only from regulators, but from market participants, and I am advised that there are a series of competitive meetings ongoing so our membership here today, gentlemen, will be continually changing I am told. But it does not in any way lessen the committee's interest in this matter, nor our attention to your testimony here today.

At this time, I would like to recognize Ranking Member Kanjorski, then come back for opening statements.

[The prepared statement of Hon. Richard H. Baker can be found on page 50 in the appendix.]

Mr. KANJORSKI. Thank you, Mr. Chairman, for the opportunity to speak before we begin today's hearing on the promotion of capital availability to American business.

As the Ranking Democratic Member on the Capital Markets Subcommittee, I want to maintain the competitiveness of our Nation's capital markets. These resources help American businesses compete in the international marketplace. They also strengthen our domestic economy by helping our Nation to remain productive, providing better jobs at higher wages for American workers, and improving the quality of life for American families.

It is therefore appropriate and constructive for us to hold hearings at this time on the revised merchant banking rules issued by our Nation's financial regulators earlier this year. These proceedings will help us determine whether these regulations run counter to the purposes of the Gramm-Leach-Bliley Act or whether they capture the essence of the law's intent.

During the debate over the modernization law, one of the most highly contentious issues debated was the extent to which we should break down the legal barriers separating banking and commerce. In Japan, the intermingling of these sectors via cozy kieretsu combinations probably contributed to the great inefficiencies that first produced the economic disorder in their banking system in the 1990's and which continues today. Ultimately, Congress learned from these concerns and we enacted a law maintaining a firewall between banking and commerce.

A closely related issue examined in the overhaul of the financial services industry concerned merchant banking. This term refers to equity investments by commercial banks in non-financial firms. In our deliberations, we recognized the importance of merchant banking in providing equity capital to the private sector, but decided that for at least 5 years only units of financial holding companies could engage in such activities. Consequently, the law permits these units to acquire equity investments in non-financial companies and to sponsor equity funds, providing that they limit their ownership positions and do not retain day-to-day management control of these investments.

In March of 2000, the Federal Reserve and the Treasury Department issued interim and proposed regulations to implement the merchant banking provisions of the modernization act. These proposals generated considerable debate among affected parties and in the press. Of particular concern to me, along with many of my Democratic colleagues, was their effect on small business investment companies, which bring important capital resources to small businesses in the communities in which they operate.

Because commercial banks represent the largest source of the SBIC program's private funding, concerns arose that provisions contained in the merchant banking rulemaking, such as the proposed 50 percent capital charge on all equity investments, would have constricted the availability of financial resources for small businesses. During our subcommittee's prior hearing on the interim rules, I expressed concerns about the effect of the proposal on SBICs, and urged the regulators to create a limited carve-out under their merchant banking rules for such investments. To their credit, the regulators responded to many of my concerns when issuing their revised capital proposal for non-financial equity investments in January, 2001.

As I noted earlier, in passing the Gramm-Leach-Bliley Act, we maintained the firewalls preventing the indiscriminate mixing of banking and commerce. From my perspective, it remains very important that our Federal financial regulators strike an appropriate balance between allowing financial holding companies to engage in merchant banking activities and insulating commercial banks, which carry Federal deposit insurance, from the associated risks.

In closing, Mr. Chairman, my colleague in the other body, Senator Paul Sarbanes of Maryland, perhaps said it best when he noted that the financial modernization law gave the Federal Reserve and the Treasury the ability to jointly develop implementing regulations on merchant banking activities "to define relevant terms and impose such limitations as they deem appropriate to ensure the new authority does not foster conflicts of interest or undermine the safety and soundness of depository institutions or the act's general prohibitions on the mixing of banking and commerce." Although I generally agree with his assessments, I believe it equally important to learn more about the views of the parties testifying before us today and, if necessary, to further refine and improve merchant banking regulations in the future.

Thank you Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 54 in the appendix.]

Chairman BAKER. Thank you.

Chairman Bachus.

Mr. BACHUS. Thank you, Chairman Baker, for your leadership on this issue and for convening this joint hearing.

One of the committee's chief central responsibilities in this Congress will be overseeing the implementation of the historic Gramm-Leach-Bliley financial modernization legislation. Among the issues that need to be addressed are the far-reaching financial privacy regulations scheduled to go into effect July 1 and a more recent regulatory proposal that would permit banks, through financial holding companies and financial subsidiaries, to engage in real estate brokerage and management activities.

Though the privacy and the real estate rules are of greater interest to individual American consumers, the merchant banking rules first proposed in March of last year have enormous consequences for the financial services industry and for capital formation processes that help fuel our economy. Private equity placements and venture capital investments provide critical seed money for American entrepreneurs whose creativity and energy have helped make the U.S. economy the envy of the world.

I was one of the Members that felt that, as originally proposed by the regulators last March, the merchant banking rules were deficient in important respects. Particularly troublesome was the requirement that financial holding companies hold 50 cents in capital for every dollar of equity investment in non-financial companies. By setting the capital threshold so high, the original capital rule served as a huge disincentive for any investment banking firm thinking of partnering with a depository institution under the financial holding structure established by Gramm-Leach-Bliley.

To their credit, the regulators took the criticism of the original proposal to heart and have come back this year with rules that clearly move in the right direction. Most importantly, the revised proposal replaces the rigid 50 percent capital requirement with a more flexible sliding scale, an approach that increases or decreases the capital charge imposed on merchant banking investments in direct proportion to the concentration of such investment in an institution's portfolio.

But acknowledging that a bad proposal has been made better is not the same thing as concluding that the proposal was a good idea in the first place. In my mind the Federal Reserve and the Treasury have simply not met their burden of proof in demonstrating that additional requirements are needed in the merchant banking arena. Banking organizations have been making private equity investments pursuant to other statutory authorities since well before Gramm-Leach-Bliley was enacted, and have done so profitably and seemingly without loss to individual institutions, depositors or the system as a whole. This track record strongly suggests that bank regulators already have the legal tools needed to effectively supervise merchant banking activities of financial holding companies and bank holding companies without these new rules.

With the welcome improvements made by the regulators, the revised merchant banking rules still place financial holding companies at a decided competitive disadvantage in relation to firms that choose to operate outside of that structure. Such a result cannot be squared with the congressional intent evidenced by Gramm-Leach-Bliley, which was to encourage, not actively impede, affiliations between securities firms and banks. This regulatory initiative before us greatly concerns me.

I yield back the balance of my time.

[The prepared statement of Hon. Spencer Bachus can be found on page 52 in the appendix.]

Chairman BAKER. Thank you Mr. Bachus.

Ms. Waters, do you have a statement?

Ms. WATERS. Yes, I do, thank you. Thank you very much.

Good morning, Mr. Chairman. I am pleased to have the opportunity to speak about the promotion of capital availability to American businesses.

As the Ranking Member of the Financial Institutions Subcommittee, I believe we have a duty to oversee the regulations implementing the merchant banking provisions of the financial modernization legislation that became law last Congress. I also believe that it is important for us to monitor the expansion of merchant banking activities themselves, to ensure that the regulations are important, to carry out the intent of the Gramm-Leach-Bliley Act.

I understand that the final revised rules address a number of industry concerns that were voiced about their original interim rules. I am pleased that the provisions governing the small business investment companies will ensure the continued ability of banks to invest in SBICs, benefiting small business as well as the communities they serve.

Regarding the larger issue of merchant banking in general, there must be sufficient oversight of these activities. We have a responsibility to limit the risk inherent in merchant banking and not sacrifice safety and soundness in the haste to expand these activities too rapidly. This intent is crystal clear in the statutory language of the Gramm-Leach-Bliley Act.

The legislation did permit financial holding companies to engage in merchant banking activities. Moreover, the bill imposed a series of prudential restrictions on the conduct of the merchant banking activity. It required that the merchant banking activity be conducted in an affiliate of the depository institution rather than in the depositary institution itself or a subsidiary of a depository institution.

It also required that merchant banking investments be held only for a period of time long enough to enable the sale or deposition of each investment on a reasonable basis. Furthermore, the legislation restricts the ability of financial holding companies to routinely manage or operate companies held under the merchant banking authority.

Finally, the legislation specifically granted the Federal Reserve and the Treasury Board authority to issue joint regulations implementing the merchant banking activities. Merchant banking was singled out, appears the only one of nine activities listed in the legislation as financial in nature to receive an explicit grant of authority to the regulators to issue regulations. Moreover, the Federal Reserve retains this authority under the Bank Holding Company Act to set capital standards for bank holding companies which include financial holding companies.

The legislation also explicitly prohibited cross marketing between the depository institution and merchant banking portfolio companies acquired under the new authority. I understand that there are some members of the industry that would want this provision changed, but the law is clear on this point and should not be undermined through additional changes in the regulations.

While I understand that the industry is concerned about the ability of American banks to compete in the global marketplace, we certainly do not want to model our banking policy after the Japanese system, which serves an example to all of what can happen when the separation between banking and commerce is breached.

I believe these regulations will not prove to be unreasonably burdensome and will fullfil the congressional intent to ensure adequate oversight of merchant banking activities.

During the consideration of the financial modernization legislation, Federal Reserve Board Chairman Alan Greenspan testified that, of the nine banking activities permitted in various versions of H.R. 10, merchant banking should be viewed as the most risky of those activities. With that in mind, I look forward to hearing the views of the witnesses and thank you in advance for your testimony.

[The prepared statement of Hon. Maxine Waters can be found on page 58 in the appendix.]

Chairman BAKER. Thank you, Ms. Waters.

Are there additional opening statements?

Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. I want to thank both you and Mr. Bachus for agreeing to hold the hearing on the promotion of capital availability to American businesses.

The issue revolves around a large source of capital to many businesses; and, as we know, capital is the lifeblood of industry. As the Chairman of the Oversight and Investigations Subcommittee, the issue is very high on my list of priorities; and I am very pleased that we all share this interest.

As we are aware, in March of 2000 the Federal Reserve and Treasury issued two rules for financial holding companies which contain provisions that run contrary to the language Congress agreed to as part of the Gramm-Leach-Bliley law. In particular, I was concerned about the 50 percent capital charge on all merchant banking activities and I believe that the cross marketing restrictions were too severe. I feared that the capital charge would force divestment from some banks of sound investments which could, in turn, have negative effects on the economy.

I was pleased to see that the final rule issued in January of 2001 eliminated the hard dollar cap, removed some of the automatic penalty associated with holding investments over the time limits set by the rules and relieved some of the cross-marketing restrictions. While it was a good step in the right direction, I believe the Federal Reserve should go farther.

The rule seems to neglect to take into account the sophisticated internal risk modeling mechanisms banks employ to accept the risks inherent in merchant banking activities and the new and existing powers for bank examiners analyzing merchant banking activities. While I strongly believe we must ensure safety and soundness, we must also ensure the law as we wrote it in Gramm-Leach-Bliley is implemented as we intended.

I want to thank the witnesses for joining us here today to share their considerable knowledge on these issues, and I look forward to the testimony and discussing the issues with them.

I thank you again for holding this hearing, and I yield back the balance of my time.

[The prepared statement of Hon. Sue W. Kelly can be found on page 56 in the appendix.]

Chairman BAKER. Thank you, Mrs. Kelly.

Does any Member wish to give an opening statement?

If not, I would suggest that we are just under 8 minutes or so on the matter pending on the floor, that we would recess momentarily, come immediately back, keep you about 10 minutes, and we will reconvene our hearing at that time.

[Recess.]

Chairman BAKER. I would like to reconvene the hearing.

Members are on their way, returning from the vote. I am told we will have about an hour before we are interrupted again, so at this time I would like to proceed with recognition of our first panel of witnesses.

The Honorable Laurence Meyer, Governor, Board of Governors of the Federal Reserve, we welcome you here and look forward to your testimony. Your comments will be made part of record, as well as that of Mr. Hawke. Please proceed.

STATEMENT OF HON. LAURENCE H. MEYER, GOVERNOR, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. MEYER. Thank you, Chairman Baker, Chairman Bachus and subcommittee Members.

When I last appeared here to address the topic of merchant banking, the Board and the Department of the Treasury were considering comments on rules we had proposed only recently before the testimony. As I indicated at that time, our experience has been that public comments generally provide us with valuable insights and information.

That is, in fact, what happened in this case. The Board and the Treasury received a significant amount of useful information that led us to revise our rules that implement the merchant banking powers in the Gramm-Leach-Bliley Act. We have also consulted with our fellow banking agencies regarding the appropriate capital treatment for equity banking activities. As a result, we have significantly revised and again sought public comment on a proposed capital approach.

Let me provide some background that I hope will put both what we did and what we have proposed in context.

The Bank Holding Company Act reflects a long-held concern of Congress that mixing banking and commerce could result in an adverse effect that may reduce the availability of credit to unaffiliated companies and create a greater risk to deposit insurance funds and, ultimately, the taxpayer.

As part of the consideration of the GLB Act, Congress considered and rejected the idea of allowing banking organizations to affiliate broadly with commercial firms. At the same time, Congress recognized that merchant banking represents a form of ownership of commercial firms by banking organizations that is functionally equivalent of financing for small businesses.

To distinguish merchant banking from the more general mixing of banking and commerce, the GLB Act requires that merchant banking investments be held only for a period of time to enable the resale of the investment and prohibits the investing financial holding company from routinely managing or operating a commercial firm except as necessary or required to obtain a reasonable return on resale of the investment.

The final rule adopted in late January of this year focuses on defining these important restrictions. Generally, the rule permits a 10-year holding period for direct investments and a 15-year holding period for investments in private equity funds. Many commenters acknowledged that merchant banking investments are rarely held beyond these periods.

The final rule also contains several safe harbors and examples of routine management. For example, the final rule allows representatives of a financial holding company to serve on the board of directors of a portfolio company. In addition, a financial holding company may enter into agreements that restrict extraordinary actions of the portfolio company. On the other hand, a financial holding company would be considered to be routinely managing a company if an officer or employee of the financial holding company is also an executive officer of the portfolio company or if the financial holding company restricts decisions made in the ordinary course of business of the portfolio company.

In response to commenters, the final rule provides a mechanism for allowing specific employee and junior officer interlock in the limited situation where the interlock does not rise to the level of routine management of the portfolio company.

The GLB Act allows an investing financial holding company to routinely manage a portfolio company in special circumstances. The final rule adopts statutory language in this area.

The final rule also contains several provisions that are designed to encourage the safe and sound conduct of merchant banking activities. The Board recently issued supervisory guidance that outlines some of the best practices employed by merchant bankers for managing the risks of equity investment activities. That guidance has been well received by the industry as useful and flexible.

In addition, the interim rule contained two thresholds that triggered agency review of the financial holding companies that devote significant amounts of capital to merchant banking activities. The final rule eliminates the absolute dollar threshold and contains a sunset provision that automatically eliminates the entire threshold review process once the banking agencies have implemented final banking rules governing merchant banking activities.

I should note that the thresholds may be exceeded with Board approval, and one experienced investment firm has already received Board approval to exceed the thresholds.

The GLB Act contains provisions that prohibits cross-marketing activities and restricts credit and other funding transactions between a depository institution and a portfolio company controlled by the same financial holding condition. Both are contained in the GLB Act to reinforce the separation between banking and commerce and are mirrored in the final rule.

An integral part of our original merchant banking proposal involved the regulatory capital that would be required to support merchant banking activities. This proposal attracted quite a bit of comment, and it is an example of an area where we learned from the public comments.

Together with the other agencies we have developed a new, revised capital proposal. In developing this new capital proposal, the banking agencies were guided by several principles. First, equity investment activities in non-financial companies generally involve greater risks than traditional bank and financial activities. I have explained in much greater detail our analysis of the risk associated with equity investment activities in my testimony last June. If anything, the activity in equity markets since last June has confirmed this analysis; and few of the commenters on that original capital proposal disagreed with the substance of that analysis or our conclusion.

A second and related principle is that financial risks to an organization engaged in equity investment activities increase as the level of investment accounts for a larger portion of the organization's capital, earnings and activities. The grant by the GLB Act of merchant banking authority to financial holding companies with its promise of increased equity investment activities was an appropriate time to reevaluate whether existing capital charges were adequate to account for this risk.

A third principle guiding the agencies' efforts is that the risk of loss associated with a particular equity investment is likely to be the same regardless of the legal authority used to make the investment or whether the investment is held in the bank holding company or in the bank. In fact, the agencies' supervisory experience is that banking organizations are increasingly making investment decisions and managing investment risks as a single business line across legal entities.

In light of these principles, the Board and the other agencies issued a revised proposal that would apply symmetrically to equity investment activities of bank holding companies and banks.

The revised proposal would apply a series of marginal capital charges that begin with an 8 percent capital charge and increase to a 25 percent charge as the level of the banking organization's overall exposure to equity investment activities increases relative to the institution's Tier 1 capital. These charges are regulatory minima, and financial holding companies are expected to hold capital based on their assessment of the nature and risk of their investment activities.

Commenters, including a number of Members of the subcommittee, strongly urged the agencies not to impose a higher capital charge on investments made through a small business investment company. These commenters argued that SBICs serve the important public purpose of encouraging investment in small businesses, are already subject to investment limitations imposed by the Congress and the Small Business Administration, and have generally been profitable to date.

Commenters made similar arguments in support of an exception for investments made by State banks under the special grandfathering authority preserved by Section 24 of the Federal Deposit Insurance Act. These investments also have been reviewed and limited by Congress and are subject to further review and limitation by the FDIC.

The agencies recognized substantial merit in these arguments. Accordingly, we revised the capital proposal so that it does not generally impose a higher capital charge on investments made through SBICs.

The proposal also includes an exception for investments held by State banks under the special grandfather rights in Section 24 of the FDI act.

One of the comments made most often in response to our original proposal was that internal risk-based models for assessing capital adequacy better reflect the individual risk profile of individual organizations than the more general formulas that currently underlie the agencies' regulatory capital requirements. We have been working with the Basel Capital Committee on a proposal, recently published for public comment, that would focus regulatory capital requirements at least at large banking organizations on internal risk models developed by the organization and verified by the regulatory agencies.

But neither the banking agencies nor most banking organizations are at the stage where we can rely on these models as a replacement for regulatory minimum capital requirements. We view our revised capital proposal for equity investment activities as a bridge to a robust internal model approach.

The invitation for public comments on the revised capital proposal will remain open until April 16. We will carefully review all of the comments that we receive so that we may develop a final rule that will be workable and, importantly, will enhance safety and soundness.

[The prepared statement of Hon. Laurence H. Meyer can be found on page 60 in the appendix.]

Chairman BAKER. I thank you, Governor Meyer.

Our next witness is the Honorable John Hawke—no stranger to the committee as well—Comptroller of the Currency. Welcome, sir.

STATEMENT OF HON. JOHN D. HAWKE, JR., COMPTROLLER OF THE CURRENCY, DEPARTMENT OF THE TREASURY

Mr. HAWKE. Thank you, Mr. Chairman.

Chairman Baker, Chairman Bachus, Chairman Oxley and Members of the subcommittees, thank you for inviting the Office of the Comptroller of the Currency to participate in this hearing on the new and proposed rules relating to the merchant banking investment activities of banking organizations.

Our written testimony focuses principally on the performance of national bank equity investments made through small business investment corporations—SBICs—and the OCC's involvement in the February 2001, capital proposal, which addresses the regulatory capital requirements for those investments. Because the OCC was not a party to the final rule adopted jointly by the Federal Reserve Board and the Treasury Department specifying the conditions under which the newly authorized merchant banking activities can be conducted, we do not address issues relating to that regulation.

Merchant banking is a term with no fixed definition that is generally used to describe a range of financial activities, many of which have long been permissible for national banks. For example, national banks for many years have engaged in the business of buying and selling securities for the accounts of customers, they have advised customers on mergers and acquisitions, and they have represented customers in connection with the private placement of securities—all of which might be considered part of traditional "merchant banking" activities. The Gramm-Leach-Bliley Act—GLBA—did not affect the ability of national banks to engage in any of those activities.

The rules we are discussing today address only one aspect of the business referred to as merchant banking, namely, the making of private equity investments in non-financial firms, in particular, equity investments having a venture capital character. In this regard, as well, it is important to recognize that banks and bank holding companies have long had the authority to make such investments through SBICs and through explicit permission granted under the Bank Holding Company Act.

Prior to the enactment of GLBA, no significant public policy or safety and soundness concerns were raised by bank regulators concerning the ability of either bank holding companies or banks to make private equity investments under existing investment authorities. In fact, the clear intent of Congress in that far-reaching new law was to expand the ability of banking organizations to make such investments in excess of the limits contained in prior law, even where such investments might constitute control of the company in which they were made.

As part of a compromise negotiated in the final stages of the GLBA legislative process, this new merchant banking authority was limited to bank holding companies for a period of 5 years. Given the experience of banks in a broad range of merchant banking activities and the safety and soundness protections included in GLBA for financial subsidiaries of banks, we did not believe it was necessary to so limit the new authority. Prudent bank supervision has been emphasizing the need to diversify the revenue streams of banks so as to reduce the dependence of banks on net interest margins. Non-interest income has become an increasingly important component of bank earnings, and permitting banks to provide expanded venture capital financing to customers, within prudent limits, would serve to lessen the concentration of bank earnings in traditional loan income. The OCC believes that the elimination of the disparate treatment for banks and bank holding companies in this area is appropriate certainly no later than the end of the GLBA-imposed moratorium.

The OCC's primary objective in the development of regulatory capital rules for merchant banking activities was to protect the existing capital and regulatory infrastructure surrounding SBICs, which reflects the long-standing congressional preference for these entities. Many commenters did not believe that the original Federal Reserve Board capital proposal was consistent with that objective. That proposal would have assessed, at the holding company level, a 50 percent Tier 1 capital charge on the carrying value of private equity investments in non-financial companies held directly or indirectly by a holding company, and would have applied this capital charge to a variety of existing investment authorities for banks and bank holding companies beyond the new GLBA banking merchant authority.

One of the OCC's principal concerns about the proposal was that any consolidated holding company capital requirement that would apply a charge to assets held by or under a bank that was more stringent than the charge that was fixed by the primary regulator of the bank would undermine the congressional mandate that bank capital requirements be set by the primary Federal bank regulator. Since the primary purpose of holding company capital is to protect the subsidiary bank, the OCC saw no basis for the judgments of the primary bank regulator to be supplanted through the establishment of more strict consolidated holding company capital requirements.

I am pleased to say that the revised capital proposal is a significant improvement over the original proposal in several respects. First, the scope of the proposal is much narrower than the earlier version. It limits the scope of the regulation to specified equity investment activities of a character similar to those that might be engaged in by financial holding companies under Gramm-Leach-Bliley.

Second, the new capital proposal is more consistent with the experience that national banks have had with regard to SBIC investment activities for over 40 years, during which there have been no safety and soundness concerns. In view of this record of performance, the safeguards placed on these activities, and the important public purpose of encouraging the development and funding of small businesses, the recent proposal accords SBIC investments preferential treatment.

The banking agencies have recognized, however, in light of the substantial growth in SBIC investments in recent years, that significant concentrations of private equity investments could potentially result in safety and soundness concerns, just as with any heavy concentration of assets. The OCC favors the approach adopted in the recent proposal, that is, requiring stepped-up capital charges when aggregate equity investment levels exceed specified concentration thresholds. Thus, we believe that the revised capital proposal promotes the continued conduct of private equity investments, while maintaining safety and soundness principles and preserving the intent of Congress to promote bank investments in small businesses through SBICs.

I would be pleased to respond to any questions.

[The prepared statement of Hon. John D. Hawke Jr. can be found on page 101 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Hawke.

I would like to start our questions with you, Governor Meyer.

Oh, excuse me, I would be reminded Chairman Oxley has joined our committee, and I would like to at this time recognize the Chairman for any opening statement he may wish to make.

Mr. OXLEY. Thank you, Mr. Chairman; and I will submit my formal statement for the record.

Let me just welcome our witnesses, Mr. Meyer from the Fed and Mr. Hawke from the Comptroller's Office. We have had a number of opportunities to work together over the years, particularly on the Gramm-Leach-Bliley bill.

I would say to both you, Chairman Baker, and to Chairman Bachus I thank you for having this hearing. I think we need to explore some of these merchant banking issues, particularly in light of the recent changes that were made in the regs; and I guess the old admonition about doing no harm from the Hippocratic oath probably has some reference here as well.

We look for a modern financial marketplace based on the tenets of the Gramm-Leach-Bliley Act, and to a large extent all of us are working our way through this major change that was made in the statute from almost 70 years ago. It is important to have this kind of hearings so that the members can get our arms around these kinds of issues that in many cases were just simply not issues before the passage of Gramm-Leach-Bliley. The merchant banking issue is clearly one of them, and how the regulators and how the Congress deals with this will have a great deal to do with how successful we are in moving toward that modern financial services marketplace. So, again, Mr. Chairman, thank you for these instructive hearings. I yield back, and I ask unanimous consent that my statement be made part of the record.

Chairman BAKER. Certainly, without objection. Thank you, Mr. Chairman, for your interest and your participation here this morning.

[The prepared statement of Hon. Michael G. Oxley can be found on page 57 in the appendix.]

Chairman BAKER. Governor Meyer, under current law, the Credit Suisse First Boston now manages, on behalf of Louisiana State Teachers Pension Fund, approximately a half a billion dollars at the Teachers Pension Fund direction and from time to time will make minority investments in firms and as a condition of that investment establish a restrictive covenant which would allow Credit Suisse First Boston, for example, but not exclusively, to make managerial changes they deem in the best interest and in accordance with their fiduciary area responsibility to the pension plan.

As I am understanding the rule as now promulgated, they would no longer have the unconditioned right to do—they could do it, but it would come only in consultation with the Fed's approval. Is that correct?

Mr. MEYER. No, I don't think that is correct. The final rule makes clear that the financial holding companies can engage in what would be considered routine management in exceptional circumstances, and you gave one example. When it comes to changing senior management, for example, because of a change in the strategic direction of the firm or performance of the firm, the final rule recognizes that explicitly as one of the situations in which it would be appropriate to have that involvement.

Chairman BAKER. Let's explore further what constitutes exceptional circumstances. That is the trigger then that would allow the third party to make strategic changes. Is there a blueprint that you can go down and say here's what we can do under certain circumstances?

Mr. MEYER. We have tried to provide a list of examples, although we do not claim it is exhaustive, because you can't in advance think of all the situations that would be relevant, but to reduce uncertainties and give guidance. So we have talked about situations where there was a change in management, where there was a sale of some business line or where there was a significant acquisition, where there were significant losses that had to be remedied. It was a long list, but I think it is a very good list of the circumstances in which it is important to give the financial holding company the opportunity to intervene to protect its investment.

Chairman BAKER. Well, my point is that this appears, at least from an outside reading of the regulation, to restrict conduct which prior to the January promulgation may have been in the course of ordinary business an acceptable practice which now, at the very least, may be subject to a second look before you proceed to determine if the Fed's approval may be necessary. Is there anything in market practice from your view that warrants this divisional level of concern?

My view is that the modernization proposal was to enable more relationships with less regulatory oversight to occur to facilitate economic growth. It would appear that this, at the very least, if I agree with your view that there is a list of things that you are allowed to do as illustrative but not exclusive, that there may be things that you can't do now that you could do previously without Fed's approval, is that a correct summation?

Mr. MEYER. Let me try to work on that.

First of all, the examples that we gave in the modifications we made in the revised rule reflected careful discussions with commenters; and we put into the final rule examples that they gave us that reflected what is considered to be best practice in the industry.

Before we even wrote our interim rules we sat down and we interviewed large security firms and large banks that were heavily involved in merchant banking to get an idea of what industry practice was, and we thought of ourselves as codifying best practice in these areas. Where we found we had overstepped and hadn't gotten it right, we tried to do a better job in the final rule.

Now, let's see, I have lost——

Chairman BAKER. Principal point was, are there things which historically you could engage in which pursuant to the promulgation you may not?

Mr. MEYER. I think the other point that you were making is a very, very important one. It goes to the tension between Gramm-Leach-Bliley, making a determination that shouldn't be a broader mixing of banking and commerce and then on the other hand providing authority for merchant banking activities. And the key point in the legislation, mirrored in the regulation, is that there are certain restrictions on merchant banking so that it is not the same as the broad mixing of banking and commercial.

We did not put into the legislation such things as holding periods and prohibitions on routine management. You have put them in there. But I presume the Majority put them in there because they wanted to assure that this won't become a broader mixing of banking and commerce. So we are simply mirroring what you did.

Chairman BAKER. Let me, before I recognize Mr. Bentsen, make one declarative statement. I wouldn't have done it, but some Members did it on the direction of expert financial advice from somewhere.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

I apologize for having to step out during both of your testimonies. And, Mr. Hawke, I don't want you to think I missed your testimony altogether, that that is any indication of where I think you might be or not be.

Chairman BAKER. Mr. Bentsen, can you pull your mike up, please?

Mr. BENTSEN. Looking at the proposed capital requirements, which I guess was the most controversial aspect of the proposed rule, how did the Board and the Treasury come up with this new sort of sliding scale? Is that modeled after anything or was that just something you all came up with internally?

Mr. MEYER. Well, after the comments came in, we thought that they justified a total reassessment of our approach to the capital rule. We began with the proposition that equity investments are riskier than traditional banking activities and required some additional capital treatment.

As we worked further on that, we determined that the risk to the banking institution from the equity investments depended very critically on how large those equity investments were relative to the total organization. So, for example, if you have an SBIC that is 5 percent of the Tier 1 capital, that doesn't impose much risk on the banking organization because it is so small relative to the total. So we decided that what that would justify would be a sliding scale, where the capital charge would be quite low for low concentrations of merchant banking activity but get progressively larger as the concentrations rose. This came out of very careful analytical thinking.

The staff member who led the effort is sitting behind me, and we think it was a major contribution to an improved capital rule.

Mr. BENTSEN. I don't know if you want to comment on that or not.

Mr. HAWKE. Just briefly, Congressman Bentsen. During the discussions that we had with the Federal Reserve, we made our position very strongly known that we wanted a preference for SBICs, and that was our overwhelming concern about the capital reg. The Fed staff expressed the view that they were concerned about concentrations, and we recognized that at some point concentrations could become important. But the stair-step formulation that appears in the final regulation protects SBIC investments up to a level that matched the outermost limits of the experience that we had had with our banks in terms of SBIC investments. A bank can only invest up to 5 percent of its capital in an SBIC, so anything over 5 percent of total capital has to come from appreciation in the investments.

Mr. BENTSEN. Let me ask you also, because my time is running out. The way I read this, on top of the scale the Board and the Comptroller have the authority to subsequently go back in and look at financial holding companies' equity investment in their merchant banking operation and apply other criteria. Am I reading that correct? Is that only after you exceed a certain threshold or is that in any case?

Mr. MEYER. Well, in general, the capital rule is about a regulatory minimum. Banks are expected to hold economic capital in excess of that regulatory minimum. So in general you would be expecting to see banks hold more than that amount of capital, and we would be assessing their economic capital allocation through the supervisory process.

Second, once their concentration got up to a level of 50 percent of Tier 1 capital, then we have indicated that their merchant banking activities would come under more intensified scrutiny. Since we are already up to the highest marginal capital charge of 25 percent, when they get up to 25 percent of Tier 1 capital, when it gets up to 50, we would intensify our supervisory review; and depending upon the risk management and the nature of the equity investments, we could ask for additional capital.

Mr. BENTSEN. You state in your testimony with respect to internal risk models that you all are reviewing that, but at this point in time—if I understand that, that means whether or not the internal risk models of the institution itself, not the Fed or the Comptroller, but at this time you all intend to still rely on your own risk molding, risk assessment.

Mr. MEYER. We intend to rely on this capital charge for the purpose now. But, as we have indicated, we do think it is a bridge ultimately to the use of internal risk models by banking organizations overseen by their regulators.

Mr. BENTSEN. With the Chairman's indulgence, you referenced the Basel reviews are ongoing discussions about this. With respect to internal risk models, would the idea be that there would be some standard, some international standard that regulators would use for what is a qualified risk model versus what anybody comes up with?

Mr. MEYER. Yes. What the Basel approach is now working with in the new proposed rule is an approach whereby the banks could use their internal systems for their banking books, for example, to determine the appropriate capital charge in relationship to risk. But that would be overseen and validated by their supervisors.

I should note that banks are much more advanced in their measurement and management of risk in the banking book than they are in their equity investments in their merchant banking portfolios. Very frankly, I don't know of a single bank at this point that has a model sophisticated enough to put it before us and have any hope that it would be appropriate for determining their capital charges.

Chairman BAKER. Mr. Bentsen, your time is expired.

Mr. Bachus.

Mr. BACHUS. Thank you.

First of all, the committee has prepared about 15 questions, some of which may not be covered today in oral questions. We would like to submit those to you, those that are not answered today.

My first question is about process; and, Governor Meyer, I am going to direct this to you. You had an interim rule in March, and then 9 days before the change in Administration you issued a final rule. Didn't that preclude the new Administration from weighing in on these rules?

Mr. MEYER. When the law was passed, first of all, we needed to move quickly to reduce uncertainty in the industry. So within a day or two after the powers became effective we put out an interim rule. We certainly wouldn't have wanted to wait longer to reduce that uncertainty. There were a lot of comments about that rule and we wanted to move as quickly as we could to make revisions in that rule, again to reduce uncertainty and to improve it.

Now, you will undoubtedly recall that one of the reasons that this law was passed was because the Federal Reserve and the Treasury had worked together to bridge their differences and to reach agreements to allow it to go through, and we were partners in that process. It seemed only natural that these partners worked together to do the regulations, which we did.

Now if we had waited, for example, for the new Administration, we would not have yet had our first meeting. The Under Secretary for Domestic Finance has not been officially nominated, to my understanding; and we would still be waiting for our first meeting with the new Administration on this topic. I don't think that would have been a prudent thing to do.

Having said that, I expect to have as exceptional a relationship with the new Treasury as we did with the previous Treasury; and I look forward to sitting down with the Under Secretary for Domestic Finance at the earliest convenience and reviewing all of the implementation we have done with Gramm-Leach-Bliley and getting feedback on that.

Mr. BACHUS. Thank you. I hope that you will do that.

I have several concerns, and I noted this is what you said in response to Congressman Bentsen: Equity investments are more risky than traditional activities. Now a lot of what you have done here is premised on that fact. But, in fact, is that true? I mean, a lot of your merchant banking activities historically have been high profit, maybe some would argue not as risky as commercial lending. So did you all make a determination that this premise was, in fact, correct?

Mr. MEYER. We have indeed studied it very carefully. And, frankly, when we had meetings with trade associations, and so forth, to give us feedback on the original capital proposal, oftentimes the very first thing they would say is, these are no riskier than traditional banking assets. But when I confronted them and we had a full discussion on it, few held on to that position very long. Very frankly, few of the commenters made that point. Most agreed that equity investments are riskier.

Mr. BACHUS. We are talking about a percentage. Say they invest five times and two of them go flat but three of them are highly profitable. What I am talking about is an average here.

Mr. MEYER. Absolutely. There is an iron law of economics that when a particular activity or instrument has very high risk, it has to offer higher expected returns to get people to hold it. It is very fundamental.

Merchant banking activity is a very good example of an activity that has a very high expected rate of return, and it must be high because of the risk that it holds. We did a study of 25 years of experience with venture capital firms, and we found that, for example, one-third to one-quarter of individual investments suffered losses and that 20 percent of these firms went out of business.

Mr. BACHUS. Are these bank holding companies and financial holding companies?

Mr. MEYER. No, these are firms that had 100 percent capital backing them, no leverage. Why no leverage? Because these activities were viewed as so risky to begin with that they backed them 100 percent with capital. Leverage is a way to increase your expected return by taking on more risk. But these investments were already very risky to begin with. So I really do not think that this is a reasonable concern or an issue.

Let me say one more thing. If you have a list of banking organizations that have told you that they can't tell the difference between the riskiness of their merchant banking investments and their loan portfolio I would like their names.

Mr. BACHUS. One more thing. You have put—the merchant banks often have minority investments in their portfolio companies and then they require restrictive covenants to make those investments safer, but in fact, if a final rule prohibits or restricts their ability to make these restrictive covenants, doesn't it, in fact, have the perverse effect of making that investment more risky? And what do you say to the critics who say that the final rule restricts their ability to manage and protect their minority rights in the companies they invest in?

Mr. MEYER. Well, as I indicated earlier, in the final rule we have made revisions and clarified the terms under which financial holding companies can engage in routine management in those exceptional circumstances. I think what we have done has mirrored what is industry practice.

One has to make a distinction between routine management on a day-to-day basis and interventions in those special circumstances when the threat to the investment is there, such things as losses being taken by the firm, when there has to be a change in management, when there is an important sale of another company or when you might be selling off a line of business. So these are precisely those critical junctures when intervention and routine management is allowed, and I think we have clarified that we have done something which is consistent with the best practice in the industry.

Mr. BACHUS. Let me simply close by saying I would think that any restrictions that you allow the merchant banking company to have would be a good thing as far as protecting their own interest and the more management they do would be the best. So I would hope these rules do not limit them in any way.

Mr. MEYER. I appreciate that point. I think what we are trying to do is that delicate balancing act, making those distinctions between merchant banking and the broader mixing of banking and commerce; and, quite frankly, we are hearing from some Members of this committee that they would prefer that there was a broader mixing of banking and commerce. We are restricted by what you did in the bill.

Mr. BACHUS. Remember, as a regulator, your duty is to protect the bank, not to protect the company that is being invested in.

Mr. MEYER. We certainly understand that. But also understand that when you put something into the legislation, expect it to show up in the regulation. Don't expect a regulation to undo what the Majority did in their legislation.

Mr. BACHUS. If you could identify those areas, it would be helpful.

Chairman BAKER. Thank you, Mr. Bachus.

Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman. I am going to pass and come back with some questions.

Chairman BAKER. Certainly.

Mr. Lucas.

Mr. LUCAS. Pass.

Chairman BAKER. Mr. Ford.

Mr. FORD. Since I just walked in, I am definitely going to pass.

Chairman BAKER. That is OK.

Mrs. Roukema.

Mrs. ROUKEMA. Mr. Chairman, I didn't think I had a question, but I do want to make a statement, and then I guess I will ask a question.

I am one of those that was very concerned in Gramm-Leach-Bliley regarding the safety and soundness and the mixing of banking and commerce. And I believe we did the right thing. I have no regrets about that. And I am deeply concerned as to whether or not you are following through consistent with the law.

But you have both made the case that what you are doing is enforcing the law. Now, your statement—I am going to go over them—but it sounds to me you have hit the proper balance here consistent with Gramm-Leach-Bliley.

But I do want to ask a question, and maybe it is obvious, but it may be a good example of how you are translating through regulation the meaning of Gramm-Leach-Bliley. And I am not sure but why you have indicated that the FHCs have to wait, as I understand it, "for an extraordinary corporate event prior to being permitted to intercede in the management of the portfolio company."

Now this is evidently a good example of how you have to translate the legislation into your regulation. I don't quite understand it. How do you do that? Wouldn't it be better to serve the interests of safety and soundness if there were action before the fact rather than after the fact? And I am not quite sure how you would address it after the fact, after there is significant evidence. Could you use that as an example of how you translate the legislation and your regulations into practical action?

Mr. MEYER. Well, I think you made the point very well. The issue here is balance, and it is a difficult balance to strike. I think I would agree with that.

The question here is, how do you carry out the statute's prohibition on routine management? And simply by saying that you can intervene any time you want with no restrictions would seem to go against the spirit of the prohibition of routine management. So we had to find a way to balance that, and so what we did was to say that, no, in the ordinary course of business you can't have covenants which restrict the ordinary course of business, day-to-day routine management, but you could in these critical cases. And we laid out a series of examples, as I noted before.

We don't mean that that list is exhaustive, and we will gain more experience with this regulation over time. But I think that is the only way we could do it that on the one hand would be consistent with the prohibition on routine management and on the other hand would allow opportunities for intervention at critical junctures when it is necessary to protect the investment.

Mrs. ROUKEMA. What is an example, however, of the extraordinary corporate events?

Mr. MEYER. Change in senior management, a significant loss that the firm was incurring, a purchase of a new business, sale of an existing business line. There are many, many other examples.

Mrs. ROUKEMA. You would automatically take that under review.

Mr. MEYER. We have given guidance so there would be no uncertainty. If a financial holding company found a portfolio company in one of those circumstances, it doesn't have to come back to us and ask permission. They have the authority to intervene. Now it has to be temporary.

Mrs. ROUKEMA. I am sorry?

Mr. MEYER. They can't do it forever.

Mrs. ROUKEMA. Temporary?

Mr. MEYER. Temporary.

Mrs. ROUKEMA. All right. Well, I hope this is working well.

Mr. MEYER. Well, we will find out.

Mrs. ROUKEMA. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mrs. Roukema.

Mrs. Maloney.

Mrs. MALONEY. I would like to, first of all, welcome you. Good to see you. Thank you for having this hearing.

First of all, I would like to ask the Honorable John Hawke and Governor Meyer, how does the proposed merchant banking capital rule compare with the new proposed Basel capital standards? How do they compare?

Mr. HAWKE. Mrs. Maloney, the Basel proposal is very much a work in progress right now and——

Mrs. MALONEY. They came out with preliminary guidelines, did they not?

Mr. HAWKE. The Basel proposal is out for comment—similar to a proposed rule.

To try to simplify a very complicated process, the Basel proposal is divided into two parts. One is the standardized approach, which is very simple. The other is a complicated approach.

In the simple standardized approach, the current proposal is that equity investments of this sort would have 150 percent risk weighting, which I think works out to be something not terribly different from what the Federal Reserve proposal is. As far as the more complicated proposal, that is still up in the air. There hasn't been a specific proposal yet for the treatment of equity in the more complicated part of the proposal.

Mrs. MALONEY. But if the committee completes its work and the United States signs on for uniform global capital standards, wouldn't any additional merchant banking capital charges and changes be repealed? I mean, would the Basel Committee, if we sign on, would that then become the capital standard that we are going to use in this country and in foreign countries?

Mr. HAWKE. I think that is a very good, very pertinent question; and it applies to a number of aspects of the Basel proposal. I would certainly hope that when the dust all settles our domestic capital requirement would be consistent with what Basel comes out with. But we are still quite a ways from the end of the line on that.

Mrs. MALONEY. When do you expect them to complete their work?

Mr. HAWKE. The Basel Committee is hoping to have a final proposal out by the end of the year, and it would not essentially take effect until 2004.

Mrs. MALONEY. Now, are the capital standards basically the same for domestic operations as for foreign loans? Is there any difference now?

Mr. HAWKE. In the Basel proposal?

Mrs. MALONEY. Not in the Basel. I am just talking about now in the United States.

Mr. HAWKE. At present, the existing Basel Accord applies to internationally active banks, but the existing accord is much simpler in its contours than the proposed accord will be. So, essentially, it has been applied up and down the line domestically.

Mrs. MALONEY. But are the capital standards higher for loans domestically or for foreign or are they the same?

Mr. HAWKE. For individual loans, they are the same.

Mrs. MALONEY. The Fed is, as I understand, heading the Basel Committee. Do you have any comments on it?

Mr. MEYER. The Federal Reserve does not head the Basel Committee. The president of the Federal Reserve Bank of New York is chairman of the Basel Committee. But the Federal Reserve participates, as the OCC does, as a member of the Basel Committee.

Mrs. MALONEY. So do you have any further comment on it? Do you see it, likewise, that what they are proposing is basically what you are proposing? Is it basically the same, and once it becomes complete then that will be the standard? Is that how you see it, too?

Mr. MEYER. I see it working the following way: First of all, right now the treatment of equity is really one of gaps that hasn't been completely worked through at Basel. We are in discussions about what that will be, particularly for the more advanced approaches; and we are hopeful that the final Basel rule will be flexible enough that it will be consistent with our rule. We will be trying to move it in that direction, but we can't guarantee that.

Whatever happens at Basel will require us then to review our capital proposals in light of the Basel treatment. It should be understood, however, that national authorities always have the opportunity and the authority to impose higher, more conservative capital requirements than Basel. They just can't be more liberal than what Basel comes out with. So we will have to look over the Basel rule, we will have to look over the nature of the equity investments that are typical in merchant banking investments in the U.S. compared with equity investments that are undertaken abroad and reach a final determination at that time.

Mrs. MALONEY. So, in other words, you see a higher capital standard for our domestic——

Mr. MEYER. Not necessarily.

Mrs. MALONEY. I find it interesting there is more default on our foreign loans than on our domestic loans, and I read a report on that from some of our private banks. Why do you believe that is?

Mr. MEYER. Well, I would presume that if one took a poll and one asks about the default rate as the loans were given further and further away from where that banking organization was located that the default rates would go up. That is fairly typical. It reflects the greater knowledge that banks have with respect to domestic conditions and laws, and so forth, then what is going on in other countries. So I don't find that particularly surprising.

Mrs. MALONEY. But then, because of the outcome, should we have higher standards for foreign loans or capital requirements possibly so that we would not have such a great default?

Mr. MEYER. Under the new Basel approach the capital requirements against individual loans would depend upon the risk assessment by the bank. That couldn't take into account all of these kinds of considerations, so I think it is perfectly consistent.

Chairman BAKER. Mrs. Maloney, your time is expired.

Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman.

Gramm-Leach-Bliley prohibits the depository institution controlled by a financial holding company from cross-marketing any product or services with or through any company in which the financial holding company or a bank holding company hold an equity interest through the merchant banking authority. However, a depository institution generally may cross-market the product or services of non-financial companies held by insurance affiliates of the financial holding companies through statement stuffers, internet sites, portals, things like that. Would the Fed support an amendment to Gramm-Leach-Bliley that would correct that kind of inequity and allow the same kind of cross-marketing abilities to be extended to products or services of portfolio companies that are held under the merchant banking authority?

Mr. MEYER. The Board hasn't taken a position on this.

As you well know, this asymmetry in Gramm-Leach-Bliley is probably not one of its greatest virtues, and we would agree with that. However, in correcting it, one has to make a decision as one makes it more symmetrical whether one wants to have the same restrictions on cross-marketing everyplace or reduce those restrictions everyplace.

Again, clearly the restrictions on cross-marketing were one of the vehicles that the Congress used to make the distinction between merchant banking activities and the broader mixing of banking and commerce. That is an issue you may want to reconsider, but we haven't taken a position on it.

Mrs. KELLY. I want to jump to the committee statement that talks about the fact that depository institutions should be able to compete on an equal basis with Section VI(C)(3)(h) of the Gramm-Leach-Bliley Act. Do you think that the joint rules, even in their current form, given their numerous restrictions, satisfy the congressional intent which talks about the fact—and I can read it for you. It says, "the Board shall take into account that investment banking firms affiliated with depository institutions should be able to compete on an equal basis for principal investments with firms unaffiliated with any depository institutions so the effectiveness of these organizations and their investment banking activities is not compromised."

Do you believe that the joint rules, even in their current form, satisfy the Congressional intent?

Mr. MEYER. We do believe so. Remember that what we did, as I indicated earlier, is that we sat down with large securities firms and large banks to try to determine how they conduct their merchant banking activities and to put in our regulations what constituted best practice. In that way we thought we would ensure that the two-way street which is so important in the Gramm-Leach-Bliley Act remained open.

If you take a look, for example, at capital treatment, we did find out that the large securities firms tend to hold more capital relative to their merchant banking investments than banking organizations did. So we don't really think that the capital rules are going to provide an obstacle for securities firms to affiliate with banks.

I will also note that a very large number of the major securities firms are already affiliated with banks, and we have had two others that have become affiliated with banks, with foreign banking organizations, and another sizable securities firm with merchant banking activities has recently elected to become a financial holding company. So I don't see this as an obstacle, and we tried very hard in our rules to keep that two-way street open.

Mrs. KELLY. Mr. Chairman, I am going to run out of time here, but I would like to ask one more question. What is the statutory authorization for the aggregate cap on merchant banking investments?

Mr. MEYER. For the caps?

Mrs. KELLY. Yes.

Mr. MEYER. I think the authority that we would use would be the authority for overall safety and soundness that comes from the Bank Holding Company Act for bank holding companies. After all, what it is is not a strict cap, but it is a threshold that requires us to do a careful review of the safety and soundness and risk management of those financial holding companies that have devoted a very high amount of their capital to these activities.

Mrs. KELLY. So there is no statutory authorization as far as you know.

Mr. MEYER. No. Just as we are given the authority for capital in general, in order to protect safety and soundness, it is that authority that we are using in this case.

Mrs. KELLY. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mrs. Kelly.

Mr. Grucci.

Mr. GRUCCI. Thank you, Mr. Chairman. I have no questions at this time and yield back my time.

Chairman BAKER. Mrs. Biggert.

Ms. BIGGERT. Thank you, Mr. Chairman. I have no questions either.

Chairman BAKER. Mr. Hinojosa, if you do not have a question at this time, we will start the second round at this point.

Mr. HINOJOSA. Go ahead.

Chairman BAKER. Governor Meyer, I want to return to the presumption on which much of this has been constructed, something subsequent to the line Mrs. Kelly was pursuing. The explanation for many of the determinations is based on the predicate that Congress acted; therefore, the regulator implemented. But the law did not require a 50 percent capital offset, nor did it require a 20 percent offset, nor did it require a sliding scale. Those were all determinations made under the broad directive, as I understood your answer to Mrs. Kelly, that you have the responsibility to provide for capital adequacy, that is correct.

Second, with regard to the modifications made since the earlier addition, we now have the—and this is a summary. I don't believe this to be the rule. I didn't get that clarified.

With regard to managerial relationships, the final rule was modified to clarify that the holding company may be considered routinely managing if they provide investment advisory services and management consulting services to the portfolio company so long as the holding company does not exercise managerial discretion of decisionmaking authority. To me, that reads, I can sit in a room and say we think you might ought to look at this, but I cannot say I recommend that you do this. What is the distinction? I see a differing view behind you there.

Mr. MEYER. The final rule does indicate that you can provide consulting services and give advice, and that does mean giving recommendations.

Chairman BAKER. How does that—is distinguished from making a managerial——

Mr. MEYER. It is not a decision. It is advice. There is a difference between advice and a dictate that says, this is what you are going to do in the ordinary course of business. Do it because we are the financial holding company and we own a share of this firm. You can't do that.

Chairman BAKER. But clearly the law didn't make a provision as to doing either A or B. That is a recommendation of the regulation.

Mr. MEYER. We are trying to strike the balance.

Chairman BAKER. I understand.

Mr. MEYER. There is no precise way of doing it. So these questions are all reasonable ones, but we had to try to strike a balance between the Majority in Congress' view that we should do something to prohibit routine management. That was a difficult task. We have done our best to try to draw that balance.

Chairman BAKER. I am not questioning the credibility of your decisionmaking acumen. I am merely pointing out that much of the earlier explanations to questions was that Congress dictated certain courses of action to which you responded, and in my view there was a broad discretionary grant of authority given in which the Fed found it appropriate to act.

My view is that I have some philosophic disagreements with the exercise of the discretion as provided by the final rule. But if wasn't clearly marked, it wasn't I-66 that you are on—this is more David Copperfield—first you see it, then you don't—and somebody has got to make a decision about what the final illusion looks like. Were it to be our judgment, and I am speaking a little in advance with final agreement with Mr. Bachus, and I may wish to speak to this later, to provide more clarification in the formulation of these rules by way of further congressional deliberations.

I noted in your comment that Gramm-Leach-Bliley was not symmetrical in its market consequence. To the extent you could help us provide for symmetry I would very much appreciate your direction in order to better understand where those inequities exist. The underlying philosophy that I think many members of this committee have adopted is whatever A can do in the marketplace to B, B ought to be able to do in the marketplace to A. And from what I am getting from much of the presentation this morning and the questions, that does not appear to be the current circumstance. Do you agree with that observation?

Mr. MEYER. Mr. Chairman, I was responding to the asymmetry that was introduced at the last minute into Gramm-Leach-Bliley with the special preference for insurance affiliates with respect to cross-marketing activities. So that was a very good example of a place in which the law became asymmetrical at the last minute, and I could understand why there might be some questions about that. But, again, the rule mirrored that. As I say, we have not taken a position on that, on how that should be corrected.

Chairman BAKER. That is my point. If there are identifiable areas of market distortion, we very much are interested in not wanting to provide arbitrage or preference or anything else. One might choose to try it, but I want to make sure if we provide in that manner we are correcting it and not making it worse.

Mr. MEYER. We would look forward to working with you in those areas.

Chairman BAKER. Thank you very much.

Mr. Bentsen, you would be recognized for a second round, if you would like.

Mr. BENTSEN. Thank you, Mr. Chairman. I keep trying to read the rule. Every time, you are interrupting me. But I do have a question.

Chairman BAKER. At least I am not waking you up.

Mr. BENTSEN. No, no, it is really fascinating. But I do have a couple of questions.

Mr. Hawke, and this may be more of an agency or political question, but in reading this, as I now recall some of the details of Gramm-Leach-Bliley that I have forgotten, national bank subsidiaries are precluded for 5 years from engaging in merchant banking above the current 5 percent rule or the civic rule, is that right.

Mr. HAWKE. As I said in my direct testimony, merchant banking is a very broad term. What banks were not given was authority parallel to what holding companies got to make private equity investments beyond what they can already do, say, with respect to SBICs.

Mr. BENTSEN. Until?

Mr. HAWKE. Until 5 years.

Mr. BENTSEN. Four years or five years, I guess.

Would it be the position of the Comptroller's office that what is being proposed right now—the capital standards that are being proposed right now—would apply to national bank subsidiaries as it does to holding companies? And I would ask the same question of the Fed as well, or is that too prospective in nature?

Mr. HAWKE. You mean, would it apply 5 years out?

Mr. BENTSEN. Right.

Mr. HAWKE. We would hope that if 5 years out the Fed and the Treasury see fit to extend the new merchant banking authority to financial subsidiaries of banking organizations, we would have an opportunity to examine then what the appropriate capital requirements were under those circumstances. There is certainly going to be some momentum behind the existing rule that the Treasury and the Fed adopted in this area. I would think that it would likely become a standard for what banks might be able to do 5 years out.

Mr. BENTSEN. Governor Meyer, would that—I mean, again, obviously, this is some ways down the road and you would have to take into consideration civic investments and other issues, but would it be fair to assume that if these standards go through and the Fed find them to be workable and prudent, that if and when a petition is made to open up merchant banking activity for national banks, which I would bet would probably be made, that the Fed would view these rules as being commensurate for a national bank subsidiary.

Mr. MEYER. Congressman, I would not like to see you lose money, so I would just say this. There is no presumption one way or another. That is a decision that would be made within the 5-year time. There is no presumption one way or another which way it will go at this point as to whether or not this will be extended.

Second, I think the important principle in the capital rule which I hope would be preserved would be one of symmetry. That is, the capital treatment of merchant banking investments should be independent of whether they are held in the bank holding company or in the bank; and I hope that principle would be one which would continue if the new merchant banking authority were then extended to banks.

Mr. HAWKE. We would certainly support the symmetrical extension of new authority to national banks.

Mr. BENTSEN. I appreciate that.

If I could ask one or one more question on symmetry. If I read this correctly, Mr. Hawke, in your testimony, the ongoing Basel proposal would apply a risk weight standard of 150 percent for venture and equity, and I think you all are looking at it using a factor of 100 percent. But you perceive there is symmetry because, I think, of what Governor Meyer said. You are trying to establish minimums, and you have regulatory discretion which would allow you to go higher. Is that a correct interpretation?

Mr. HAWKE. The Basel proposal is awfully complicated, but under the simplified Basel approach there would be a 150 percent risk weighting that could be applied at the regulator's discretion to equity investments. They did not particularly characterize the type of equity investment, whether it is speculative or venture capital, but equity investment generally.

I should say that is a very controversial issue within the Basel Committee, because there are banks in the home countries of many members of the committee that have long had the ability to be invested in equity.

Mr. BENTSEN. Thank you.

Chairman BAKER. Mr. Bachus.

Mr. BACHUS. Thank you.

Governor Meyer, why should a financial holding company have to wait for what we have called extraordinary corporate events prior to being permitted to intervene or intercede in the management of one of their portfolio companies?

Mr. MEYER. I would answer as I have before. Because you have, the Congress, put into the bill a prohibition.

Mr. BACHUS. Under risk management.

Mr. MEYER. That is the higher reason.

Mr. BACHUS. So if we amended that——

Mr. MEYER. Absolutely. If you eliminated the restrictions on the mixing of banking and commerce, of course, a lot of other things would be possible, too.

Mr. BACHUS. We are talking about the risk management provision.

Mr. MEYER. OK.

Mr. BACHUS. As the routine management——

Mr. MEYER. If you eliminated the routine management, that is one of the protections that make merchant banking different from the mixing of banking and commerce, but obviously you could change that.

Mr. BACHUS. Don't you agree that we would all be better served if these companies that have expertise were allowed to intercede before, say, their investment got in trouble.

Mr. MEYER. You are perhaps not talking to a sympathetic party here, because I do support the provisions and the spirit of Gramm-Leach-Bliley that at this point we shouldn't move ahead to a broader mixing of banking and commerce, and I appreciate the restrictions that were put into the law to make that effective.

Mr. BACHUS. But to me, anytime you allow one to assist in the management of something they have invested in, it would obviously improve the safety and soundness of their investment.

Mr. MEYER. I appreciate that point, and it is a valid one. But you understand as well the balance that we are trying to strike here.

Mr. BACHUS. I think our main concern is safety and soundness of the investment. And if these companies have expertise and management I would think we would want to encourage——

Mr. MEYER. In terms of risk management, that is always something that a financial holding company can intervene in, in terms of the process of risk management but not the day-to-day activity. Risk management is a process, and that process definitely comes under the review and intervention of the financial holding company. It has to be satisfied with the risk management.

Mr. BACHUS. I am thinking about Warren Buffett, for example, going down and firing the CEO, which he does and is very successful.

Mr. HAWKE. Mr. Bachus, if I could add a note to that. It is very traditional for banks that have extended loans to a company to exercise some involvement in the affairs of the company when the loan gets into trouble. I would hope that the rule that the Fed and the Treasury have adopted would not interfere in any way with the ability of a bank, whether it is in a holding company that made a merchant banking investment or not, to exercise the normal rights and authorities of a bank to take remedial steps with respect to a company it has made a loan to.

Mr. BACHUS. Otherwise, if they do it in a commercial loan then they will start——

Mr. MEYER. But it is perfectly appropriate to do that, and I think there is considerable effort to do just that, prepare for a financial holding company to intervene to protect its investment.

Mr. BACHUS. I would just say I think they ought to be free to assist management any way they see proper.

But let me ask you another question. Why is a carrying value of merchant banking investment used to determine the aggregate merchant banking investments instead of the actual cost of the investment? The reason I ask that, it seems the more successful the investment the more they are penalized.

Mr. MEYER. As the carrying value goes up, the capital to the firm goes up. As the carrying value goes down, the capital of the firm goes down. So that is the real exposure to the firm from that merchant banking investment. When the firm reports its balance sheet and its financial statements, its merchant banking activities, it is going to report its carrying value.

Mr. BACHUS. Because of that, the more successful a financial holding company's investments are, the less ability they have to make other investments.

Mr. MEYER. Not at all. The more successful they are, the more they can make investments. But they have to hold capital against their carrying value, because that carrying value reflect the exposure of that organization to the risks.

OK, if you have a 10 percent or a 20 percent or a 50 percent decline in the value of the firm, the risk depends upon the current carrying value.

Mr. BACHUS. Mr. Hawke.

Mr. HAWKE. Mr. Bachus, I think a great many investments, particularly made by SBICs, are carried at historical cost, and they are not written up. This is particularly true of investments in privately held venture capital—in companies that don't have a public trading market. Any assets held in the available-for-sale account of an institution will be carried at what may be a higher value, but the unrealized appreciation will not count toward Tier 1 capital. So the big difference is whether the increase in value that is unrealized can be counted toward Tier 1 capital.

Mr. BACHUS. All right. I have got 47 seconds, right.

Chairman BAKER. No, you are 47 seconds over, but I am not counting.

Mr. BACHUS. I will ask a real short one.

Chairman BAKER. Good.

Mr. BACHUS. Has the Fed considered excluding investments from the rules once a portfolio company has gone public?

Mr. MEYER. No. Once a portfolio company goes public those now publicly traded equities are held under the merchant banking authorities and are subject to the same rules. We have made no distinction between the private equity investments and the publicly traded ones. That is something that, over time—for example, if banks develop internal risk models that are more sophisticated and can make that distinction—we would certainly be willing to consider.

Mr. BACHUS. Thank you.

And I just want to make a comment. Oftentimes—you talked about market volatility and what the market has done since you came out with these rules. But I think you might agree that since you have shown the merchant banking investments are more stable than some of your publicly traded equity which have really gone down in value.

Mr. MEYER. Well, the difference between publicly traded equity and private equity investments is that the latter are not regularly marked to market, so you wouldn't know right now to what degree losses are incurred. If the market stays as it is right now, then we will find out over time.

Chairman BAKER. Thank you, Mr. Bachus.

I just want to make a quick observation. It has always been a matter of mystery to me—Mr. Bachus and I used to know the citations when we were in the depths of the Gramm-Leach-Bliley debate—why a holding company can have up to a 24.9 percent interest equity in a domestic corporation non-voting but you can have up to a 40 percent position in a foreign corporation. And I never have ever had a successful explanation as to why that appears to be a less risky position than a 24.9 percent in the domestic corporation. So there are a lot of apparent inconsistencies, to me at least, in providing opportunity as it relates to risk in the markets.

I think this committee has a lot of work to do, and I look forward to working with Mr. Bachus and Mrs. Maloney and others on this matter.

I am informed that we have a series of votes. Do we know how many? I am told two, two votes; and I make this announcement for the benefit of our next panel. We would conclude this panel of witnesses, express our appreciation for your courtesy and long participation this morning. It is an important matter to the committee. We do look forward to having further informational exchanges and follow-up with our written questions and look forward to working with the gentlemen.

Mr. BACHUS. Could I?

Chairman BAKER. Sure.

Mr. BACHUS. One thing that we would like you to do, we have identified the routine management provision within the Act that is problematic. Would you work with us to identify other areas in which you might inadvertently work against us?

Mr. MEYER. I think perhaps we would like to communicate with you a little further to clarify the routine management aspects.

Mr. BACHUS. Not only that, if there are other provisions that you are mandating, some of these regulations, we would like to sort of identify it. Because it is sort of my understanding that it did not mandate any of these regulations.

Mr. MEYER. We are looking forward to working with you.

Chairman BAKER. We have a follow-up question.

Mrs. MALONEY. The Chairman raised an important point, and I would like to hear from both of you. What is the explanation that you can have 40 percent in a foreign company but only 24 percent here? What is the explanation?

Mr. HAWKE. We pointed out that anomaly a number of times during the Gramm-Leach-Bliley.

Chairman BAKER. I think you and I have been doing this for a decade.

Mrs. MALONEY. I would like to hear why.

Mr. HAWKE. I would rather not try to justify that.

Mrs. MALONEY. Can you, Mr. Meyer, justify it?

Mr. MEYER. The only thing I can say is today you can have a 100 percent ownership in a U.S. firm under the new merchant banking authority, but I really can't comment on the previous rules. I don't know why they exist as they do.

Chairman BAKER. It is an area where we really do need to do some work. We tried unsuccessfully in Gramm-Leach-Bliley to address that concern. You can only have up to a 5 percent voting interest with a 24.9 percent equity position. To me, it seems, along the lines of Mr. Bachus' questioning, if you have your financial resources at risk or worse, where you have a fiduciary responsibility to the Louisiana Teachers Fund and you see something going on, you ought to be able to exercise your discretion to improve the operation, safety and soundness of that enterprise for the benefit of teachers, much less the shareholders of the underlying management.

Mr. MEYER. Mr. Chairman, if you see something going on that is a threat to your investment, you can. It doesn't mean you can manage the firm on a day-to-day basis.

Chairman BAKER. I understand that. If you can smell the smoke and see the fire, you can grab a fire extinguisher. But if you see a guy piling rubbish in the corner with matches in his pocket, you can't say a word. I think that is the distinction that troubles me.

With that explanation, I would conclude this panel. We will reconvene as quickly as possible. Hopefully, no more than 20 minutes.

[Recess.]

Mr. BACHUS. [Presiding.] At this time, we will reconvene our hearing with our second panel. They are: Mr. Robert J. Kabel, Counsel for the Bank Private Equity Coalition, representing Manatt, Phelps and Phillips; Mr. John P. Whaley, Partner, Norwest Equity Partners and Norwest Venture Partners, on behalf of American Bankers Association Securities Association; and Mr. Peter D. Grauer, Managing Director, Leveraged Corporate Private Equity Group, representing Credit Suisse First Boston Equity, on behalf of the Securities Industry Association and the Financial Services Roundtable.

We welcome you gentlemen to the hearing. Did you all have an opportunity to hear the first panel? All right. All of you did.

At this time we will start, and we will go from my left to right with opening statements.

STATEMENT OF ROBERT J. KABEL, PARTNER, MANATT, PHELPS AND PHILLIPS, LLP; ON BEHALF OF THE BANK PRIVATE EQUITY COALITION

Mr. KABEL. Thank you, Chairmen Baker and Bachus, Members of the subcommittee.

I am Robert Kabel and, just to correct the record, I am a partner at the law firm at Manatt, Phelps and Phillips, but I have been outside counsel to the Bank Private Equity Coalition for some years.

On behalf of BPEC, I want to thank you for your continuing interest in the regulatory implementation of the merchant banking authority enacted as part of the Gramm-Leach-Bliley Act. BPEC appreciates your convening of this important hearing and the opportunity to present our views on the implementation of the merchant banking provisions of GLBA.

BPEC was formed in early 1995 by the direct investment subsidiaries of several large commercial bank holding companies to address various statutory and regulatory issues that prevented them from competing effectively with non-bank direct investment firms.

Prior to the enactment of GLBA, BPEC members had been involved for many years in direct investment activities. These direct investment subsidiaries have many years of direct investment experience and excellent earning track records.

BPEC worked in the 104th Congress with then House Banking Committee Chairman Jim Leach on the merchant banking language included in the first financial modernization bill he introduced early in 1995. Identical merchant banking language was included in every subsequent version of financial modernization legislation, including the legislation that was signed into law in November of 1999. The purpose of the merchant banking provision was to expand the existing direct investment authority of commercial bank holding company subsidiaries so they could compete more effectively with securities firms and insurance companies who were not subject to Glass-Steagall and Bank Holding Company Act restrictions.

Prior to the enactment of GLBA, the SBA regulated SBICs, and the Federal Reserve regulated all other direct investments made through bank holding companies. The regulation of merchant banking activities was burdensome and often unpredictable. The Federal Reserve examinations varied widely in regard to several critical issues. Therefore, BPEC and others in the industry advocated the enactment of the merchant banking provisions in GLBA as a means by which to streamline the regulation of merchant baking activities as well as provide for greater competitive equality.

Since enactment of GLBA, BPEC has worked with the Federal financial regulators on implementation issues through a series of meetings and comment letters.

Chairman Baker, we appreciate the attention you and the Capital Markets Subcommittee have given to this important issue since enactment and look forward to working with both subcommittees in the future. BPEC strongly believes that the appropriate regulatory implementation of the GLBA merchant banking provisions in accordance with congressional intent will determine whether with this new statute leads to the modernization of our financial industry as Congress had intended. Nothing less than that is at stake here. If GLBA is not properly implemented, the two-way street concept that Congress worked toward for so many years will fail to be achieved.

In view of the intense scrutiny given merchant banking issues during the development of GLBA, BPEC was surprised and disappointed when the Federal Reserve Board and Treasury issued their interim merchant banking regulations on March 17 of last year and the Board issued its proposed capital rules.

The interim rule established an extensive set of complex rules for merchant banking which BPEC members, and many other members of the financial community, thought to be exceedingly restrictive. We are pleased the regulators took into account many of the extensive comments submitted regarding the interim rule and modified several of its provisions so that the final rule provides some greater flexibility and certainty of its provisions.

We remain concerned, however, that the final rule imposes a series of restrictions on the financial holding company merchant banking operations that our non-FHC merchant banking competitors are not required to follow. In particular, BPEC remains troubled by the cross-marketing restrictions included in the final rule. The GLBA explicitly provides insurance companies involved in merchant banking with authority to cross-market products and services. This apparent disparity is unfair and unwarranted and should be changed. If regulatory relief is not forthcoming, BPEC recommends amending GLBA to permit financial institutions to cross-market products and services.

BPEC, like almost everyone in the financial services industry, also was disappointed by the Federal Reserve's original proposed capital rule for merchant banking activities. During the several year debate which led to the enactment of GLBA, none of the regulators ever publicly suggested that there should be the prospect of special capital rules for merchant banking activities. Congress rightly did not impose an excessive capital requirement because it recognized that existing merchant banking firms had a long history of making prudent investments and therefore did not require a separate capital rule.

BPEC is pleased that the Federal Reserve carefully reviewed the substantial industry comments submitted in regards to the proposed capital rule and made significant changes in the revised proposal now out for comment. Comments made by this committee and others in Congress were very constructive, and we appreciate the committee's leadership on this issue.

While BPEC appreciates the fact that the Federal Reserve carefully reviewed and responded to many of the comments submitted on the original proposed rule, we continue to object to singling out any individual class for discriminatory treatment. BPEC believes that the Federal Reserve should utilize the internal capital allocation models of those financial holding companies with merchant banking operations. The Federal Reserve should review those models during the normal examination process and impose specific capital requirements only if the internal models are deemed inadequate to protect against the inherent risk in the institution's merchant banking portfolio.

Again, I want to thank you for this opportunity to present the views of the Bank Private Equity Coalition on the final merchant banking regulations and the revised proposed merchant banking capital rule; and I would be happy to answer any questions.

Mr. BACHUS. Thank you.

Mr. Kabel, before you stop, we are going to correct the record to show that you are actually testifying—you are a partner in Manatt, Phelps, but you are testifying on behalf of the Bank Private Equity Coalition.

Mr. KABEL. That is correct, Mr. Chairman.

Mr. BACHUS. Also, Mr. Grauer.

Mr. GRAUER. Yes, sir.

Mr. BACHUS. You are also testifying on behalf of Financial Services Roundtable as well as the Securities Industry Association.

Mr. GRAUER. Correct.

Mr. BACHUS. Thank you.

[The prepared statement of Robert J. Kabel can be found on page 115 in the appendix.]

STATEMENT OF JOHN P. WHALEY, PARTNER, NORWEST EQUITY PARTNERS AND NORWEST VENTURE PARTNERS, ON BEHALF OF AMERICAN BANKERS ASSOCIATION SECURITIES ASSOCIATION

Mr. WHALEY. Messrs. Chairmen, my name is John Whaley. I am a partner of Norwest Equity Partners and Norwest Venture Partners.

I am here today on behalf of the ABA Securities Association, or ABASA, and the American Bankers Association. Many of ABASA's members regard the merchant banking authority as the most important feature of the Gramm-Leach-Bliley Act. We want to ensure that we may exercise that authority to the fullest extent allowed under the law.

ABASA strongly opposed the original capital proposal as well as the interim rule. Subsequently, both of these were revised, and we are pleased that the regulators chose to address many of our concerns.

Today, I will highlight three issues: the proposed special capital charge on equity investments, the rules on private equity funds and legislative relief from certain cross-marketing limits.

Regarding capital charges, bank regulators have proposed a three-tier system for assessing capital against equity investments made by financial and bank holding companies. Specifically, the proposed rule would assess an 8, 12 or 25 percent capital charge deduction on an organization's Tier 1 capital as the level of equity investments increase. This graduated capital charge is a significant improvement over the one-size-fits-all 50 percent capital charge originally proposed.

We remain concerned, however, that any special capital charge will exacerbate the inequity between financial holding companies, or FHCs, and non-FHCs engaged in merchant banking activities, thereby undermining congressional intent that all investment banking firms engaged in these activities operate on a level playing field.

The special capital charge, even as reduced under the new proposal, would preclude FHCs from engaging in merchant banking activities on the same terms and conditions as their non-bank-affiliated competitors. It also might discourage the securities and insurance firms from becoming FHCs because the price may be too steep.

For these reasons, we earlier advocated and continue to maintain that a supervisory approach would be the optimum way to address this issue. Further, the capital charge would apply not only to newly authorized merchant banking equity investments but also to the four pre-Gramm-Leach-Bliley types of investments which are listed in my written statement.

Of these four types of investments, only SBICs are given special treatment under the proposal. No special capital charge is applied to any SBIC investment unless the total amount of such investments exceeds 15 percent, and then only the excess amount above 15 percent is subject to the capital charge.

ABASA opposes any special capital charge on equity investments authorized prior to Gramm-Leach-Bliley. The banking industry has a long history of engaging in such activities, and there is simply no evidence that additional capital is warranted. At the very least, all investments through SBICs should be excluded from the special capital charge.

If the regulators do not exclude all pre-Gramm-Leach-Bliley authorities or at least SBICs from the special capital charge, at the very least all equity investment made prior to March 13 of 2000 should be grandfathered. Without such grandfathering, many investments made before March 13 will become uneconomic, not because of any change in inherent worth but solely because of a change of regulatory treatment.

With respect to private equity funds, merchant banking equity investments may be made through pooled funds or directly in portfolio companies. The interim rule properly recognized that investments made through a private equity fund in which an FHC, by definition, may only be a minority investor should have fewer restrictions than investments made directly in portfolio companies. Nevertheless, the interim rule needlessly imposed many of the same restrictions on portfolio investments made through private equity funds that it imposed on direct portfolio investments. That is, the rule's restrictions applied to the FHC's investment in the private equity fund itself and then looked through the equity fund and applied it to the portfolio investment made by the fund as well.

ABASA strongly objected to these look-through provisions. The restrictions deterred FHCs from investing private equity funds and created a significant disincentive to include FHC investors in many private equity funds. We are pleased that the final rules on private equity funds have been simplified and clarified to address many of ABASAs concerns.

Regarding the need for relief from cross-marketing limits, under the cross-marketing limitation a bank cannot market any product or service of a portfolio company in which its FHC has made a merchant banking investment; and the portfolio company in which the FHC has invested may not market the banks products and services. A limited exception is provided, however, for banks that are affiliated with insurance companies. That kind of bank can market its product through internet websites and statement stuffers to a portfolio company in which the insurance company has made a merchant banking investment. Products and services offered by the portfolio company in which the insurance company has invested also may be marketed through internet websites and statement stuffers via the insurance company's affiliated bank.

Nearly all of ABASAs members are FHCs that may make merchant banking investments because of their affiliation with securities firms. Very few own insurance companies. As a result, our FHC members cannot take advantage of the website statement stuffer exception. There is simply no rationale or public policy reason for this competitive inequity.

The ability to cross-market through internet websites and statement stuffers is an important tool. As Representative Kelly stated and Governor Meyer confirmed and was mentioned by Chairman Baker, there is not a great deal of symmetry in how Gramm-Leach-

Bliley is applied. Therefore, we urge the subcommittees to fix this inequity by expanding the website statement stuffer exception to all FHCs engaged in merchant banking activities.

Thank you, and I will be happy to respond to any questions you have.

[The prepared statement of John P. Whaley can be found on page 120 in the appendix.]

Mr. BACHUS. Mr. Grauer.

STATEMENT OF PETER A. GRAUER, MANAGING DIRECTOR, LEVERAGED CORPORATE PRIVATE EQUITY GROUP, ON BEHALF OF CREDIT SUISSE FIRST BOSTON PRIVATE EQUITY, THE SECURITIES INDUSTRY ASSOCIATION AND THE FINANCIAL SERVICES ROUNDTABLE

Mr. GRAUER. Thank you, sir.

I am Peter Grauer, Managing Director and Senior Partner of Credit Suisse First Boston's private equity business, which is the largest manager of private equity assets in the world. Credit Suisse First Boston as a financial holding company commends the Federal Reserve and Treasury for the significant improvements that the joint rules reflect from the original interim rules put out in March of 2000. We appreciate the Federal Reserve and Treasury's willingness to be open-minded and work with the industry to improve these rules. In the same spirit, we look forward to further refining the rules as the agencies gain greater expertise in private equity activities.

While we recognize how far the agencies have come, we still believe that the joint rules present an unnecessarily burdensome array of restrictions that are neither mandated by safety and soundness concerns, nor in keeping with the language or spirit of Gramm-Leach-Bliley. In fact, the changes in our view do not correlate with the way successfully run merchant banking business have conducted their activities over the last 15 years. Indeed, we believe that more than any factor the merchant banking restrictions have impeded non-bank financial firms from becoming financial holding companies.

In our view, the unwillingness of these firms to elect financial holding company status serves to underscore both the continuing difficulties that the joint rules raise and that financial holding companies are operating at a significant disadvantage in the marketplace.

It is important to start from this premise, entirely borne out of our experience in the business, that active merchant banking, properly managed, poses no greater risk to financial holding companies than any other activities that regulated financial institutions are permitted to engage in without restrictions.

Today I would like to highlight three specific problem areas under the rule. The first I will address are the restrictions on routine management or operation of a portfolio company for minority investors. Second, I would like to underscore what my colleagues have stated with regard to the aggregate limit on merchant banking investments causes operational difficulties. And, thirdly, restrictions on a maximum holding period for merchant banking investments are not customary in the private equity market and will increase the risk of those investments without any countervailing benefit.

In my view, these restrictions significantly diminish an important business opportunity for financial holding companies and undercut the intent of Congress under Gramm-Leach-Bliley without adding in any material way to the regulatory goals referred to in the joint rules.

First, in general, the joint rules' restrictions on routine management or operation of a portfolio company appear to presume that an investment can be protected from bad or improper management through control of a portfolio company's board of directors. However, where an investor is a minority investor and therefore does not have the ability to control the portfolio company's board, the need for additional contractual and operational protections become significantly greater than in the majority-investment context.

The joint rules' prohibition on the use of many traditional covenants that dictate prudent business practices or controls increase the risk associated with a minority investment and cause minority investors to lose an important tool to protect value.

Based on our experience at Credit Suisse First Boston Private Equity, I would strongly recommend that the Federal Reserve and Treasury revise the joint rules to permit financial holding companies making minority investments to retain the right to use a wide range of restrictive covenants. These covenants are intended to ensure prudent management and operating practices.

While we recognize that the joint rules do provide limited examples of covenants that, if granted to a financial holding company, would not be considered to be routine management or operation, the regulatory list is limited and incomplete.

I believe that the current restrictions on routine management or operation of a portfolio company are unnecessary and could result in a significant handicap to our business. Accordingly, I believe that a far broader range of events and business developments should expressly be subject to a private equity investor's approval without such approval being deemed improper participation in routine management or operations.

Examples should expressly include: all matters affecting the financing of a portfolio company; matters affecting the regulatory tax or liability status of a portfolio company; approval of capital expenditures and major expense items; policies regarding the hiring, firing, or setting or changing the compensation of non-executive employees; any transactions with affiliates or related persons; negative covenants relating to any material operations; and the creation of any subsidiary, partnership or joint venture to conduct any part of a portfolio company's business.

These rights are typical of those that private equity funds routinely seek in connection with a minority equity investment in a portfolio company. Indeed, most of them are little different from a covenant that a lender would require. While the joint rules have left the door open that these items may be acceptable on some type of case-by-case basis, the facts are that market circumstances will not wait for regulators to make these determinations; and if we are unable to negotiate for these types of controls on behalf of our managed funds this will undercut our ability to participate most effectively in private equity market.

Another aspect of the way in which the joint rules address routine operations or management that we find particularly troubling is the prohibition on any officer or employee interlock between a financial holding company and a portfolio company at the executive officer level. From time to time, it has been important for us to provide our direct expertise to a portfolio company in a variety of different contexts. Certain situations can require full-time senior assistance in building or restructuring a management team. Investors count on our ability to provide this assistance when choosing to invest in our funds. There is no reason in my judgment why flexibility should not be brought to bear in respect to appropriate senior officer interlocks, and such flexibility would be entirely consistent with the way in which non-financial holding company merchant banking and private equity operations are currently conducted.

The second area I would like mention briefly is the aggregate percent of capital-based investments and related capital charges imposed on merchant banking investments. In light of the fact that my colleagues next to me have addressed this item in substantially more detail than I did, I would like to join in their remarks on these important issues.

My third point, holding periods for private equity investments should be eliminated. The recent amendments to the joint rules should reduce, but will not eliminate, the fire-sale mentality by creating these limits. A simple look at the market circumstances over the past several weeks demonstrates why forced sales and formally limited holding periods could be problematic from an investment as well as a safety and soundness viewpoint.

Private equity is the ultimate buy-and-hold experience, and the profitability of merchant banking activities come from the ability to develop companies over a substantial time period, waiting for the appropriate market windows for exit and liquidity purposes. It seems particularly inappropriate to require prior Federal Reserve staff review of every proposed merchant banking investment holding which exceeds the regulatory maximum and to impose a capital charge for longer term investments. Requiring such a process will only provide an unfair degree of leverage to portfolio companies in dealing with their merchant banking investors if such companies know that an investor could be forced to dispose of its interest or suffer adverse regulatory consequences.

It also dramatically changes the negotiating between the financial holding company seller and the potential buyer who would be smart enough to know the consequences to the seller if it fails to compete the sale. We submit that any abuses associated with holding investments beyond some regulatory benchmark be addressed through the normal supervisory and examination process.

In closing, I very much appreciate the opportunity to raise these points with you. As a senior officer of an entity that until recently functioned outside the Gramm-Leach-Bliley framework, I can appreciate perhaps more than most the significant and potentially harmful impact of the imposition of rules and limitations which, for all of their good and well-appreciated intention, simply do not translate well to the actual operations of the merchant banking bills.

While we greatly appreciate the efforts of the Federal Reserve and Treasury staff to improve the joint rules, we still believe that, even in their current form, they give significant advantages to other non-financial holding company competitors. We do not believe that this was your intention, and we look forward to further dialogue to remedy this situation.

Mr. Chairman, thank you.

[The prepared statement of Peter A. Grauer can be found on page 137 in the appendix.]

Mr. BACHUS. I thank the panel.

Mr. Kabel, one problem on the cross-marketing we have is the Gramm-Leach-Bliley Act does prohibit some of the cross-marketing, but in that I think we have created an inequity, and I think Mr. Baker and I plan to offer an amendment or some legislative proposal to amend Gramm-Leach-Bliley to allow the same cross-marketing abilities to be extended to products or services of portfolio companies held under merchant banking authorities. We are going to address that.

Mr. KABEL. Well, thank you, Mr. Chairman. We certainly support that and would like to work with you on that and promoting it.

Mr. BACHUS. Thank you. We are not sure whether that will fix the problem, but it should, and they say it is a prohibition in the bill. Also, you heard what Mrs. Kelly, you noted that she had questioned Governor Meyer about that.

Mr. KABEL. Actually, the Bank Private Equity Coalition would actually encourage a look again at the statute. I know that it has been stated rather explicitly that there is no discretion, but frankly it would be better if the regulators would look at it again and perhaps review that, and we would ask—we are going to encourage them to do that.

Amending a statute is difficult, and I think people certainly on the panel understand that better than anyone else, but we would hope they would do that. And it has created some difficulty. I think these gentlemen could address that better, but there are certain relationships that they would like to have with online companies and so forth which they can only have if they are an investor, and the cross-marketing restrictions has prevented them from having those relationships.

Mr. BACHUS. Thank you. I think these are the usual kinks that you have with a new act, so I think we will hopefully work through that.

Mr. Grauer, I understand your analysis insofar as it applies to large merchant banking operations such as CS First Boston, but should—or maybe I will ask it, shouldn't we be concerned that loosening up the joint rules in the manner you suggest would be inappropriate for comparatively small financial holding companies of which, by my count, there are more than 400, including 12 in Alabama?

Mr. GRAUER. To the contrary, Mr. Chairman. I think that our suggestions are even more relevant as it relates to the smaller financial holding company operations in their merchant banking operations, that they should be given the same latitude as the larger funds have to be able to conduct their activities regardless of whether they are operating out of a major money center or anywhere else in the country. We think that is both sound investment judgment and also basically good for the economy.

Mr. BACHUS. In fact, the view that I posed is sort of prejudicial toward your smaller companies. Many of them do have that expertise. I do agree with your answer.

I guess the last thing I will say, I have got a minute, Mr. Whaley, one of the things that we have asked the Fed and Treasury to respond to is why aren't all merchant banking investments grandfathered so that financial holding companies and bank holding companies do not have to reconfigure their internal capital allocations for existing activities. We think that is appropriate, so we are responding to that.

Mr. WHALEY. Well, I appreciate that that would be very beneficial to everyone. I mean, it is kind of an issue of fairness in equity, but to have a capital charge after the fact is like a retroactive tax increase, and so I think that it would just be a fairer way to implement the regulation to grandfather existing investments.

Mr. BACHUS. And it could cause profitable investments to become unprofitable. So I would agree with you. I would be interested in their response to that request.

At this time, I would recognize the gentlelady from New York.

Mrs. MALONEY. Thank you, Mr. Chairman.

I understand you were not pleased with the original rules that came out as they affected SBICs in the revised standard. What are your comments on it? Are there any remaining concerns affecting SBIC merchant banking investments of which Congress should be aware, and your comments on their current rules on SBICs.

Mr. WHALEY. The new rules do go a long way with respect to SBICs. They still assess a capital charge to the extent there is more than 15 percent of capital base. In a SBIC, there isn't an incremental charge, and SBICs are also counted in the aggregate total as to whether—as to which level of capital charge is appropriate. So they have improved it quite a bit, but there still is some implicit additional capital charge with larger SBICs.

Mrs. MALONEY. I asked the first group this question, but I would like to hear from the industry what you think about the proposed merchant banking capital rule and how it compares with the new proposed Basel capital standards. Do you have any comment on that?

Mr. KABEL. Mrs. Maloney, if I could comment by way of background, I think all of our institutions have taken the position that we don't feel there is a need for special capital rules period for merchant banking, that existing capital rules standards for the bank holding companies were sufficient to take into consideration the risk. Because we simply do not agree with the proposition that merchant banking investments are riskier. We just simply do not agree with that.

Frankly, I am not an expert of capital of any kind, much less the new Basel, but our position has been, BPEC's position, and it will be again in our comment letter to the Federal Reserve Board on the revised proposed rules, that they should simply utilize internal capital models to the maximum extent possible, which I think most people would agree are very well done. The purpose of these capital models is to reflect the actual risk inherent within the merchant banking portfolio. And then if through the examination process those models are viewed to be inadequate then impose specific capital with the inherent regulatory authority.

Mrs. MALONEY. OK. Thank you very much.

Mr. WHALEY. We would share that view, by the way.

Mrs. MALONEY. Thank you.

Mr. BACHUS. Mr. Baker.

Chairman BAKER. Thank you, Chairman Bachus.

I would like to suggest, Mr. Chairman, that we consider on the principal elements that have been mentioned here today that perhaps you and I and other interested Members, perhaps Mrs. Maloney, consider, although the final rule has been promulgated, a letter of comment concerning some of the obvious deficiencies in the current reg, which would include the routine management definitions, comment on the aggregate limits, certainly including the holding period.

I have before me what the Gramm-Leach-Bliley provisions are with regard to holding period. It is, quote, to enable the deposition thereof on a reasonable basis consistent with financial viability. Now to take that and to translate it into a specific term, as we were repeatedly told earlier that the Congress legislated with regard to these matters, seems to be a bit at contravention with what the language says.

There are a couple of other additional elements I would like to throw on the pile, one of which, with regard to a holding company forming a private equity fund, and you start out with the plan to have only a 20 percent stake and, because of the way the fund is structured, the holding company winds up with a 25 percent stake, that fund then no longer qualifies as a private equity fund. Then you have got to go back to your investors and tell them they are no longer part of a qualifying fund, and you are now subject to these restrictions.

It is just sort of common-sense business formation issues that have no consequence with regard to safety and soundness or risk to the markets.

Second, the area where I have the most difficulty on all of this is things that were previously permissible which now appear to be in contravention of the new rule, under Section 4(c)(6) of the Bank Holding Company Act, bank affiliated firms have made investments under that provision without any risk to safety and soundness historically, that now the agencies have determined or the Fed has determined to apply the new capital charge to those investments which previously had no capital charge against them.

So we have—in my view of the world, we have gone backward, Mr. Chairman, instead of forward in promulgating rules which enable cooperative ventures to benefit the economy and investors. We are now taking a business practice previously authorized that has not presented market risk to my knowledge and saying you will now be subject to the new capital charge which did not previously exist.

I would suggest, Mr. Chairman, that certainly all other matters which you deem appropriate to include in such a letter, that we will try to get Members of both subcommittees to join together in this, I think there are bipartisan concerns that the consequences of this action will deter what this Congress tried to do over longer than a decade to modernize our financial regulatory system.

Mr. Grauer, particularly with regard to your firm's responsibility with the Louisiana State Teachers Pension Fund—you caught my attention when the word Louisiana got thrown in—where you have historically managed minority interest investments for the benefit of that fund, am I understanding that the total assets available to your organization is equal to or exceeds $5 million?

Historically, you have been able to enter into restrictive covenants that had certain restrictions which would enable you to take appropriate actions—"appropriate" being defined as whatever you think it is in order to protect the interest of the individual investing teacher. Am I understanding the rule modification properly, that you would either have that ability now significantly limited or eliminated in making such covenants or agreement with minority investments of the sort you have engaged in?

Mr. GRAUER. We believe the rules have been significantly limited.

Chairman BAKER. Would there be cause of concern for the Teachers Fund to rethink their investment strategy, or what is the outcome of this?

Mr. GRAUER. Each investor, and particularly the Teachers Fund, goes through an extensive due diligence process before they ever commit equity to any capital funds. One of the aspects of that due diligence is to go through and evaluate our track record, both with successful investments and less successful investments; and I think they have satisfied themselves that, as is a professional manager such as ourselves and others, we are not alone in this world by having the ability to move quickly and exercise discretion over these investments. It has gone a long way not only to protecting their investments but maximizing their returns.

I think in the absence of that flexibility we would be looked upon by them much less favorably than perhaps someone who is not subjected to the financial holding company limitation under Gramm-Leach-Bliley.

Chairman BAKER. So you probably feel some obligation henceforward to advise your customer—your client that we have had these changes in law which do not enable us to take certain actions. Consequently, we want you to be aware of this. As a result of our due diligence process that here—now are the rules under which we operate, and it could potentially steer the teachers investment guidance in a different direction.

And, for the record, I am not promoting anyone's private profitability at the expense of the teachers. What I am concerned about is getting the best return for the teachers with the best possible return available.

I don't know if you'll say it, but my summation is the rule unintentionally precludes them from getting the best professional management advice for the return for the teachers.

Mr. GRAUER. We would agree with that.

Chairman BAKER. Thank you. Thank you very much.

Mr. Chairman, I yield back my time.

Mr. BACHUS. Thank you.

Chairman BAKER. I had one other question. There was testimony provided by the SIA which I don't think has been made part of record, Mr. Chairman. It is here. I would like to ask that be made part of the record.

Mr. BACHUS. Without objection, that testimony or letter will be included in the record.

Chairman BAKER. Thank you, Mr. Chairman.

[The information can be found on page 153 in the appendix.]

Mr. BACHUS. Mr. Grauer, the holding period also concerns Chairman Baker and me. You mentioned the necessity of a forced sale or having to unload the investment when equity markets are depressed. I would ask the other two gentlemen, can you see any justification for having a holding period, other than just the broad language of the Act which basically says as long as it is justified?

Mr. WHALEY. I cannot see a reason for having an absolute time limit to hold an investment. It is true that most investments are made and then liquidated within a 10-year period, but there are many circumstances where it makes sense to continue to hold them. Sometimes it is market circumstances that require you to hold them, and sometimes it is in the very best interest of the company that we have invested in for us—it is very disruptive if we go to the company and say, you know what, we have all got to sell our positions because of this regulation. And it is a problem.

Mr. BACHUS. I can see where Uncle Sam would want it so, particularly if it has been successful and it would generate tax revenues. Other than that, I can't imagine.

Mr. KABEL. Mr. Chairman, I think that is an excellent example of using this issue of time period. It is really an issue that should be dealt with through the examination process, as opposed to providing regulatory time periods, whereby, if you bump up against the 10-year period, then you are required to divest. Why not have the regulators look at these investments and ask why an institution is holding an investment for a certain period of time.

There are some investments where there is no market for them. I am not sure what we should do with these investments when the subsidiary bumps up against the 10-year period. There may be absolutely no market for these investments. Often, they have already been written down to zero, and that is part of the process. The advantage of portfolio investing is that the institution invest in a lot of companies and a lot of different industries, and that is why the direct investment subsidiaries, on balance, have been extremely successful.

You can say on an individual basis that an individual investment may be risky, but it is important to remember that these are banks who are doing the investing. These subsidiaries have to report to the bank holding companies, and they are prudently managed. I am not suggesting that the direct investment folks outside of banks are not prudently managed, because they are. It is a very successful business. These are people who really understand what they are investing in, and they understand how to add value to the companies in which they are investing.

Chairman BAKER. Mr. Chairman, can I jump in on that point?

Mr. BACHUS. Yes.

Chairman BAKER. I just want to make sure I understand the operative conditions under which the 10-year disposition rule works.

Let's assume you have a holding you have had for 9 years and 4 months. You know the rule requires to dispose. So you go into the market. The other guy figures this out. Maybe he is not quite so anxious to close. Maybe the terms change. Something happens. It is not to your best financial interest.

You then procedurally could go to the Fed and apply for an extension, but even if the extension were granted you would then have to have a 25 percent capital charge against the holding until you disposed of the asset. So that then drives down your margin or you have got to increase your price in order to dispose of the asset on the terms in which you originally contemplated. Are those facts close?

Mr. KABEL. It is my understanding that is correct.

Mr. WHALEY. That is correct.

Mr. KABEL. That is exactly what happens.

Chairman BAKER. So at the end of the day you have an arbitrary window. If it is a profitable center, you probably do not want to get rid of it. But yet if you are going to the market any time near the duration is coming to an end—if I was on the other side I would certainly like to have you in that position, knowing that if you didn't take my deal on the terms I suggested you will take the capital hit and then we will talk then. I love that.

Mr. GRAUER. Mr. Chairman, just as a point of clarification I think that capital charge could be as high as 100 percent.

Chairman BAKER. I am told it was at 100, but it was reduced in the modification. It could go down to as low as 25. Apparently, this is another one of those David Copperfield things. We don't know where it is.

Mr. BACHUS. Thank you.

I will ask a general question of the panel, and it may give you an opportunity to expound on some of the comments of the first panel, too.

I think underlying all this is the continuing debate on how safe are your activities and do they threaten the safety and soundness of your institution. Given the current economic conditions, how do you respond to the regulators' concern that merchant banking activities, if not subjected to close regulatory scrutiny and stringent capital requirements, could jeopardize the safety and soundness of those institutions that conduct such operations? How have merchant banking investments generally fared in comparison with other types of banking activities during tough economic times?

We will just go from right to left.

Mr. GRAUER. I will make a stab, and my colleagues will elbow me if I am talking too long or perhaps getting off the point.

One of the things that we do, and I think all of us in the private equity business do, is when we—prior to making an investment we do an extensive amount of research on how we think the portfolio company will behave in different economic environments. And as we see those environments develop, either we are in them or we expect that they will occur, we try to capitalize our companies so they can weather the storm that occurs as a result of their business suffering through an economic downturn.

So invariably there are some companies in all of our portfolios that don't do as well as others, but, by and large, most of them have been capitalized, particularly if those are businesses that are subject to economic cycles such that they will be able to come through those cycles with solid cash flow, the ability to service their debt, meet their payroll and fulfill all the various obligations to their constituents.

So, number one, we try to plan for that ahead of time as we do the evaluation for each new investment that we look at. Number two, we also, once we are in an investment, try and take considerable care as we go through each annual operating plan cycle to look at the more macro-economic events that are in front of us and again try to batten down the hatches to the extent we need to by downsizing the expense base to the extent we have to, shutting down our capital expenditure programs to preserve cash and do various other things to ensure that we can get through the economic cycle.

So those of us who have been in the business for a long time, such as firms as my own, we have been doing this for over 16 years, we have been through a number of economic cycles, and I think we have prepared our portfolio to go through those economic cycles successfully. I think that is one of the factors that is not brought to bear in the kind of broader analysis that occurs in preparing legislation like Gramm-Leach-Bliley where perhaps the level of professional investment expertise that each one of the major merchant banking firms have exercised and developed over the years is not necessarily taken into account. It is a business that clearly has risks associated with it, but certainly as professional managers we do our darnedest to be able to take those risk out of the equation day-in and day-out.

Mr. BACHUS. Thank you. I would note for the record that we have your resume, and it firmly establishes that you have been very successful in making these investments and that you certainly have the background to testify and to be an expert witness.

Mr. GRAUER. Thank you, Mr. Chairman.

Mr. WHALEY. That was very well said, Peter.

I would just add to that the fact that, at Norwest, we have been in the private equity investment business for close to 40 years now, which includes a number of upcycles and downcycles, and you learn to manage through those cycles really doing the kind of things that Peter alluded to. How that performs relative to other banking assets, I can't really respond succinctly to that, other than to say that there was a lot of discussion earlier today about risk and how you manage that risk. And it isn't the riskiest class of assets that banks have. I think risk is only half the equation.

You have to look at the risk return situation, and I think we would be much more interested in managing a portfolio of 25 equity investments, as opposed to 25 senior loans that are fully collateralized. Because you have less risk in the loan that is fully collateralized. You don't make a lot of money on a loan. You make a net interest margin, whereas in the private equity business you have the opportunity to make a number of times on your investment; and, on balance, I think that it affords the opportunity to make more money and make a more meaningful revenue stream for the bank holding company.

Mr. KABEL. Mr. Chairman, I don't have much to add. These gentlemen have been in the business for many years.

But each member of the Bank Private Equity Coalition is similarly situated in that they have all been in the business for many, many years. They have well-diversified portfolios, and they do understand how to manage risk. That is why they have been so successful.

The regulators often during the course of the lengthy process—during the process leading up to Gramm-Leach-Bliley and certainly subsequently would say to my members, we are really not concerned about you. We are concerned about people entering the business.

I can appreciate that. But, again, I fall back—the Federal Reserve examiners are excellent regulators. They understand how to look at portfolios. They understand how to talk to the executives of the organizations about what they see.

So, again, I think we fall back on the fact that there was a system in place that was working. We promoted the specific merchant banking language in the Gramm-Leach-Bliley Act because we wanted in the statute a section that talked about classic portfolio investing that is exactly what the Gramm-Leach-Bliley provisions provide. That is why when we get into the definitional issues is where we are clearly running into problems. But we wanted that statutory provision because of some of the problems we have seen through the examination process over a period of years where examiners had different views as issues.

The classic example that was often brought up was, depending on where you were situated in the country, you either could or could not have a member of a board of directors if you were an investor. I think anyone who looks at that objectively for safety and soundness would say, of course you want to have a member of the board of directors. The board of directors members are the ones who learn of the information first to know whether there is a problem.

So that has been taken care of. Clearly, that is one of the advantages of having this provision enacted as part of Gramm-Leach-Bliley. And I think just over a period of time hopefully we will be able to work our way through a lot of other issues hopefully in dealing with the Congress and hopefully in dealing with the regulators.

Mr. GRAUER. Mr. Chairman, if I could add one other thing. That is, particularly as it relates to some of the restrictions that I talked about under the new legislation on our ability to act in both majority and minority investments, in addition to the analytical framework that I described that we applied both before and as we look at investments, we monitor our portfolio companies literally on a monthly basis and in some instances on a weekly basis, depending on what they are doing, what kind of capital they are spending and what we think the cash flow implications of that are.

We oftentimes will make changes. We will move in very quickly to do things. That is largely because we have consummated over the last 16 years over $50 billion worth of acquisitions. We have put to work over $5 billion worth of equity capital, over $7 billion of equity and no capital. We have dealt with some 160 investment opportunities over that period of time where we have had a portfolio shareholder interest.

As a consequence, the same way you and your colleagues structure the legislation and other things that you do day-in and day-out both for your constituents and for our country, we do the same thing with our portfolio companies. And having either one hand or two hands tied behind our back and limiting our ability to do that we are not serving our constituents, people like the Louisiana teachers and the retirees that exist in that system, properly.

I want to say one other point before we give up our time. We in your number of the 29 States that are represented on your two subcommittees, we manage a retirement system capital for 10 of those States. We manage today—of the $22 billion of assets that we have under management—roughly 50 percent of that capital comes from the public pension fund retirement system, either public employees in the case of Utah—excuse me, in the case of Louisiana, it is the teacher system. In the case of Utah, who we manage over $800 million for, it is the public employee retirement system.

We do the same thing for the States of Arkansas, Connecticut, California, Illinois, Massachusetts, Michigan, North Carolina, Pennsylvania, just so mention some of the representatives who are in your committees.

We have to have the ability to make decisions and make those decisions on an unfettered basis not only to protect your constituents but also to generate the kind of rates of return that we expect our investors have put their monies with us as a fiduciary to accomplish.

Mr. BACHUS. Thank you.

Chairman Baker.

Chairman BAKER. Mr. Chairman, I have no further comments. Thank you for your courtesy.

Mr. BACHUS. Ranking Member Waters had indicated she had no questions.

Ms. WATERS. No, I have no questions. I thank you. I did not have an opportunity to thank you for making sure that your subcommittee joined in to have this combined hearing, and we got a lot of information from it. Thank you.

Mr. BACHUS. Thank you.

Finally I will just conclude, Mr. Kabel, we appreciate your comment about whether or not Gramm-Leach-Bliley does, in fact, prohibit cross-marketing that we have talked about. I know Mrs. Kelly's question presupposed that it did. We will go back and take a look at that. She had suggested that a regulation could possibly take care of that interpretation, that concern.

So, with that, if any of you gentlemen want to make a final comment, we would invite it. But I think we have a wonderful record. I think we will close at this time.

Mr. KABEL. Thank you very much.

Mr. WHALEY. We appreciate your leadership on this whole process. It has been very helpful from our end.

Mr. BACHUS. Chairman Baker particularly has expressed his concerns for over a year, which you all have concerns, and has alerted me to these concerns. So this won't be the end of the story. Thank you.

Mr. WHALEY. Thank you.

Mr. BACHUS. The hearing is adjourned.

[Whereupon, at 1:20 p.m., the hearing was adjourned.]

A P P E N D I X

April 4, 2001

EXCHANGE
Subcommittee on Capital Markets
Richard H. Baker, Chairman
Securities, Insurance, Government-Sponsored Enterprises

The News from U.S. Rep. Richard H. Baker
Sixth District, Louisiana
FOR IMMEDIATE RELEASE: April 4, 2001
CONTACT: Michael DiResto, 225-929-7711

Opening Statement
The Honorable Richard H. Baker
Chairman, House Financial Services Subcommittee on
Capital Markets, Insurance and Government Sponsored Enterprises
April 4, 2001
Joint Capital Markets-Financial Institutions Subcommittee Hearing
On Merchant Banking Rules

I would like to commend Chairman Bachus for taking such an active interest in this issue. I would also like to express my appreciation to our witnesses who have taken the time to testify before us today.

During the enactment of Gramm-Leach-Bliley, Congress went to great lengths to create a two-way street between banks and securities firms so that the financial regulatory structure would better reflect the realities of modern financial markets. An important part of the two-way street is the authority granted by the Act for financial holding companies (FHCs) and bank holding companies (BHCs) to conduct merchant banking investment activities.

Merchant banking -- private equity fund and direct equity investment in companies -- is a vital part of our economy. The funds provided through such investments can be the seed money for the new coffee shop on the corner or the latest biological research firm. They are also used by established companies to expand or restructure. In either scenario, merchant banking investments foster and reward innovation, create new jobs, and contribute to the country's economic growth.

Many financial institutions have been conducting merchant banking activities for decades prior to the Gramm-Leach-Bliley Act under a number of pre-existing authorities. Merchant banking portfolios have consistently performed well over the long term through both good and bad economic conditions.

The investors in these activities are not just the high net-worth clients and corporate giants. In fact, the largest merchant banking investor in the United States is represented here today in Credit Suisse

First Boston. I have been informed that 50 percent of their investment in merchant banking activities is placed for public pensions, including $530 million from the teachers' pension fund of Louisiana.

It is incumbent upon government to promote the availability of this valuable source of capital to American businesses. I had serious concerns last year when the Federal Reserve and Treasury issued the initial rules on merchant banking activities and capital requirements that the rules contradicted the spirit and intent of the Gramm-Leach-Bliley Act. While the Federal Reserve and other regulators have gone a long way to improve the merchant banking rules that were issued last spring, I still question whether a special capital rule and restrictions on merchant banking investments are necessary.

I look forward to the testimony of our witnesses here today so that we can better understand the policy behind the final rule and the revised proposed capital rule. I am also interested to hear how the rules could be improved. If these rules truly act as an obstacle to merchant banking investments by FHCs and discourage securities firms from choosing FHC status, we must determine whether the regulators should reconsider the need for the rules and whether there is a need to examine the possibilities of legislative remedies.

Rep. Spencer Bachus
Chairman
Subcommittee on Financial Institutions and Consumer Credit
Hearing on Merchant Banking
April 4, 2001

Thank you, Chairman Baker, for convening this joint hearing of our two subcommittees to review the revised merchant banking rules recently published by the Federal Reserve and the Department of the Treasury.

One of our Committee's central responsibilities in this Congress will be overseeing regulatory implementation of the historic Gramm-Leach-Bliley financial modernization legislation enacted by the last Congress. Among the issues that will need to be addressed are the far-reaching financial privacy regulations scheduled to go into effect on July 1, and a more recent regulatory proposal that would permit banks, through financial holding companies and financial subsidiaries, to engage in real estate brokerage and management activities.

Though the privacy and real estate rules are of greater interest to individual American consumers, the merchant banking rules first proposed in March of last year have enormous consequences for the financial services industry and for the capital formation process that helps fuel our economy. Private equity placements and venture capital investments provide critical seed money for America's entrepreneurs, whose creativity and energy have helped make the U.S. economy the envy of the world.

I was one of those Members who felt that, as originally proposed by the regulators last March, the merchant banking rules were deficient in several important respects. Particularly troublesome was the requirement that financial holding companies hold 50 cents in capital for every dollar of equity investment in non-financial companies. By setting the capital threshold so high, the original capital rule served as a huge disincentive for any investment banking firm thinking of partnering with a depository institution under the financial holding company structure established by Gramm-Leach-Bliley.

To their credit, the regulators took the criticisms of their original proposal to heart, and have come back this year with rules that clearly move in the right direction. Most importantly, the revised proposal replaces the rigid 50 percent capital requirement with a more flexible "sliding scale" approach that increases (or decreases) the capital charge imposed on merchant banking investments in direct proportion to the concentration of such investments in an institution's portfolio.

But acknowledging that a bad proposal has been made better is not the same thing as concluding that the proposal was a good idea in the first place. In my mind, the Federal Reserve and the Treasury have simply not met their burden of proof in demonstrating that additional regulatory requirements are needed in the merchant banking arena.

Banking organizations have been making private equity investments pursuant to other statutory authorities since well before Gramm-Leach-Bliley was enacted, and have done so profitably and seemingly without loss to individual institutions, depositors, or the system as a whole. This track record strongly suggests that bank regulators already have the legal tools needed to effectively supervise merchant banking activities of financial holding companies and bank holding companies without these new rules.

Even with the welcome improvements made by the regulators, the revised merchant banking rules still place financial holding companies at a decided competitive disadvantage in relation to firms that choose to operate outside of that structure. Such a result cannot be squared with the congressional intent evidenced by Gramm-Leach-Bliley, which was to encourage - not actively impede - affiliations between securities firms and banks. This regulatory initiative before us greatly concerns me.

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OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE PROMOTION OF CAPITAL AVAILABILITY TO AMERICAN BUSINESS

WEDNESDAY, APRIL 4, 2001

Mr. Chairman, thank you for the opportunity to speak before we begin today's hearing on the promotion of capital availability to American business. As the Ranking Democratic Member on the Capital Markets Subcommittee, I want to maintain the competitiveness of our nation's capital markets. These resources help American businesses to compete in the international marketplace. They also help our nation to remain productive, providing better jobs at higher wages for American workers and improving the quality of life for American families.

It is therefore appropriate and constructive for us to hold a hearing at this time on the two revised merchant banking rules issued by our nation's financial regulators earlier this year. These proceedings will help us to determine whether these regulations run counter to the purposes of the Gramm-Leach-Bliley Act or whether they capture the essence of the law's intent.

During the debates over the modernization law, one of the most contested issues was the extent to which we should break down the legal barriers that separate banking and commerce. In Japan, the intermingling of these sectors via cozy *kieretsu* combinations probably contributed to the great inefficiencies that first produced the economic disorder in their banking system in the 1990s which continues today. Ultimately, Congress learned from these experiences and we enacted a law that maintains firewalls between banking and commerce.

A closely related issue that we examined in the overhaul of the financial services industry concerned merchant banking, which refers to commercial banks' equity investments in non-financial firms. In our deliberations, we recognized the importance of merchant banking in providing equity capital to the private sector, but decided that for at least five years only units of financial holding companies could engage in such activities. The law consequently permits these units to acquire equity investments in non-financial companies and to sponsor equity funds provided that they limit their ownership positions and that they lack day-to-day management control in these investments.

In March 2000, the Federal Reserve and the Treasury Department issued interim and proposed regulations to implement the merchant banking provisions of the modernization act. These proposals generated considerable debate among affected parties and in the press. Of particular concern to me -- as well as to many of my Democratic colleagues -- was the effect of the proposals on Small Business Investment Companies or SBICs, which bring important capital resources to small businesses and the communities in which they operate.

Because commercial banks represent the largest source of the SBIC program's private funding, concerns arose that provisions contained in the merchant banking rulemaking, such as the proposed 50 percent capital charge on all equity investments, would have constricted the availability of financial resources for small businesses. During our Subcommittee's prior hearing on the interim rules, I expressed considerable concerns about the consequences of the proposal on SBICs, and I urged the regulators to create a limited carve-out under their merchant banking rules for such investments. To their credit, the regulators responded to many of my concerns when issuing a revised capital proposal for non-financial equity investments in January 2001.

As I noted earlier, in passing the Gramm-Leach-Bliley Act, we maintained the firewalls preventing the indiscriminate mixing of banking and commerce. From my perspective, it remains very important for our federal financial regulators to strike an appropriate balance between allowing financial holding companies to engage in merchant banking activities and insulating commercial banks, which carry federal deposit insurance, from the associated risks.

In closing, Mr. Chairman, my colleague in the other body, Senator Paul Sarbanes of Maryland, perhaps said it best when he noted that the financial modernization law gave the Federal Reserve and the Treasury the ability to jointly develop implementing regulations on merchant banking activities to "define relevant terms and impose such limitations as they deem appropriate to ensure that this new authority does not foster conflicts of interest or undermine the safety and soundness of depository institutions or the Act's general prohibitions on the mixing of banking and commerce." Although I generally agree with his assessments, I believe it equally important that we at least learn more about the views of the parties testifying before us today and, if necessary, work to further refine and improve the merchant banking regulations in the future.

Statement of Congresswoman Sue Kelly
House Committee on Financial Services Joint Hearing of The Subcommittee on Capital Markets and The Subcommittee on Financial Institutions on The Promotion of Capital Availability to American Businesses
Wednesday, April 4, 2001 at 10:00 a.m. in 2128 Rayburn

I want to thank Chairmen Baker and Bachus and Ranking Members Kanjorski and Waters for agreeing to hold this important hearing on the promotion of capital availability to American businesses. This issue revolves around a large source of capital to many businesses, and as we know capital is the lifeblood of industry. As the Chairwoman of the Oversight and Investigations Subcommittee this issue is high on my list of priorities and I am pleased that you all share my interest.

As we are all aware, in March 2000 the Federal Reserve and Treasury issued two rules for financial holding companies which contained provisions that ran contrary to the language Congress agreed to as part of the Gramm-Leach-Bliley Law. In particular, I was concerned by the 50 percent capital charge on all merchant banking activities and I believe that the cross marketing restrictions were too severe. I feared that the capital charge would force divestment by some banks of sound investments which could in turn have negative effects on the economy.

I was pleased to see that the final rule, issued January 2001, eliminated the hard dollar cap, removed some of the automatic penalties associated with holding investments over the time limits set by the rules and relieving some of the cross marketing restrictions.

While this was a good step in the right direction, I believe the Federal Reserve should go further. The rule seems to neglect to take into account the sophisticated internal risk modeling mechanisms banks employ to assess the risks inherent in merchant banking activities and the new and existing powers for bank examiners analyzing merchant banking activities. These are the areas I will focus on for this hearing.

I want to thank our witnesses for taking the time to join us here today to share their considerable knowledge on these issues and I look forward to discussing these issues with them.

I yield back the balance of my time.

Opening Statement
Chairman Michael G. Oxley
House Financial Services Committee

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises/ Subcommittee on Financial Institutions and Consumer Credit

Promotion of Capital Availability (Merchant Banking) Hearing

I want to thank Chairman Baker and Chairman Bachus for holding this important hearing and for their commitment over the last year to seeing that the rules we examine today do no harm to the promotion of funding of American businesses. It is essential that government do all in its power to encourage the availability of investment capital to businesses rather than construct obstacles to the free flow of capital.

To this end, the 106th Congress passed the Gramm-Leach-Bliley Act to streamline financial services regulation to better reflect the modern financial marketplace. An important part of the Act is the authorization given to financial holding companies and bank holding companies to conduct merchant banking investment activities. This authorization sought to level the playing field so that banks would not be at a disadvantage relative to securities firms in the merchant banking arena.

Merchant banking investment is a vital source of funding for private equity funds and venture capital activity. These funds are used as seed money for new businesses and to fund the growth and reorganization of existing firms. All types of businesses tap the private equity funding market, from the smallest corner shop to the publicly traded industrial giants.

The interim rule and proposed capital rule governing merchant banking activities of FHCs and BHCs issued by the Federal Reserve Board of Governors and Treasury in March of last year seemed to perpetuate just the obstacles to merchant banking investments by banks that the GLBA attempted to avoid.

The Fed, Treasury, OCC and FDIC should be congratulated for taking a more flexible approach with regard to capital requirements and for easing some of the restrictions in the interim rule that has now been finalized. Notably, the exemption from the capital charge carved out for Small Business Investment Corporations is an important change that will promote the funding of small businesses and the creation of jobs.

Despite the great steps taken to improve the initial rules, financial services firms continue to express some legitimate concerns regarding the final rule and the revised proposed capital rule. As the provisions of Gramm-Leach-Bliley are implemented, it is incumbent upon this Committee to conduct oversight to ensure that regulations do not contradict its purpose.

This hearing is an opportunity to openly discuss how the new rules might affect the financial services industry and the businesses they fund. It is an opportunity to suggest ways in which the rules might be further improved. Also, we'll explore whether any legislative action is necessary to ensure that the two-way street for banks and securities firms remains open as envisioned in Gramm-Leach-Bliley.

I thank each of our witnesses for coming today to discuss this issue, and I look forward to your testimony.

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CONGRESSWOMAN WATERS' OPENING STATEMENT

Good morning, Mr. Chairman, I am pleased to have the opportunity to speak about the promotion of capital availability to American businesses. As the Ranking Member of the Financial Institutions Subcommittee, I believe we have a duty to oversee the regulations implementing the merchant banking provisions of the financial modernization legislation that became law last Congress. I also believe that it is important for us to monitor the expansion of merchant banking activities themselves to ensure that the regulations are appropriate to carry out the intent of the Gramm-Leach-Bliley Act.

I understand that the final revised rules address a number of industry concerns that were voiced about the original interim rules. I am pleased that the provisions governing the Small Business Investment Corporations will ensure the continued ability of banks to invest in SBICs, benefitting small businesses as well as the communities they serve.

Regarding the larger issue of merchant banking in general, there must be sufficient oversight of these activities. We have a responsibility to limit the risks inherent in merchant banking, and not sacrifice safety and soundness in the haste to expand these activities too rapidly. This intent is crystal clear in the statutory language of the Gramm-Leach-Bliley Act.

The legislation did permit financial holding companies to engage in merchant banking activities. However, the bill imposed a series of prudential restrictions on the conduct of the merchant banking activity. It required that the merchant banking activity be conducted in an affiliate of the depository institution, rather than in the depository institution itself or a subsidiary of a depository institution.

It also required that merchant banking investments be held only for a period of time long enough to enable the sale or disposition of each investment on a reasonable basis. Furthermore, the legislation restricts the ability of financial holding companies to routinely manage or operate companies held under the merchant banking authority.

Finally, the legislation specifically granted the Federal Reserve and the Treasury broad authority to issue joint regulations implementing the merchant banking activities. Merchant banking was singled out as the only one of the nine activities listed in the legislation as "financial in nature" to receive an explicit grant of authority to the regulators to issue regulations. Moreover, the Federal Reserve retains its authority under the Bank Holding Company act to set capital standards for bank holding companies, which include financial holding companies.

The legislation also explicitly prohibited cross-marketing between the depositary institution and merchant banking portfolio companies acquired under the new authority. I understand that there are some members of the industry that would like this provision changed, but the law is clear on this point and should not be undermined through additional changes in the regulations.

While I understand that the industry is concerned about the ability of American banks to compete in the global marketplace, we certainly do not want to model our banking policy after the Japanese system, which serves as an example to all of what can happen when the separation between banking and commerce is breached. I believe these regulations will not prove to be unreasonably burdensome, and will fulfill the clear Congressional intent to ensure adequate oversight of merchant banking activities.

During the consideration of the financial modernization legislation, Federal Reserve Board Chairman Alan Greenspan testified that of the nonbanking activities permitted in various versions of H.R. 10, merchant banking should be viewed as the most risky of those activities. With that in mind, I look forward to hearing the views of the witnesses and thank you in advance for your testimony.

Statement of

Laurence H. Meyer

Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

and the Subcommittee on Financial Institutions and Consumer Credit

of the Committee on Financial Services

United States House of Representatives

April 4, 2001

I am pleased to appear before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit to outline the rules recently adopted jointly by the Federal Reserve Board and the Secretary of the Treasury to allow financial holding companies to engage in merchant banking activities under the Gramm-Leach-Bliley Act. I will also discuss the proposal recently published by the Federal Reserve, the OCC and the FDIC to establish regulatory minimum capital requirements for equity investment activities conducted by banking organizations.

When I last appeared before this Subcommittee to address the topic of merchant banking, the Board and the Department of the Treasury were in the middle of considering comments on rules we had proposed only recently before the testimony. As I indicated at that time, our experience has been that public comments are generally very helpful, and provide us with valuable insights and information from practitioners, analysts, other policy makers and informed members of the public.

That is in fact what happened in this case. The Board and the Treasury received a significant amount of useful information and comment that led us to revise in some important respects the rules that implement the merchant banking powers in the Gramm-Leach-Bliley Act. The comments also caused the Board to rethink and revise our proposed capital treatment for equity investment activities. We have also consulted with our fellow banking agencies regarding the appropriate capital treatment for equity investment activities. As a result of the comments and those interagency consultations, we have significantly revised our capital proposal and again sought public comment on a proposed capital approach. The comment period on that proposal is open until April 16.

Before discussing the merchant banking rule and the capital proposal, I will outline both the final rule that we and the Secretary of the Treasury adopted to implement the merchant banking provisions and the revised capital proposal. Let me start with some background that I hope will help put both what we did and what we have proposed in context.

A. The Gramm-Leach-Bliley Act.

The Bank Holding Company Act generally prohibits bank holding companies from owning more than 5 percent of the voting stock of non-financial companies, with limited exceptions. This prohibition was included in the Act in 1956 and extended in 1970 because Congress has long been concerned that the mixing of banking and commerce could result in a number of adverse effects. Among the concerns are that mixing banking and commerce could result in concentration of economic power in a few large conglomerates, less stringent credit standards for and higher risk exposures to affiliates, less attractive credit terms to unaffiliated commercial firms, and other similar conflicts of interest, all of which could reduce the availability of credit to unaffiliated companies and create greater risks to the federal deposit insurance funds and ultimately the taxpayer.

The Gramm-Leach-Bliley Act did not remove this general prohibition. In fact, as part of the consideration of that Act, Congress considered and rejected the idea of allowing banking organizations to affiliate broadly with commercial firms.

At the same time, Congress recognized that there are some forms of ownership of commercial firms by banking organizations that are the functional equivalent of financing for small businesses. It was on this basis that Congress authorized financial holding companies to engage in merchant banking activities.

Toward this end, the GLB Act contains several provisions in its authorization of merchant banking activities that are designed to distinguish merchant banking investments from the more general mixing of banking and commerce. In particular, the GLB Act defines permissible merchant banking investments as investments that meet two important requirements: the investment may only be held for a period of time to enable the *resale* of the investment, and, while the investment is held by the FHC, the investing FHC may not routinely manage or operate the commercial firm except as necessary or required to obtain a reasonable return on the investment on resale.

In addition, the GLB Act imposed limits on bank funding of portfolio companies owned by the bank's parent holding company and on cross-marketing activities between banks and portfolio companies owned by the same financial holding company. These restrictions were also intended to reinforce the separation between banks and the commercial companies owned in reliance on the new merchant banking authority.

B. Summary of the Final Rule governing Merchant Banking Activities.

The final rule adopted by the Board and the Treasury in late January of this year focuses on defining these two important restrictions. In addition, the final rule explains the types of risk management policies, procedures and systems that the agencies expect will be in place at FHCs that engage in merchant banking activities, and the manner in which the cross-marketing restrictions and inter-affiliate lending restrictions imposed by the GLB Act apply. Finally, the rule temporarily establishes an interim procedure for agency review of a FHC's risk management policies and systems in the event the organization seeks to commit a significant portion of its capital to merchant banking activities.

Together, these provisions are important for maintaining the difference between merchant banking activities and the authorization of banking and commerce within the same organization. They also support the important objective of encouraging the safe and sound exercise of the new merchant banking authority.

As I suggested earlier, the final rule was modified in several important respects from the original interim rule that was the subject of my testimony last June. These changes reflect insights and suggestions made by commenters that we believe improve the workability of the rule while maintaining the differences required by the GLB Act and the BHC Act between merchant banking, on the one hand, and banking and commerce, on the other. Critically, the final rule also does not sacrifice the safety and soundness benefits of the rule. I will point out the most significant changes between the interim rule and the final rule in my remarks.

The final rule provides guidance on the GLB Act's requirement that merchant banking investments be held only for a period of time long enough to enable the sale or disposition of each investment on a reasonable basis. Generally, the rule permits a 10-year holding period for direct investments and a 15-year holding period for investments in private equity funds. The Board may approve a longer holding period on a case-by-case basis.

Many commenters acknowledged that merchant banking investments are rarely held beyond these periods and, in fact, are typically sold within 3 to 5 years after the investment is made. The longer holding periods permitted in the final rule allow some flexibility for FHCs to adjust their investment exit strategies to account for fluctuations in market conditions.

While some commenters advocated no restrictions on holding periods, this approach did not appear to be either suitable or workable. The GLB Act itself contemplates that investments would not be held indefinitely, and the agencies believe that it is better to establish a regulatory safe harbor that gives assurance regarding holding periods, and thereby allow FHCs to plan their investment strategies, than for the agencies to forego providing regulatory guidance and impose decisions on holding periods for each investment on an ad hoc basis through the supervisory process. The uncertainty and potential for reaching different decisions regarding holding periods as different supervisors examine competing banking organizations would frustrate planning by investing companies and, we believe in the end, lead to a firm rule in any event. To accommodate situations in which the regulatory safe harbor is not sufficient in an individual case, the final rule allows financial holding companies to seek approval, when events require it, to hold an investment longer than the periods established in the rule.

As I noted earlier, the GLB Act restricts the ability of FHCs to routinely manage or operate companies held under the merchant banking authority. The final rule contains several safe harbors and examples of routine management and operation. For example, the final rule allows representatives of a FHC to serve on the board of directors of a portfolio company without running afoul of the routine management restrictions. In addition, a FHC may enter into agreements that restrict extraordinary actions of the portfolio company, such as the sale of major assets or acquisition of other companies, without the approval of the investing company. Director interlocks and agreements that govern extraordinary transactions are common in connection with merchant banking investments and allow the investing company to monitor its investment and the activities of the portfolio company without becoming involved in the routine management or operation of the company.

The final rule also identifies several situations that would be considered restricted routine management of the portfolio company. In particular, a FHC would be considered to be routinely managing or operating a company if an officer or employee of the FHC is also an executive officer of the portfolio company. In addition, agreements that restrict decisions made in the ordinary course of the business of the portfolio company are considered to be routine management of the company, and thus, are permitted by the final rule only in special circumstances.

The interim rule originally provided that any type of officer or employee interlock between a FHC and a portfolio company would be considered to involve the FHC in routinely managing the portfolio company. Commenters argued that employee interlocks may allow FHCs to share expertise--both giving and gaining--with portfolio companies without becoming involved in the routine management or operation of the company.

In response to commenters, the final rule has been modified from the interim rule to convert its absolute prohibition into a rebuttable presumption. This provides a mechanism for allowing a specific employee and junior officer interlock in the limited situation where the interlock does not rise to the level of routine management or operation of the portfolio company.

The GLB Act allows an investing FHC to routinely manage or operate a portfolio company in special circumstances when intervention is necessary or required in order to enable the investing company to obtain a reasonable return on the investment on its resale or disposition. The final rule adopts this statutory standard. For example, a FHC may become involved in the routine management of a portfolio company to avoid or address a significant operating loss or in connection with a loss of senior management at the portfolio company. The final rule also replaces the interim rule's requirement that a FHC obtain Board approval to routinely manage a company for more than six months, with a provision that the FHC provide the Board with notice in the event that the FHC routinely manages a portfolio company for more than nine months. This notice provision will allow the Board to monitor management interventions to assure compliance with the limitations in the GLB Act and the final rule.

The final rule also contains several provisions that are designed to encourage the safe and sound conduct of merchant banking activities. In particular, the final rule requires that FHCs establish policies, systems and procedures to monitor and address the risks associated with their merchant banking activities. The final rule provides FHCs with significant discretion in formulating the policies, systems and procedures that best fit the management style of the FHC and the type, scope and nature of the FHC's merchant banking activities. The Board recently issued supervisory guidance that outlines some of the best practices employed by merchant bankers for managing the risks of equity investment activities. That guidance has been well received by the industry as useful and flexible.

The final rule also generally requires that FHCs retain records sufficient to allow the FHC to monitor and assess the risks and exposures associated with their merchant banking activities. The final rule allows FHCs to assemble the records that best fit these purposes, and contemplates that FHCs may satisfy these requirements with the types of records and reports kept in the ordinary course of conducting merchant banking activities. The final rule does not adopt the provision of the original interim rule that required these records to be maintained at a central location. FHCs must already make all of their records, including their merchant banking records, available to the Federal Reserve in the examination process.

The interim rule included two reporting requirements for FHCs engaged in merchant banking activities. One was a relatively brief quarterly report of the gross amounts of investments made by the FHC, and the other required annual reporting of investments that were held for a substantial period--seven years or longer. The final rule does not include either of these reporting requirements. A limited amount of information regarding equity investments is already collected by the banking agencies on existing regulatory reports. The Board is in the process of developing other reports that would focus on collection of additional basic information regarding equity investment activities, such as the total amount invested in and carrying value of privately owned securities and publicly traded shares owned by the banking organization, and on individual merchant banking investments held for extended periods. The Board will separately invite public comment on any new reporting requirements in the near future.

The interim rule contained two thresholds that triggered agency review of FHCs that devote significant amounts of capital to merchant banking activities. These thresholds--one triggered when total merchant banking investments exceed the lesser of $6 billion or 30 percent of the FHC's Tier 1 capital, and the other triggered when the direct investments of a FHC excluding investments in private equity funds exceed the lesser of $4 billion or 20 percent of the FHC's Tier 1 capital--were designed to allow the Board to ensure that FHCs that devote significant amounts of capital to merchant banking activities had in place the types of risk management policies, procedures and systems to conduct these activities safely and soundly. The Board and the Treasury indicated that they would review the continued need for these thresholds when a final capital requirement for merchant banking activities was adopted.

Even though these thresholds were high and applied only to the newly authorized merchant banking activities, these thresholds were very controversial and were viewed by many commenters as, in effect, caps on their merchant banking activities. Consequently, commenters strongly urged the agencies to eliminate this review process, or, at a minimum, to remove the component of the thresholds that was based on the absolute dollar size of the FHC's merchant banking portfolio.

The agencies continue to believe that capital and strong risk management policies and procedures provide the best protection for FHCs that engage in merchant banking activities. Consequently, in line with the comments on this matter and the intent behind the original proposal, the final rule takes two steps. First, the absolute dollar thresholds in the interim rule were eliminated from the final rule. Accordingly, the thresholds are triggered only when merchant banking activities are at high proportions to the FHC's capital. And recall, the thresholds trigger an agency review process--they are not an absolute cap on activity.

Consistent with the original proposal, the final rule also contains a sunset provision that automatically eliminates the entire threshold review process once the banking agencies have implemented final rules governing the capital requirements for merchant banking activities. As I'll discuss in a moment, the agencies have already jointly proposed a new capital treatment for public comment, and are working toward adopting a final capital rule. I should note also that the thresholds may be exceeded with Board approval.

and one experienced investment firm has already reached the thresholds and received Board approval to exceed the thresholds.

The GLB Act contained two provisions that govern the relationship between depository institutions and portfolio companies owned by the same FHC: one prohibits cross-marketing activities and the other restricts credit and other funding transactions. Both are contained in the GLB Act to reinforce the separation between banking and commerce. The prohibition in the GLB Act on the ability of a depository institution controlled by a FHC to cross-market its products and services with a portfolio company that is held under the merchant banking authority is included in the final rule. The final rule also clarifies that this cross-marketing restriction does not prevent a depository institution from marketing the shares of private equity funds controlled by an affiliated FHC, and does not apply to situations in which the FHC owns less than 5 percent of the voting shares of the portfolio company.

The final rule also adopts the presumption established by the GLB Act that applies the limits on inter-affiliate transactions contained in section 23A of the Federal Reserve Act to transactions between a depository institution controlled by the investing FHC and any portfolio company in which the FHC owns at least a 15 percent equity interest. In response to suggestions made by commenters, the final rule includes several safe harbors from this statutory presumption for situations in which the Board would consider, absent evidence to the contrary, that the presumption is rebutted and the restrictions of section 23A would not apply.

C. Capital Proposal.

An integral part of our original merchant banking proposal involved the regulatory capital that would be required to support merchant banking activities. As anyone who has experienced a down-turn in the stock market will attest, an investor's chances of financial survival are greater if the investor has used capital rather than debt to finance their investments. And in the case of banking organizations, it is also important that the organization have sufficient capital after losses associated with declines in stock prices to support its other activities.

The Board's capital proposal was intended to offset some of the risks from merchant banking investments by requiring financial holding companies to limit the amount of debt they used to support their merchant banking activities. While many merchant bankers fund their merchant banking investments entirely with equity capital--that is, each dollar of investment is funded with one dollar of their own equity capital--the Board originally had proposed a regulatory minimum requirement of 50 cents of equity capital for each dollar invested in merchant banking.

This proposal attracted quite a bit of comment, and is an example of an area where we learned from the public comments. Importantly, most of the commenters did not disagree with our concern that merchant banking activities are riskier than more traditional banking activities. Nonetheless, most commenters criticized our proposed capital treatment, and several offered constructive alternative approaches.

In addition to reviewing the public comments, we worked with the other Federal banking agencies to improve the proposal in ways that took account of commenters concerns but also addressed the necessity for risky assets to be adequately capitalized by equity. Together with the other agencies we were able to develop a new, revised capital proposal that would apply uniformly to equity investments held by bank holding companies and those held by depository institutions.

The banking agencies were guided by several principles in considering the appropriate levels of capital that should be required as a regulatory minimum to support equity investment activities. First, equity investment activities in nonfinancial companies generally involve greater risks than traditional bank and financial activities. As I noted, this is a principle over which there is little disagreement. Industry data on venture capital investments indicate losses on one-fourth to one-third of individual deals. For portfolio investments, studies suggest that, while some portfolios achieve extraordinary returns, nearly 20 percent lose capital. I explained in much more detail our analysis of the risks associated with equity investment activities in my testimony before this Subcommittee last June. If anything, the activity in the equity markets since last June has confirmed that analysis, and few of the commenters on our original capital proposal disagreed with the substance of that analysis or with its conclusion that equity investment activities are significantly riskier activities than most traditional banking activities.

A second and related principle is that the financial risks to an organization engaged in equity investment activities increase as the level of its investments accounts for a larger portion of the organization's capital, earnings and activities. Banking organizations have for some time engaged in equity investment activities using various authorities, including primarily Small Business Investment Companies (SBICs) and the authority to make limited passive investments under sections 4(c)(6) and (7) of the BHC Act. When the current capital treatment, which requires a minimum of 4 percent Tier 1 capital (6 percent in the case of depository institutions that must meet the regulatory well-capitalized definition), was developed, these equity investment activities were small in relation to the more traditional lending and other activities of these organizations.

The level of these investment activities has grown significantly in recent years, however. For example, investments made through SBIC's owned by banking organizations have alone more than doubled in the past five years. Industry wide, investments have more than quadrupled over the same period. The grant to financial holding companies of a significant new authority to make equity investments under the GLB Act without many of the restrictions that apply to other authorities currently used by banking organizations to make these investments was an appropriate time to re-evaluate whether existing capital charges were adequate.

A third principle guiding the agencies' efforts is that the risk of loss associated with a particular equity investment is likely to be the same regardless of the legal authority used to make the investment or whether the investment is held in the bank holding company or in the bank. In fact, the agencies' supervisory experience is that banking organizations are increasingly making investment decisions and managing equity investment risks as a single business line within the organization and across legal entities. These organizations use different legal authorities available to different legal entities within the organization to conduct a unified equity investment business.

In light of these principles, the Board and the other agencies issued a revised proposal that would establish special minimum regulatory capital requirements for equity investments in nonfinancial companies. This capital treatment would apply symmetrically to equity investment activities of bank holding companies and banks.

Under the original capital proposal made last March, the Board proposed to apply a uniform 50 percent capital charge to all equity investments made by bank holding companies. The revised proposal would apply a series of marginal capital charges that increase with the level of a banking organization's overall exposure to equity investment activities relative to the institution's Tier 1 capital. Under the new proposal, with several exceptions that I will discuss in a moment, a modest 8 percent equity capital charge would apply to the portion of the banking organization's equity investment portfolio that totals less than 15 percent of the Tier 1 capital of the organization, and a 12 percent equity capital charge would apply to the portion of the portfolio between 15 percent and 25 percent of the banking organization's Tier 1 capital. A 25 percent equity capital charge would be applied to the portion of a portfolio that exceeds 25 percent of the Tier 1 capital of the investing banking organization. These charges are regulatory minima, and FHCs are expected to hold capital based on their assessment of the nature of their capital investments and the quality of the over-all risk management of these portfolios.

The agencies announced that they would intensify their supervisory review and oversight of the equity investment activities at all banking organizations, including in particular banking organizations with concentrations in this activity that exceed 50 percent of the organization's equity capital. The agencies also indicated that they would apply higher minimum regulatory capital charges on a case-by-case basis as appropriate in light of supervisory concerns regarding an organization's risk management systems; the risk, nature, size and composition of an organization's portfolio of investments; market conditions; and other relevant information and circumstances.

The series of marginal capital charges in our revised proposal is somewhat more complex than the original single-charge proposal. However, we believe that it better reflects the reality that, as an organization concentrates greater amounts of its resources in riskier activities, the organization increases its overall risk profile. In order to continue to operate safely and soundly, a banking organization must increase its capital as it increases its risk profile.

Commenters, including a number of members of this Subcommittee, strongly urged the agencies not to impose a higher capital charge than is currently applied on investments made through SBICs. These commenters argued that SBICs serve the important public purpose of encouraging investment in small businesses, are already subject to investment limitations imposed by Congress and the Small Business Administration, and to date have been generally profitable.

Commenters made similar arguments in support of an exception from higher capital charges for investments made by state banks under special grandfathering authority preserved by section 24 of the Federal Deposit Insurance Act. These investments have also been reviewed and limited by Congress and are subject to further review and limitation by the FDIC.

The agencies recognized substantial merit in these arguments. Accordingly, we revised the capital proposal so that it does not generally impose a higher capital charge on investments made through SBICs. Because SBICs may, under certain conditions, hold investments that exceed the statutory limitations imposed on bank investments in SBICs, the revised proposal would apply the higher marginal capital charges to SBIC investments only when the total amount of these investments exceeds 15 percent of the parent bank or bank holding company's Tier 1 capital.

This 15 percent threshold allows banking organizations a cushion for growth between the statutory investment limit and the higher capital charges under the revised proposal.

The proposal also includes an exception for investments held by state banks in accordance with the special grandfather rights under section 24 of the FDI Act. As commenters noted, these investments are limited by statute in both amount and type, and may only be made by a small, and diminishing group of grandfathered companies.

Section 24 of the FDI Act also permits other, non-grandfathered investments with the approval of the FDIC. In nearly all cases, the FDIC has imposed a higher capital charge on these investments than the marginal charges included in the revised interagency proposal. Consequently, although the proposal covers these investments, it would not have an effect on the regulatory capital required for these investments. The proposal would allow the FDIC, in exceptional individual cases, to impose a lesser minimum regulatory capital charge on investments under section 24 where the total of all investments made by the organization under section 24 and through an SBIC is less than 15 percent of the organization's Tier 1 capital. The FDIC also retains authority to impose greater capital requirements on any investment activities under section 24 of the FDI Act as it deems appropriate to protect the deposit insurance funds and assure the safe and sound operation of the investing bank.

One of the comments made most often in response to our original capital proposal was that the Board had selectively adopted part of the internal risk models used by banking and securities firms to assess the capital risks and needs of their organization--the part of the model that recognized that equity investment activities are risky activities that require substantial capital support--without also adopting the parts of those internal models that assess lower capital charges to activities with less risk. Some commenters urged the Board to rely on internal capital models for assessing all aspects of regulatory capital requirements.

Internal risk-based models for assessing capital adequacy of an organization would, indeed, better reflect the individual risk profile of individual organizations than the more general formulas that currently underlie the agencies' regulatory capital requirements. As a result, we believe that internal capital models are important and ideally should serve as the basis for both economic and regulatory capital requirements. However, the development of internal risk models is still in its infancy, with many organizations only beginning to develop internal models, and, even with those that have begun this task, with categories of assets and activities--such as portfolios of equities--still not adequately factored into most models. We are committed to enhancing our ability as supervisors to assess and aid in the development of strong internal models. We have been working with the Basle Capital Committee on a proposal, recently published for public comment, that would focus regulatory capital requirements at least at large banking organizations on internal risk models developed by the organization and verified by the regulatory agencies.

But neither the banking agencies nor most banking organizations are at the stage where we can rely on these models as a replacement for regulatory minimum capital requirements. We view our revised capital proposal for equity investment activities as a bridge to a robust internal model approach--one that covers a banking organization's assets generally and not just a subset of those assets. When we cross that bridge will depend on a number of factors, including how the Basle proposal is received and develops, on the ability of banking organizations to develop their own models, and on our own ability to evaluate and verify the models that develop. For those banking organizations that engage in equity investment activities but choose not to adopt internal capital models, the revised capital proposal will help provide a standard against which we can analyze the organizations' capital adequacy.

The invitation for public comments on the revised capital proposal is still open, and will remain open until April 16, 2001. We find the public comment process to be a useful and instructive discipline, especially for analyzing rules that will govern new activities and the banking industry broadly. As always, the Board will carefully review all of the comments that we receive. While we have not reached a final decision on the capital proposal, we believe that we are homing in on a final rule that addresses the information and concerns of commenters, will be workable, and, importantly, will enhance safety and soundness.

Governor Meyer subsequently submitted the following in response to written questions received from Representatives Spencer Bachus, Richard H. Baker, and Sue W. Kelly in connection with the April 4, 2001, hearing before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises; and the Subcommittee on Financial Institutions and Consumer Credit:

1. How do you answer critics of the merchant banking rules who submit that they are the primary reason that the major investment banking firms with extensive private equity investment activities have, thus far, been unwilling to select financial holding company (FHC) status under the Gramm-Leach-Bliley Act (GLB)? What more can be done to facilitate the "two-way street" envisioned by Congress when enacting the merchant banking provisions of GLB?

Since passage of the GLB Act, several securities firms, including some with large merchant banking investment portfolios, have affiliated with banks through the FHC structure. For example, last year Donaldson, Lufkin & Jenrette, a major source of private equity capital in the United States, was acquired by Credit Suisse Corporation, a financial holding company. In addition, in March 2001, Friedman, Billings, Ramsey & Co., Inc., a technology-oriented investment banking firm with significant merchant banking holdings, acquired a bank and became a financial holding company. PaineWebber and Charles Schwab & Co. also have taken advantage of the FHC structure established by the GLB Act to become affiliated with banks.

The GLB Act also has allowed the numerous securities firms that became affiliated with banks prior to the GLB Act under the more limited section 20 authority to expand their merchant banking activities and compete more effectively. These firms include Salomon Smith Barney (which is affiliated with Citigroup), Alex Brown (which is affiliated with Deutsche Bank AG), and Quick & Reilly, Inc. and Robertson Stephens Group (which are affiliated with Fleet Boston Corporation). In fact, five of the top 10, and eleven of the top 20, securities firms in terms of consolidated capital currently are affiliated with banks through FHCs, which suggests that a meaningful two-way street exists between the industries.

While some large securities firms have chosen not to acquire or become affiliated with a bank, this fact is not surprising. The GLB Act does not mandate that securities firms affiliate with banks; rather the Act *permits* banks and securities firms to affiliate when such action is consistent with their overall business strategies. The ultimate decision of whether to acquire or become affiliated with a bank remains a complex one that must be evaluated in light of the particular competitive strategy of the individual organization. It is likely that some securities firms continue to evaluate whether the FHC structure best fits their business model and that, ultimately, some will decide not to acquire or affiliate with a bank.

Furthermore, several of the large securities firms that have, as of yet, not become FHCs already conduct a significant amount of banking activities through the ownership of banks and bank-like entities that technically are not considered "banks" for purposes of the Bank Holding Company Act ("BHC Act"). For example, one independent securities firm owns two nonbank banks that together control approximately $55 billion in deposits and another owns a nonbank bank that holds more than $14 billion in deposits. The ability of these firms to offer banking services through existing loopholes no doubt affects their decision to become an FHC under the GLB Act.

2. Don't the restrictions placed on merchant banking activities conducted by FHCs place those firms at a decided competitive disadvantage vis-à-vis their investment banking counterparts?

No. The final rule on merchant banking activities reflects the routine management, holding period, cross-marketing and other limitations imposed by statute on the conduct of merchant banking activities by FHCs. Accordingly, there are some restrictions that apply to merchant banking companies that choose to affiliate with an insured bank that do not apply to merchant banking firms that are not affiliated with an insured bank. Nevertheless, we believe the final rule allows FHCs to conduct their merchant banking activities in much the same manner as their independent investment banking counterparts. Where the Board had discretion in setting specific parameters under the rule, it considered both the purposes of the GLB Act and the extensive comments and information provided by the public, including members of the investment banking and banking industry.

For example, in identifying actions that would involve an FHC in routinely managing or operating a portfolio company, the Board was guided by Congress' desire to ensure that FHCs do not conduct the business of their portfolio companies and, thereby, erode the separation of banking and commerce. The final rule allows FHCs to have representatives serve on the board of directors of a portfolio company and to participate, either through their representatives on the board of directors or otherwise, in decisions relating to the hiring and firing of the portfolio company's executive officers. The rule also allows FHCs to restrict the ability of a portfolio company to take actions that are outside the ordinary course of business. These types of relationships and review rights were found to be the standard practice of private equity investors.

Importantly, the Act and the rule also allow an FHC to assume direct control over the day-to-day management or operations of a portfolio company when necessary or required to obtain a reasonable return on the sale or other disposition of the investment. In this way, the rule permits an FHC to take full control of a portfolio company when such action is necessary to protect its investment. The final rule adopted the statutory language on this point and receded from the more limiting definition of these special situations contained in the original interim rule.

The rule's holding period and cross-marketing restrictions also reflect statutory mandates. Many commenters on the rule noted that the holding period "safe harbors" included in the rule exceed the typical holding periods for merchant banking investments. These long safe harbors were included in recognition of the fact that regulatory parameters should provide flexibility to account for varying circumstances and market conditions. The rule also allows an FHC to hold an investment beyond these "safe harbors" with the Board's approval. Furthermore, the Board's final rule clarifies that the Act's cross-marketing restrictions do not apply with respect to shares of private equity funds or to portfolio companies in which the FHCs owns less than a 5 percent voting interest.

The new regulatory capital proposal has an average capital charge that is well below the internal capital charges employed by virtually all banking organizations that have developed sophisticated economic capital allocation models for their private equity portfolios. It is also below the internal allocations used by the private equity business lines at investment banks we surveyed. The proposal reflects the agencies's preliminary view of the minimum capital required to operate this business line in a safe and sound manner over the long term and, based on our survey, would not appear to place banks at a competitive disadvantage with respect to independent merchant banking investors. More generally, operating a business on an adequately capitalized basis is not a competitive disadvantage in the long run.

On balance, the final rule and revised capital proposal effectively reflects the legislative direction given to the Board in the GLB Act and reconciles Congress' desire to provide new merchant banking authority to FHCs while preventing the wholesale mixing of banking and commerce and ensuring the safety and soundness of affiliated depository institutions. We are not aware of any serious competitive disadvantage that the final rule imposes on FHCs vis-á-vis independent investment banks.

3. You have grandfathered some merchant banking investments made under pre-GLB authority. However, the capital rule would still apply to all other merchant banking investments. Banks are concerned that imposition of new capital requirements on these investments, which historically have been both profitable and low-risk, will cause them to become unprofitable. Why aren't all merchant banking investments grandfathered so that FHCs and bank holding companies (BHCs) do not have to reconfigure internal capital allocations for existing activities?

The Board has not made a final decision on whether to apply the proposed new capital charges to equity investments that were made prior to March 13, 2000--the date of the first proposed capital rule. In fact, the capital proposal requests public comment on precisely this point. The Board requested comment on this subject in recognition of the fact that investments made prior to March 13, 2000, were made and priced in reliance on the existing capital rules. Any grandfathered holdings would count in the base for determining the appropriate marginal capital charge for investments made after the grandfather date, but the pre-existing holdings themselves would continue to be subject to the current capital charges.

No decision, of course, will be made on grandfathering until all the comments are analyzed and reviewed by the three banking agencies. An initial review of the comments received on the revised proposal, however, indicates that the vast majority of commenters support grandfathering investments that were made prior to March 13, 2000.

As discussed in response to Question 4, the agencies have proposed to apply certain marginal capital charges to new equity investments made under various authorities, including both newly granted and existing investment authorities. This reflects the fact that the risk of equity investments to a banking organization grows with the size of the organization's investment portfolio and is largely unrelated to the legal authority used to make the investment.

4. Please advise as to the rationale for subjecting preexisting investments held by FHCs under Section 4(c)(6), Section 4(c)(7), Section 4(c)(13), and other provisions of the Bank Holding Company Act to higher capital requirements than applicable under current law. In this regard, please state whether there are any specific events, losses or financial developments that would justify the imposition of new capital requirements to investments held under such Bank Holding Company Act provisions.

Prior to passage of the GLB Act, bank holding companies were permitted to acquire limited amounts of equity in nonfinancial companies under sections 4(c)(6) and 4(c)(7) of the BHC Act, section 302(b) of the Small Business Investment Act of 1958, and the Board's Regulation K. As discussed in greater detail in response to Question 5, empirical evidence indicates that equity investments generally involve greater risks than traditional bank and financial activities. The importance of these risks to the financial condition of an organization also grows with the size of the organization's investment portfolio. The risks associated with an equity investment, moreover, are likely to be the same regardless of the legal authority used by a banking organization to hold the investment. For example, a bank holding company faces the same volatility and liquidity risks from an equity investment in a start-up business whether that investment is held under section 4(c)(6) of the BHC Act or under the GLB Act's merchant banking authority.

When the existing capital rules were developed, the equity investments held by bank holding companies under pre-GLB Act authorities were small in relation to their more traditional lending and other activities. In recent years, however, the equity investments held by bank holding companies under these earlier investment authorities have grown significantly and equity investment activities have become an increasingly important source of earnings for banking organizations. In light of the significant growth of these equity investments since development of the current capital guidelines, the higher risks associated with these investments, and the expectation of further expansion of equity investment activities under the new merchant banking authority, the Board and the other banking agencies determined that it was time to re-examine the appropriate regulatory capital treatment of nonfinancial equity investments. However, as noted in response to Question 3, the Board has requested comment on whether investments made prior to March 13, 2000, under pre-existing authorities should be grandfathered for purposes of the capital rules.

5. FHCs and BHCs with extensive merchant banking portfolios argue that these activities historically have posed no greater risk to their operations than many other activities conducted without special restrictions or capital charges. They also submit that historical returns in merchant banking are very profitable even when the economy and financial institutions as a whole are not performing well, and that merchant banking investments are not subject to the short-term volatility of publicly traded equities. In the rulemaking process, did you determine whether these claims are correct? If they are, why are these investments being treated differently than other banking activities?

Prior to enactment of the GLB Act, equity investment activities were conducted by banking organizations in the domestic market principally through two channels--SBICs and non-controlling investments made under sections 4(c)(6) and 4(c)(7) of the BHC Act. Until the last few years, equity investment activities conducted under these pre-GLB Act authorities were relatively modest. Over the past few years, however, these activities have increased dramatically and, until the market correction of the past two quarters, have contributed significantly to earnings and capital at some banking organizations.

The fact that equity investment activities by banking organizations have increased dramatically only in the past few years suggests that the history of profitability of these activities as conducted by banking organizations is based on an unusual period, since it largely corresponds with a 10-year bull market. This is clearly a period that does not reflect risk over the long term. A review of a wider range of data indicates that equity investments are indeed quite volatile and riskier than more traditional banking activities. For example, one measure of the market's confidence in the financial strength of a banking organization is the investment rating given to the debt issued by the organization. Banking organizations universally strive to maintain an investment grade rating on their outstanding debt. An analysis of annual returns for the period 1946 through 1998 for publicly traded U.S. small capitalization stocks indicates that a banking organization engaged in equity investment activities would have to hold capital well in excess of 25 percent to maintain the margin of safety required to retain the lowest investment grade rating on a bond issued to finance a portfolio of small cap stocks.

The use of small cap stocks in this case as a proxy for private equity investments is appropriate insofar as most private equity investments involve smaller companies and the returns generated from these investments frequently arise from bringing the investment public through an initial public offering. Indeed, the use of small cap stocks as a proxy may somewhat underestimate the risk of private investments that are not yet ready for the public markets. Private equity, including start-up, venture capital, leveraged buyout and mezzanine financing investments, pose significant challenges with regard to estimating valuations and the potential volatility of valuations in a manner comparable to publicly traded securities. These challenges arise not only because market prices on these investments are unavailable, but also because private investments involve uneven cash flows and long life cycles. Furthermore, private equity investments, by their nature, lack the liquidity of publicly traded securities.

The performance of equity investments over the past two or three quarters further evidences the volatility and, thus, risk of private and public equity investments. In the fourth quarter of 2000, four of the top nine banking organizations active in the equity investment business line experienced losses in this activity, after reporting record gains from this business line earlier in the year. While complete data for the first quarter of 2001 is not yet available, earnings reports for this period indicate that portfolio values and earnings related to this line of business continued to decline.

Moreover, in many cases, economic losses far exceed accounting losses. This results from the fact that many private equity investments are held pursuant to available-for-sale (AFS) accounting methodology. Gains or losses on investments held AFS do not flow through to the income statement.[1] Accordingly, the impact of AFS accounting on

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[1] AFS securities are reported at market value, with unrealized gains or losses excluded from income and reported as a net amount in shareholders equity until realized. Obviously, this

(continued...)

private equity investments provides the illusion that they are less volatile than publicly-traded equities. This difference may be particularly pronounced during periods of increased market volatility--exactly when merchant banking activities may be most vulnerable.

Thus, a careful study of the long term shows that equity investment activities are generally riskier than more traditional banking activities. These risks at banking organizations have appeared less pronounced because of the recent strength of the equity markets and the accounting methodology used by some banking organizations. Importantly, these risks have been of less concern in the past because of the relatively small levels of equity investments held by banking organizations. When all of these factors are considered, it appears appropriate to apply a higher capital charge to equity investments vis-à-vis more traditional banking and financial activities. In addition, it appears appropriate to consider a capital charge that increases as the organization's equity investment portfolio becomes a larger share of the organization's assets. It should be noted that the proposed capital charge would be low (8 percent of Tier 1 capital) for modestly sized (15 percent or less of Tier 1 capital) equity investment portfolios, and that no additional capital charge would apply to SBIC investments below 15 percent of Tier 1 capital. The proposed charge would then increase to 15 percent or 25 percent as the size of the equity investment portfolio becomes a larger share of the organization's total assets.

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treatment requires that there are readily available market prices, or in their absence, objectively developed processes (e.g., third party appraisals) with which to value and report these investments. The unique nature of private equity investments, together with a lack of readily available market prices for them, makes it particularly difficult to assign fair market prices to such investments. In this case, and consistent with accounting conservatism, these investments are typically held at historical cost.

6. Please describe what steps the Board took in preparing the merchant banking rules to assure itself that such rules would be consistent with the Congressional mandate that the GLB "permit investment banking firms to continue to conduct their principal investing in substantially the same manner as at present" and that "the Board shall take . . . into account that investment banking firms affiliated with depository institutions should be able to compete on an equal basis for principal investments with firms unaffiliated with any depository institutions so that the effectiveness of these organizations in their investment banking activities is not compromised." (House Report 106-74, part 1, p. 123 (1999).)

As noted above, the GLB Act imposes several restrictions on the merchant banking activities of FHCs to preserve the BHC Act's general prohibition on the mixing of banking and commerce. The most important of these provisions restrict the period of time that an FHC may hold a merchant banking investment, and limit the ability of an FHC to routinely manage or operate a portfolio company held as a merchant banking investment.

In order to assist the Board and the Secretary of the Treasury in evaluating how to implement these statutory restrictions and address the appropriate regulatory capital treatment of equity investments, Board and Treasury staff interviewed a number of large securities firms that are active in the merchant banking business. Staff also interviewed several large bank holding companies that had relatively large portfolios of equity investments made under legal authorities that pre-existed the GLB Act. In these interviews, staff collected information concerning how these securities firms and banking organizations conducted their equity investment activities, including information on the average and "outside" holding periods of investments, the manner and extent of involvement in the management and operations of portfolio companies, and the amount of capital allocated to support equity investment activities. The Board carefully considered the information collected from these interviews, as well as its experience in supervising the investment activities of bank holding companies and state member banks, in developing its initial merchant banking interim rule and capital proposal. Importantly, the Board and Treasury then broadly invited public comment on the interim rule and capital proposal. As part of this public invitation of comment, the Board specifically requested comment on whether its proposal would allow effective competition and a "two-way street" while at the same time remaining consistent with the statutory limitations imposed by the GLB Act.

The Board carefully considered the comments received on its interim merchant banking rule and initial capital proposal, and made a number of important changes to the final merchant banking rule and capital proposal to address concerns raised by commenters. The Board believes that the final merchant banking rule and revised capital proposal permit a "two-way street" while, at the same time, giving effect to the statutory limitations and framework adopted by Congress to maintain the separation of banking and commerce and protect the safety and soundness of affiliated banks.

7. Please state whether the Board would characterize covenants affecting the following matters as "outside the ordinary course of business of [a] portfolio company" within the meaning of 12 C.F.R. § 225.171(d)(2):

- **Financing a portfolio company, whether or not in the ordinary course of business.**
- **Regulatory, tax or liability status of a portfolio company or its equity holders.**
- **Capital expenditures and other major expense items.**
- **Policies regarding the hiring, firing or setting or changing the compensation of non-executive employees (including incentive plans).**
- **Transactions with affiliates or related persons.**
- **Negative covenants relating to material operations including, in particular, financial covenants.**
- **Creation of any subsidiary, partnership or joint venture to conduct any part of a portfolio company's business.**

The Board's final merchant banking rule expressly permits FHCs to restrict, by covenant or otherwise, the ability of a portfolio company to take actions that are outside the ordinary course of business. Investors may seek a wide variety of covenants from a portfolio company in order to protect their investment, and the covenants obtained in connection with a particular investment frequently are tailored to meet the special circumstances associated with the investment. In light of these facts, the final rule does not attempt to identify all of the types of covenants that an FHC may have with a portfolio company without being deemed to routinely manage or operate the portfolio company. Rather, the final rule sets forth some examples of covenants that as a general matter would not involve the FHC in the day-to-day management or operations of the portfolio company. FHCs may use the rule's list of permissible covenants as a guide in determining whether the covenants obtained in a particular case involve actions that are "outside the ordinary course of business" of the portfolio company. In addition, an FHC may always seek guidance from Federal Reserve staff concerning whether, in light of all the facts and circumstances surrounding an investment, a particular covenant would impermissibly involve the FHC in the day-to-day management or operations of the portfolio company.

Because the question of whether a covenant would allow an FHC to routinely manage or operate a portfolio company depends on the specific terms of the covenant and the facts associated with the investment, we are unable to determine whether every covenant relating to a matter listed above would be permissible under section 225.171(d)(2) of the rule. For example, a covenant that restricted the ability of a portfolio company to convert from corporate to partnership form (and thereby alter its tax status), to make significant capital expenditures (e.g., construction of a major new plant), or transfer significant assets to a newly formed subsidiary would in many cases involve actions that are outside the ordinary course of business. On the other hand, a covenant that gave an FHC the ability to restrict any change to the portfolio company's tax policies, any capital expenditure no matter how minor, or any transfer of assets to a subsidiary or joint venture even in the ordinary course of business would allow the FHC to become involved in the day-to-day management or operations of the portfolio company.

8. Please set out any analysis or study made by the Board or its staff with respect to whether (and, if so, how) the imposition of covenants on portfolio companies by minority investors -- including covenants related to operational matters -- could constitute participation in the "routine management or operation" of a portfolio company which would not fall within the statutory exception for management or operations "as may be necessary or required to obtain a reasonable return on investment upon resale or disposition."

The GLB Act generally prohibits an FHC from "routinely managing or operating" a portfolio company held as a merchant banking investment. In this way, the Act seeks to maintain the separation of banking and commerce.

Covenants, whether obtained by a controlling or a minority shareholder, may be constructed as a means of routinely managing or operating a portfolio company. However, covenants employed by merchant bankers typically are designed to protect the investor against major changes in the operation or management of a portfolio company or to provide the investor special rights in situations in which the portfolio company is experiencing financial, operational or other difficulties. To help distinguish between the latter type of covenants, which typically involve matters outside the ordinary course of business and thus would be permissible under the rule, and other types of covenants that may involve routine management or operation of a portfolio company, the final merchant banking rule provides examples of covenants that an FHC may have with a portfolio company without routinely managing or operating the company. In this regard, the rule allows any FHC to restrict, by covenant or otherwise, the ability of a portfolio company to take actions that are outside the ordinary course of business. The rule also provides a non-exclusive list of actions that would be considered outside the ordinary course of business, including the removal or selection of the portfolio company's executive officers; the acquisition of another company by the portfolio company; the sale or merger of the portfolio company; significant changes to the portfolio company's business plan or accounting methods or policies; and the selection or removal of the portfolio company's independent accountant or auditor or investment banker. This list of permissible covenants was developed on the basis of the comments submitted during the rulemaking process and the staff's interviews with securities firms and banking organizations, and includes the most common examples of covenants that commenters indicated were typical in merchant banking investments.

Under the final rule, an FHC would be considered to routinely manage or operate a portfolio company if the FHC, by covenant or otherwise, restricts the ability of the portfolio company to make routine business decisions, such as entering into transactions in the ordinary course of business. It is important to note, however, that the Act and the rule allow an FHC to routinely manage or operate a portfolio company--through the imposition of restrictive covenants or by assuming direct managerial control--when such action is necessary or required to obtain a reasonable return on the FHC's investment upon resale or other disposition. Consistent with the GLB Act, any intervention by an FHC in the routine management or operations of a portfolio company may continue only for the period of time necessary to allow the FHC to address the cause of its involvement.

9. When making loans or establishing lines of credit, banks often impose restrictive covenants as a way of protecting their interests, including securing representation on the board of directors of the borrowing entity. Shouldn't a minority, non-controlling equity investor be entitled to take similar measures to protect its investment?

The Board's merchant banking rule allows an FHC to take both of these actions. In particular, the Board's rule allows an FHC to have <u>any number</u> of representatives serve on the board of directors of a portfolio company, regardless of whether the FHC is a controlling or minority shareholder in the portfolio company. (<u>See</u> 12 C.F.R. 225.171(d).) The FHC's representatives on the portfolio company's board may participate fully in all the matters typically presented to the directors of a company. Securities firms and banking organizations indicated in both the comment process and in interviews with Board staff that board representation is one of the most important methods they use to monitor their investment and provide strategic advice to the portfolio company. Furthermore, allowing an FHC to have director interlocks with a portfolio company appeared consistent with the Act's routine management and operation restrictions because directors typically provide strategic guidance and do not become involved in the day-to-day management or operations of the company.

As discussed above, the final merchant banking rule also allows any investing FHC, whether it has a controlling or non-controlling interest in a portfolio company, to restrict, by covenant or otherwise, the ability of the portfolio company to take actions that are outside the ordinary course of business. In this way, a controlling or non-controlling FHC may restrict a portfolio company's ability to take actions that would have a significant impact on the portfolio company and the value of the FHC's investment.

10. Please explain the rationale for the use of "carrying value" of merchant banking investments rather than the cost of such investments in determining compliance with the aggregate volume limits of 12 C.F.R. 225.174. In particular, please explain how an increase in carrying value of an investment is intended to impact the capacity of a financial holding company to make additional merchant banking investments.

The carrying value of equity investments is used for purposes of determining when review of an FHC's risk-management policies and procedures is required under the final rule and for purposes of assessing a capital charge under the proposed capital rule. The Board believes carrying value is the appropriate measure for these purposes because carrying value, unlike cost, includes gains that are included in income and Tier 1 capital under investment company accounting rules. These gains, once included in capital, can be leveraged by the banking organization to support more investments or other activities. As a result, if the carrying value declines, that decline reduces capital that is being used to support other assets and, thus, adversely affects the banking organization's own capital adequacy even if the carrying value continues to exceed the initial cost.

It is important to note that "carrying value" does not include unrealized gains on available-for-sale (AFS) equity investments. (See response to Question 9.) Unrealized gains on AFS equities are not currently included in Tier 1 capital. Therefore, for AFS securities, the adjusted carrying value under the proposal equals the cost of the investment.

In addition, the thresholds for review of an FHC's risk-management policies and procedures in the final merchant banking rule will automatically sunset once a capital rule addressing merchant banking investments is effective. The Board retained these review thresholds on a temporary basis to ensure that the Board would have the opportunity to review the risk-management policies, procedures and systems, including capital allocation policies, of an FHC that sought to devote a significant percentage of its capital to the new merchant banking activities prior to finalization of the capital rule. Furthermore, even while they remain in effect, the investment thresholds are not absolute limits. An FHC's merchant banking investments may exceed these thresholds with the Board's approval.

Only one FHC has reached these investment thresholds and that firm sought and received Board approval for its merchant banking investments to exceed the thresholds.

11. Has the Board considered excluding investments from the rules once a portfolio company has gone public?

The limits imposed on merchant banking investments by the GLB Act apply to investments in both public and private companies. Accordingly, the Board's final merchant banking rule, which covers holding periods, involvement in routine management and operation of the portfolio company, cross-marketing activities, the need for risk-management policies and related matters, applies to both public and private investments made under the merchant banking authority.

The proposed capital rule also would apply to all nonfinancial equity investments made under the authorities listed in the proposal, not just private equity or merchant banking activities. It does not appear to be prudent to exclude investments in public companies from the capital rules, given the historical volatility in the stock market. In recent quarters, this volatility has been dramatic in various market sectors that represent many of the private investments that are taken public in initial public offerings. As discussed in response to Question 5, overall, historic volatilities exceed the capital charges proposed by the agencies.

With respect to volatility of publicly traded securities, the Morgan Stanley Capital International (MSCI) indices are the most widely used benchmarks among global portfolio managers. The MSCI indices indicate that annual return volatility peaked at 35 percent for the U.S. during the period 1969 to 2000. Furthermore, over the past 12 months, the NASDAQ has lost over 40 percent of its value; from year-end 2000 to the present, it has lost almost another 11 percent. From its peak to its trough over the past 12 months, a change in value of approximately 60 percent occurred.

12. Recognizing that GLB only requires that "shares, assets, or ownership interests [acquired pursuant to the merchant banking authority be] held for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of [such] activities," please state the basis for the Board setting specific holding period limitations in 12 C.F.R. 225.172 and imposing capital penalties if such holding periods are exceeded.

The GLB Act does not allow merchant banking investments to be held indefinitely. Rather, the Act allows merchant banking investments to be held only for a limited period of time sufficient to enable the sale or disposition of the investment on a reasonable basis consistent with the financial viability of the FHC's merchant banking activities. See 12 U.S.C. § 1843(k)(4)(H). Although some commenters asserted that the Board and the Secretary of the Treasury should not establish any general holding periods by regulation, the agencies did not believe that this approach was either appropriate or workable. Silence on this issue would have created significant uncertainty for FHCs engaged in equity investment activities, complicated the ability of FHCs to plan their investment strategies, and potentially led to the inconsistent application of the Act's limits through the supervisory process.

Commenters in the rulemaking process and information gathered by Board staff indicated that merchant investments were typically held for periods of between 3 and 7 years, with investments rarely held beyond 10 years. Accordingly, the rule establishes a safe harbor for merchant banking investments that have been held for less than 10 years (or, in the case of private equity fund investments, 15 years). Investments that fall within these safe harbors are presumed to meet the statutory standard. In addition, the rule allows any FHC to hold a merchant banking investment beyond the regulatory safe harbors provided in the rule with the Board's consent. This process allows the Board to accommodate situations where, based on the circumstances involved in the individual case, a longer holding period is needed and consistent with the GLB Act.

If the Board grants an extension request, the relevant investment would be subject to a Tier 1 capital charge equal to 25 percent or the highest marginal capital charge applicable to merchant banking investments, whichever is greater. This requirement encourages FHCs to dispose of their merchant banking investments within the initial 10- or 15-year holding period, and recognizes that investments held beyond these periods are likely to have suffered significant declines in value or be subject to special liquidity risks.

13. GLB prohibits a depository institution controlled by an FHC from cross-marketing any products or services with or through any company in which the FHC or BHC holds an equity interest through its merchant banking authority. However, a depository institution generally may cross-market the products or services of non-financial companies held by insurance affiliates of FHCs through statement stuffers and Internet sites and portals. Would the Board support an amendment to GLB that would correct this inequity and allow the same cross-marketing abilities to be extended to products or services of portfolio companies held under merchant banking authority?

The GLB Act allows the depository institution subsidiaries of FHCs to engage in cross-marketing activities through statement stuffers and Internet websites with portfolio companies held by an insurance underwriting affiliate under section 4(k)(4)(I) of the BHC Act. These limited cross-marketing activities must be conducted in accordance with the anti-tying restrictions of the BHC Act Amendments of 1970, and are permissible only if the Board determines that the arrangement is in the public interest, does not undermine the separation of banking and commerce, and is consistent with the safety and soundness of depository institutions. The Board would support an amendment to the GLB Act that would allow the depository institution subsidiaries of an FHC to engage in cross-marketing activities with portfolio companies held under the merchant banking authority to the same extent as such activities are permitted with respect to insurance company investments.

14. On June 22, 2000, the Board released Supervisory Letter SR 00-9, providing comprehensive examination guidance on equity investments and merchant banking. Some have suggested that the existence of this detailed regulatory guidance calls into question the need for the final rule on merchant banking and the proposed capital rule issued earlier this year. How do you respond?

In the Board's view, the basic structure of any supervisory regime consists of three pillars--minimum capital requirements, the supervisory review process, and market discipline. Each element works with the others and none is adequate by itself. SR 00-9 reflects the Board's efforts to address the supervisory review and market discipline requirements. The capital requirements respond to the need to set minimum capital standards. The Basle Committee on Banking Supervision has adopted this same philosophy.

The final merchant banking rule addresses statutory requirements on holding periods, routine management, cross-marketing, affiliate lending and other matters that are not specifically addressed in SR 00-9. The final rule on these matters allows FHCs to plan and conduct their merchant banking activities with a higher degree of certainty regarding the statutory limitations applicable to these activities than ad hoc determinations made during the supervisory process.

TESTIMONY OF

JOHN D. HAWKE, JR.

COMPTROLLER OF THE CURRENCY

before the

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

and the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

April 4, 2001

Statement required by 12 U.S.C. 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Baker, Chairman Bachus, and members of the Subcommittees, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on the rules relating to the merchant banking investment activities of banking organizations. I welcome the efforts of the Subcommittees to focus renewed attention on this important issue. It is in all of our interests to appropriately balance the essential role that banking organizations play in promoting capital availability to American businesses with fundamental precepts of safety and soundness.

As noted in the invitation letter, the hearing will focus on the authority given to financial holding companies and bank holding companies by the Gramm-Leach-Bliley Act (GLBA) to conduct merchant banking investment activities, the rules governing these activities promulgated by the Treasury and the Federal Reserve Board (FRB), and the capital standards for merchant banking investments recently proposed by the FRB and subsequently reproposed jointly by the FRB, OCC and FDIC. The Subcommittees specifically asked witnesses to address the following issues:

- The revision of the proposed capital rule – specifically, the process through which the rule was revised, the regulatory capital approach versus the strict supervisory (examination) approach to safety and soundness, and how the revised rule can be reconciled with the proposed Basel standards.

- The Final Rule governing merchant banking activities – particularly, how the Final Rule addresses the concerns raised about the Interim Rule of March, 2000, why there continues to be a cap on merchant banking investment, and the reasons for maintaining the cross-marketing restrictions, holding periods, and other limitations on merchant banking activities.

Before addressing these issues, I would like to make some background remarks that may help to put my testimony in context.

"Merchant banking" is a term with no fixed definition that is generally used to describe a range of financial activities, many of which have long been permissible for national banks. For example, national banks have for many years engaged in buying and selling securities for the accounts of customers, they have advised clients on mergers and acquisitions and on the private placement of securities, they have acted as finders in business combinations, and they have represented and negotiated on behalf of customers in such transactions. GLBA did not affect the ability of national banks to engage in any of these activities.

While we have come to refer to the various rulemaking proceedings that are the subject of this hearing as involving "merchant banking," it is important to recognize that what we are really addressing today is simply one component of the business generally referred to as merchant banking, namely, the business of making private equity investments in non-financial firms – in particular, equity investments having a venture capital character.

Bank holding companies have for many decades had the authority to make significant non-financial equity investments, particularly pursuant to the authority granted in sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act (BHCA), which allow a bank holding company, directly or through an intermediate investment company, to invest in up to 5 percent of the outstanding voting stock of any company, irrespective of the business of that company. Moreover, sections 4(c)(6) and 4(c)(7) impose no aggregate dollar limit on such investments, nor do they limit the character of such investments. Thus, it has long been possible for a bank holding company to make very sizeable investments in a virtually unlimited range and number of non-financial companies, including venture capital companies, subject only to the inherent limits of the holding company's financial capacity to do so.

National banks, as well, have long been permitted to make private equity investments through small business investment companies, and many banks have in fact done so. The limitations on such investments and on bank ownership of small business investment corporations (SBICs) will be discussed later in my testimony. Suffice it to say that many such investments have been of a venture capital nature.

Prior to the enactment of GLBA, no significant public policy or safety and soundness concerns were raised by bank regulators concerning the ability of either bank holding companies or banks to make equity investments under the authorities described above. Indeed, the clear intent of Congress in that far-reaching new law was to expand the ability of banking organizations to make such investments in excess of the limits contained in prior law, even where such investments might constitute control of the company in which they were made.

As part of a compromise negotiated in the final stages of the GLBA legislative process, this new authority was to be limited to bank holding companies for a period of five years. At the end of that period, the new authority was expected to be extended to financial subsidiaries of banks, if the FRB and the Treasury concurred. We continue to believe that with the carefully crafted safety and soundness protections included in GLBA for financial subsidiaries of banks, the elimination of any disparity between bank holding companies and banks in this regard is appropriate.

Against this background, my testimony today will address principally the performance of national bank equity investments in SBICs, and the OCC's involvement in the February 14, 2001 Notice of Proposed Rulemaking of the Federal banking agencies (February 2001 Capital Proposal), proposing special minimum regulatory capital requirements for those investments. My testimony will address each of the issues relating to the February 2001 Capital Proposal identified in the Subcommittees' invitation letter of March 28, 2001. The second set of questions in the invitation letter, however, is not directly discussed in this testimony. Those questions specifically deal with joint Treasury-FRB rulemakings issued on March 17, 2000 and January 10, 2001 relating to the conditions under which the newly authorized merchant bank activity can be conducted. This activity did not affect banks or bank subsidiaries and, therefore, the OCC had no direct role in those rulemakings.

It is also important to note that the public comment period on the February 2001 Capital Proposal is open until April 16, 2001. Therefore, while I can discuss the issues that led to the proposal in its current form, it would be premature for me to express views about the shape of the final rule.

The OCC's primary objective in the development of the February 2001 Capital Proposal was to protect the long-standing congressional preference for SBICs. As I will discuss in more detail below, we have attempted to achieve that objective by a proposal that imposes additional capital requirements on SBIC investments only when those investments exceed specified concentration thresholds. Other private equity investments are subject to proposed higher initial marginal capital charges.

Small Business Investment Corporations

National banks have long been permitted to make certain limited equity investments in non-financial companies through SBICs, which are privately organized and managed venture capital firms that are licensed and regulated by the Small Business Administration under the Small Business Investment Act (SBIA).

The SBIA was enacted in 1958 with the stated purpose of making equity capital and long-term financing more readily available to small businesses. Based in part on an FRB study on small business capital needs[1], Congress sought to change the incentives for banks involved in small business financing. To facilitate the formation of SBICs, Congress specifically authorized national banks to invest in the stock of SBICs; state banks were also permitted to purchase SBIC stock compatible with State law. Congress did not specifically authorize life insurance companies and other types of financial intermediaries to purchase SBIC stock, noting their ability to do so would depend entirely upon existing Federal or State law. Thus, Congress created a framework in which banks, first and foremost, would improve capital availability for small businesses through SBIC investments.

Congress has consistently reaffirmed its intent to foster capital and credit availability to small businesses through SBICs. It expressly addressed the soundness of the SBIC program in at least five Senate and House hearings in the early 1990's. A key theme of those hearings was the need

[1] Financing Small Business, Report to the Committee on Banking and Currency and the Select Committees on Small Business by the Federal Reserve System, 85th Cong. 2d Sess. (Comm. Print 1958).

for greater bank involvement in debt and equity financing of small business. As recently as 1997, Congress reaffirmed the value of bank investment in SBICs when it amended the SBIA to permit banks to invest not only in SBICs organized as corporations, but also in the growing number of SBICs organized as partnerships or limited liability companies.[2]

SBICs, as the vehicles through which banks make small business investments, are themselves regulated entities that operate under detailed statutory and regulatory constraints designed to ensure safe and sound business practices. The SBA imposes a number of restrictions, including limitations on the formation, operation, funding and investment of SBICs. For national banks, the most relevant and significant limitation is the provision limiting a bank's investment in an SBIC to 5 percent of the bank's capital and surplus.[3]

Banks have used their statutory SBIC investment authority to become significant participants in the SBIC program, providing billions of dollars of seed capital to small- and medium-sized businesses. At the end of fiscal year 2000, bank-owned and affiliated SBICs held $15.9 billion in loans, debt and equity securities of small businesses, representing 70% of all SBIC program investments. At that same date, bank-owned and affiliated SBICs maintained $15.6 billion in total capital, or 75% of all the private capital in the SBIC program.

SBICs have produced strong returns with minimal losses over a relatively long period of time, involving both expansionary and recessionary markets. According to SBA data, bank SBICs have earned a positive realized return in all but one of the 24 years for which the SBA has supplied data.

March 2000 Proposal

Before describing the February 2001 Capital Proposal, it may be useful to provide some background and context for this proposed rule. The interagency February 2001 Capital Proposal was preceded by a capital proposal made by the FRB in March 2000 (March 2000 Capital

[2] Public Law 105-135, 111 Stat. 2592 (1997).
[3] 15 U.S.C. 682(b).

Proposal). This earlier proposal would have assessed, at the holding company level, a 50 percent Tier 1 capital charge on the carrying value of private equity investments in non-financial companies held directly or indirectly by a holding company – including any bank or bank subsidiary holdings. The March 2000 Capital Proposal would have applied to investments directly or indirectly made by a bank holding company under the new merchant banking authority, under Regulation K relating to international investments, under authority to invest in SBICs, under authority to hold indirectly investments under section 24 of the Federal Deposit Insurance Act, and under sections 4(c)(6) and 4(c)(7) of the BHCA.

Public comment on the proposal was extremely negative. Virtually all of the 130 commenters opposed one or more aspects of the proposal. Many commenters contended that the capital charge in the March 2000 Capital Proposal was excessive and unwarranted, and that the proposed 50 percent Tier 1 deduction, especially as it would have applied to bank-owned investments, was inconsistent with the capital standards applicable to banks themselves and with the historical performance of these investments in banks. It was also argued that any new and higher capital charge should be limited only to merchant banking investments made by financial holding companies under the new merchant banking authority in GLBA, and should not be applied to past or future investments made by banking organizations under other statutory authorities. Finally, some contended that the proposal was inconsistent with the purposes of GLBA by frustrating Congress' desire to permit a "two-way street" between securities firms and banking organizations.

A particular concern that we at the OCC expressed was that any consolidated holding company capital requirement that would apply a charge to assets held by or under a bank that was more stringent than the charge fixed by the primary regulator of the bank would undermine the Congressional mandate that bank capital requirements be set by the primary Federal bank regulator. Since the principal purpose of holding company capital is to protect the subsidiary bank, we saw no basis for the judgments of the primary bank regulator to be displaced in the setting of consolidated holding company capital requirements.

February 2001 Capital Proposal

The February 2001 Capital Proposal, which was developed jointly by the OCC, FRB, and FDIC (Agencies), is very different from the March 2000 Capital Proposal and, in my view, is a significant improvement over the original proposal in several respects. I have provided a summary of the February 2001 Capital Proposal in Attachment A. A more detailed discussion of some of the more material differences between the February 2001 and March 2000 proposals is set forth in the paragraphs below.

First, the scope of the present proposal is much narrower than the March 2000 Capital Proposal. Consistent with the attendant risk of the activity, the February 2001 Capital Proposal seeks to limit the scope of the regulation to equity investments activities of a character similar to those that might be engaged in by financial holding companies under GLBA. Accordingly, the only national bank equity investments that would be covered by the proposal are equity investments in non-financial companies made pursuant to: (1) the authority to invest through or in SBICs, or (2) the authority to make portfolio investments under Regulation K.

Second, the February 2001 Capital Proposal attempts to better reflect the historical experiences of banking organizations with equity investments in non-financial companies. As discussed above, national banks have engaged in SBIC investment activities for over 40 years without significant safety and soundness concerns. In view of this record of performance, the special statutory and regulatory safeguards placed on these activities, and the important public purpose of encouraging the development and funding of small businesses, the February 2001 Capital Proposal accords SBIC investments preferential treatment. Under the proposal, no additional capital charge would be applied to SBIC investments made by a bank or bank holding company, so long as the adjusted carrying value of the investments does not exceed 15 percent of Tier 1 capital.

As noted earlier, the SBIA restricts national bank investments in SBICs to an amount not exceeding 5 percent of the bank's capital and surplus. At this level of investment, SBIC activities have not historically posed a threat to the safety and soundness of any national bank, nor does the OCC anticipate that they would. However, post-investment appreciation is not included in this limit. Thus, if the activity is profitable, it is possible for the aggregate carrying value of SBIC investments in some banks to grow beyond the 5 percent limit applicable to original investments. In rare instances, the appreciated value of SBIC investments has approached or slightly exceeded the proposed 15 percent Tier 1 capital threshold at some banks.

The banking agencies have recognized, particularly in light of the substantial growth in SBIC investments in recent years, that significant holdings of private equity investments could potentially result in safety and soundness concerns. It is for this reason that the February 2001 Capital Proposal supplements the normal supervisory process with additional capital charges when SBIC aggregate investment levels exceed specified concentration thresholds. Under the proposal, if a bank's SBIC investments constitute less than 15 percent of its Tier 1 capital, those investments would be subject only to the existing capital requirements – a 100 percent risk weight on the assets, representing a 4 percent Tier 1 capital requirement. Once the 15 percent of Tier 1 threshold is reached, the February 2001 Capital Proposal would establish a progression of capital charges that increase with the size of the aggregate equity investment portfolio relative to Tier 1 capital. Specifically, a banking organization would be required to make a deduction from its Tier 1 capital based on the carrying value of the relevant equity investments, consistent with the table set forth in Attachment A. This focus on concentration thresholds is consistent with traditional precepts of safety and soundness and ensures that significant holdings of private equity investments are accompanied by a commensurately higher level of capital.

In its invitation letter, the Subcommittees asked whether the February 2001 Capital Proposal can be reconciled with recent proposed revisions to the Basel Capital Accord. The OCC believes that the two proposals are not inconsistent. Although the capital deductions in the February 2001 Capital Proposal would not be explicitly required under proposed Basel revisions, they are consistent with the principles underlying the revised Accord. Under Basel's proposed "standardized approach," venture capital and private equity investments are specifically mentioned as examples of "higher-risk" assets for which national supervisors may decide to apply a 150 percent or higher risk weights. The capital deduction framework proposed in the February 2001 Capital Proposal by the Agencies is consistent with the exercise of supervisory discretion envisioned by the Basel Committee under this provision, and more broadly, under the Supervisory Review pillar. The Basel Committee continues to develop details for the treatment of equity holdings under the "internal ratings-based approach," which is an alternative to the proposed standardized approach. This approach will seek to align risk weights and the resulting capital charges much more closely with the inherent economic risks. While this approach may replace many of our current risk weights for a wide range of bank assets, it is not expected to be implemented before 2004 at the earliest, and will likely apply only to a relatively small number of banks in the early years of implementation.

Conclusion

For the national banks we supervise, we believe that the approach contained in the February 2001 Capital Proposal promotes the continued conduct of private equity investments while maintaining safety and soundness principles and preserving the intent of Congress to promote bank investments in small businesses through SBICs. We look forward to hearing from members of the Subcommittees and other commenters as we work to develop a final rule.

I would be pleased to respond to any questions.

Attachment A

Summary of February 2001 Capital Proposal

Introduction. This summary describes a notice of proposed rulemaking, issued jointly by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, concerning the capital treatment of merchant banking activities. 66 FR 10212 (February 14, 2001). The proposal would apply to institutions supervised by all three agencies. This summary, however, focuses on the effect of the proposal on national banks.

Special Capital Charge for Non-financial Equity Investments. The proposal requires a banking organization to deduct a percentage of non-financial equity investments from Tier 1 capital. As described in Table 1, the amount required to be deducted generally ranges from 8 percent to 25 percent of the *adjusted carrying value*[4] of the non-financial equity investment. The percentage deduction increases as the amount of the bank's non-financial equity investments increases.

Table 1—Deduction for Non-financial Equity Investments

If the aggregate adjusted carrying value of all non-financial equity investments is . . .	Then the required percentage deduction from Tier 1 capital is . . .	
Less than 15% of Tier 1 capital	8%	As a percentage of the aggregate adjusted carrying value of non-financial equity investments
Greater than 15% but less than 25% of Tier 1 capital	12%	
Greater than 25% of Tier 1 capital	25%	

Note: "High concentration" (generally more than 50% of Tier 1 capital) of non-financial equity investments will be monitored and may be subject to heightened supervision.

Scope of Application. For a national bank, the proposal defines non-financial equity investments as only those *equity investments* in *non-financial companies* made pursuant to: (1) the authority to invest in small business investment companies (SBIC) or (2) the authority to make portfolio investments under Regulation K.

- The term *equity investment*[5] means "any equity instrument including warrants and call options that give the holder the right to purchase an equity instrument, any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity." Subordinated debt or other types of debt may be treated as equity for purposes of the special capital charge if the OCC determines that the debt instrument is the "functional equivalent" of equity.

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[4] *Adjusted carrying value* is defined as the "aggregate value at which the investments are carried on the balance sheet of the bank, reduced by any unrealized gains that are reflected in such carrying value but excluded from the bank's Tier 1 capital."

[5] A national bank's minority interest in any entity that holds non-financial equity investments in a non-financial company is not counted as Tier 1 capital if the national bank holds the minority interest pursuant to its SBIC or Regulation K investment authority.

- The term *non-financial company* means an entity that conducts activities that "have not been determined to be permissible for the bank to conduct directly" or activities that have not been determined to be financial in nature or incidental to financial activities under new section 4(k) of the Bank Holding Company Act.

Exception. No deduction is required for non-financial equity investments that are held in the trading account in accordance with applicable accounting principles and as part of an underwriting, market making or dealing activity.

Special rule for SBIC investments: No deduction is required for non-financial equity investments made in or through a SBIC in amounts less than 15 percent of Tier 1 capital. For amounts of 15 percent or more, the deduction requirement is required as provided in Table 1. Investments that fall within the 15 percent limit are included in risk-weighted assets and assigned to the 100 percent risk-weight category. Although the special capital charge does not apply to SBIC investments of less than 15 percent, those investments are counted for purposes of determining whether the bank exceeds the aggregate 15 percent limit.

Answers Provided by John D. Hawke, Jr.
Comptroller of the Currency
To Questions Submitted by Chairman Baker, Chairman Bachus and Representative Kelly
Hearing on "Promotion of Capital Availability to American Businesses"

1. *How do you answer critics of the merchant banking rules who submit that they are the primary reason that the major investment banking firms with extensive private equity investment activities have, thus far, been unwilling to select financial holding company (FHC) status under the Gramm-Leach-Bliley Act (GLB)? What more can be done to facilitate the "two-way street" envisioned by Congress when enacting the merchant banking provisions of GLB?*

The merchant banking operational rules were developed and promulgated by the Federal Reserve Board and the Department of the Treasury. Under GLB, until at least 2004, merchant banking equity investment activity under the new authority afforded by GLB is relegated to bank holding companies, and these investments are not generally permissible for national banks and their subsidiaries. The Federal Reserve Board, the agency that regulates bank holding companies, should be consulted for further information regarding possible reasons for investment banking firms' reluctance to form financial holding companies. To facilitate the "two-way street" envisioned by Congress, the OCC remains committed to seeking the eventual elimination of disparities in the authority of bank holding companies and bank subsidiaries to conduct equity investment activities.

2. *You have grandfathered some merchant banking investments made under pre-GLB authority. However, the capital rule would still apply to all other merchant banking investments. Banks are concerned that imposition of new capital requirements on these investments, which historically have been both profitable and low-risk, will cause them to become unprofitable. Why aren't all merchant banking investments grandfathered so that FHCs and bank holding companies (BHCs) do not have to reconfigure internal capital allocations for existing activities?*

The proposed new capital rule does not affect SBIC investments made by national banks or their subsidiaries unless the carrying value of those investments exceeds 15% of Tier 1 capital. The proposed capital rule solicited specific comment on the question of grandfathering investments made prior to March 13, 2000 (the date of the original Federal Reserve capital proposal), and we will be closely reviewing those comments. Moreover, members of Congress and commenters have raised questions about imposing the proposed higher capital charges on activities made under pre-GLB authority. While we cannot predict the ultimate outcome of the interagency rulemaking process, the OCC intends to fully explore those questions.

3. *Please advise as to the rationale for subjecting preexisting investments held by FHCs under Section 4(c)(6), Section 4(c)(7), Section 4(c)(13), and other provisions of the Bank Holding Company Act to higher capital requirements than applicable under current law. In this regard, please state whether there are any specific events, losses or financial developments that*

would justify the imposition of new capital requirements to investments held under such Bank Holding Company Act provisions.

The Federal Reserve System supervises activities conducted by holding companies and their non-bank subsidiaries pursuant to Sections 4(c)(6), 4(c)(7), 4(c)(13), and other provisions of the Bank Holding Company Act. Consequently, the OCC does not have sufficient information to provide substantive comments on the performance of, or the potential supervisory issues posed by, investments that are permitted solely in FHCs or BHCs under these authorities.

National banks, however, are permitted to conduct activities, through Edge Act corporations or Agreement corporations (subject to the requirements of 12 C.F.R. Part 211 (Regulation K)), that are similar to those allowed under Section 4(c)(13) of the Bank Holding Company Act. Due to the similarities in the inherent risks of these investments relative to other merchant banking-type equity investments, the proposed capital rule would apply higher capital requirement to equity investments made under the portfolio investment authority provisions of Regulation K. The level of these investments held by national banks is relatively small, and the OCC is not aware of significant losses or other specific events in Edge Act or Agreement corporations that would seriously jeopardize the safety and soundness of any national bank.

The proposed capital rule solicited specific comment on the question of whether it is appropriate to apply the capital charge to investments made through Edge Act corporations and Agreement corporations in nonfinancial companies overseas. The OCC recognizes the importance of not impeding the ability of U.S. banks to compete in foreign markets, and will carefully consider comments received in this regard.

4. *When was the OCC first consulted with regard to the content of the proposed capital rule? Was the input of the OCC sought prior to the initial capital proposal of last March?*

OCC staff was briefed by Federal Reserve Board staff shortly before the release of the initial capital proposal in March 2000. Subsequent to the issuance of the March 2000 proposal, the OCC expressed to the Treasury Department and the Federal Reserve Board a number of concerns about the implications that the holding company proposal would have on equity positions held by national banks. Over the course of the summer of 2000, numerous meetings between the banking agencies led to a decision to pursue a more reasonable capital rule that would apply uniformly to national banks, state banks, and holding companies.

TESTIMONY OF ROBERT J. KABEL ON BEHALF OF
THE BANK PRIVATE EQUITY COALITION

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES
AND THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

JOINT HEARING ON
PROMOTION OF CAPITAL AVAILABILITY TO AMERICAN
BUSINESSES: A REVIEW OF THE FEDERAL RESERVES
MERCHANT BANKING RULES

APRIL 4, 2001

**Testimony of Robert J. Kabel on Behalf of
The Bank Private Equity Coalition**

Chairmen Baker and Bachus, Ranking Members Kanjorski and Waters, members of the Subcommittees, I am Robert Kabel, counsel to the Bank Private Equity Coalition.[1] On behalf of BPEC, I want to thank you for your continuing interest in the regulatory implementation of the merchant banking authority enacted as part of the Gramm-Leach-Bliley Act (GLBA). BPEC sincerely appreciates your convening of this important hearing and the opportunity to present our views on implementation of the merchant banking provisions of GLBA.

I. Background

BPEC was formed in early 1995 by the direct investment subsidiaries of several large commercial bank holding companies to address various statutory and regulatory issues. Prior to the enactment of GLBA, BPEC members had been involved for many years in direct investment activities through existing authorities, including SBICs and the so-called five percent companies. These direct investment subsidiaries have many years of direct investment experience and excellent earnings track records.

BPEC worked early in the 104th Congress with then House Banking Committee Chairman Jim Leach on the merchant banking language included in the first financial modernization bill that he introduced early in 1995. The same merchant banking language was included in every subsequent version of financial modernization legislation, including the legislation that was signed into law in November of 1999. The purpose of the merchant banking provision was to expand the existing direct investment authority of commercial bank holding company subsidiaries so they could compete more effectively with securities firms and insurance companies who were not subject to Glass-Steagall and Bank Holding Company Act restrictions.

Throughout the legislative process, BPEC recognized that the merchant banking provisions were intended to be self-executing and would not result in any significant additional regulatory requirements being imposed on this activity. The legislative language described in considerable detail the authority for classic portfolio investing in which investments are held only for the purpose of appreciation and there is no day-to-day management of portfolio companies, except in extraordinary circumstances.

Prior to the enactment of GLBA, the SBA regulated SBICs and the Federal Reserve Board regulated all other direct investments made through bank holding companies. The regulation of merchant banking activities was burdensome and often unpredictable. Federal Reserve examinations varied widely in regards to several critical issues. Therefore, BPEC and others in the industry advocated the enactment of the merchant banking provisions in GLBA as a means by which to streamline the regulation of merchant banking activities as well as provide for greater competitive equality.

[1] BPEC Members include: DB Capital Partners, Inc.; BankBoston Capital, Inc.; Norwest Equity Partners; and, JPMorgan Capital Partners

Since enactment of GLBA, BPEC has worked with the federal financial regulatory agencies on implementation issues through a series of meetings and comment letters. Chairman Baker, we appreciate the attention you and the Capital Markets Subcommittee have given this important set of issues. BPEC strongly believes that the appropriate regulatory implementation of the GLBA merchant banking provisions in accordance with Congressional intent will determine whether this new statute leads to the modernization of our financial industry as Congress had intended. Nothing less than that is at stake here.

The question that remains is whether securities firms in particular will wish to charter financial holding companies, thereby broadening the types of financial institutions they are eligible to own under the newly authorized holding company structure. Merchant banking has been a significant business for most securities firms for many years. These firms will carefully scrutinize the regulatory requirements imposed on merchant banking activities conducted in a Financial Holding Company (FHC) before deciding whether to seek FHC status.

II. Interim and Final Rules Regarding Merchant Banking Activities

In view of the intense scrutiny Congress gave merchant banking issues during the development of the GLBA, BPEC was surprised and disappointed when the Federal Reserve Board (Board) and the Treasury Department (Treasury) issued their interim merchant banking regulations on March 17, 2000 and the Board issued its proposed capital rules.

The interim rule established an extensive set of complex rules for merchant banking which BPEC members, and many other members of the financial community, thought to be exceedingly restrictive. We are pleased that the regulators took into account many of the extensive comments submitted regarding the interim rule and modified several of its provisions so that the final rule provides somewhat greater flexibility in certain of its provisions. Modifications made in the final rule include:

- Reduces penalties for exceeding the specified holding periods;
- Modifies the limitations on control and day-to-day management of portfolio companies to more accurately reflect the statutory provisions;
- Eliminates the internal record keeping requirements in favor of requiring compliance with the Federal Reserve SR Letter No.00-9, issued by the Board on June 22, 2000, thereby not layering additional requirements on top of those already required;
- Clarifies that once capital rules are in place, the aggregate merchant banking limits in the interim rule will be eliminated, thereby removing a major impediment for our members.

We remain concerned, however, that the final rule imposes a series of restrictions on FHC merchant banking operations that our non-FHC merchant banking competitors are not required to follow. In particular, BPEC remains troubled by the cross-marketing restrictions included in the final rule. The GLBA and the final regulations prohibit merchant banking portfolio companies acquired under the new authority from marketing products and services of an affiliated depository institution and vice versa. These restrictions apply to portfolio companies in which an FHC owns more that a 5% voting equity interest. The regulators provide some level of flexibility in the final rule but have clearly stated that the statute does not permit them to go further. We believe the matter is subject to doubt nonetheless. The GLBA explicitly provides insurance companies involved in merchant banking with the authority to cross-market products and services. This apparent disparity is unfair and unwarranted, and should be changed. If regulatory relief is not forthcoming, BPEC recommends amending GLBA to permit financial institutions to cross-market products and services with portfolio companies.

III. Revised Proposed Capital Regulations

BPEC, like almost everyone in the financial services industry, also was disappointed by the Federal Reserve's original proposed capital rules for FHC merchant banking activities. During the several year debate which led to the enactment of GLBA, none of the regulators ever publicly suggested that there should be the prospect of special capital rules for merchant banking activities. Congress rightly did not impose an excessive capital requirement because it recognized that existing merchant banking firms had a long history of making prudent investments and therefore did not require a separate capital rule.

The Federal Reserve's original proposal called for imposing a 50% capital charge on all merchant banking activities regardless of under what authority they were made, where they were made or who made them. The proposed capital charge was particularly inappropriate when applied to strong, prudent and experienced merchant banking firms. The original proposed rule covered both existing and future investments.

BPEC is pleased that the Federal Reserve carefully reviewed the substantial industry comments submitted in regards to the proposed capital rule and made significant changes in the revised proposal now out for comment. Comments made by this Committee and others in Congress were constructive and we appreciate the Committee's leadership on this critical issue. The revised proposal imposes a sliding scale of deductions from Tier 1 capital that are calculated as a percentage of the adjusted carrying value of the merchant banking portfolio. The percentage increases as the ratio of the size of the equity portfolio increases relative to Tier 1 capital. The capital charge ranges from a minimum of 8% for portfolio less than 15% of Tier 1 capital up to a capital charge of 25% for portfolio investments that exceed 25% of Tier 1 capital. The larger the portfolio relative to an FHCs Tier 1 capital, the higher the capital charge. Therefore, under any scenario, merchant banking investments will require more capital than the "well capitalized" level of 6% required of other assets.

The Federal Reserve's revised capital proposal establishes a special rule for investments made through an SBIC. Specifically, SBIC investments that do not exceed 15% of Tier 1 capital of the bank, or if the SBIC is housed in the FHC, 15% of the Tier 1 capital of all of its depository institution subsidiaries, are not subject to the capital deduction. However, SBIC investments count in determining the adjusted carrying value of the institution's merchant banking portfolio and, therefore, the marginal rate of capital that applies to the rest of the portfolio automatically increase if the SBIC investments push other investments into a higher deduction bracket.

Consequently, it seems that FHCs whose total merchant banking portfolios exceed 15% of Tier 1 capital will have a capital charge on any SBIC investments even if they are below the 15% level

While BPEC appreciates the fact that the Federal Reserve carefully reviewed and responded to many of the comments submitted on the original proposed rule, we continue to object to singling out any individual asset class for discriminatory treatment. As we stated in our comment letter on the original proposed capital rule, BPEC believes the Federal Reserve should utilize the internal capital allocation models of those FHCs with merchant banking operations. The Federal Reserve should review these models during the normal examination process and impose specific capital requirements only if the internal models are deemed inadequate to protect against the inherent risk in the institution's merchant banking portfolio.

BPEC's comment letter to the Federal Reserve on the revised proposed regulations will maintain this same position and, in response to specific requests for comment, will urge the Federal Reserve to grandfather investments made before March 13, 2000, the date the original proposed capital rules were published, and, in the alternative, to implement a three year phase on these investments.

IV. Conclusion

I want to thank you again for this opportunity to present the views of the Bank Private Equity Coalition on the final merchant banking regulations and the revised proposed merchant banking capital rule. Our members appreciate the continuing attention you and members of the Committee have given this important financial modernization issue. We look forward to working with you and other members of the House Financial Services Committee on the implementation of GLBA and, if necessary, to provide FHC merchant banking subsidiaries with appropriate flexibility with respect to cross-marketing opportunities.

Testimony of John P. Whaley

On Behalf of the ABA Securities Association

Before

The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

And

The Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services
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Chairmen Baker and Bachus, Representatives Kanjorski and Waters, distinguished members of the subcommittees, my name is John P. Whaley. I am a partner of Norwest Equity Partners and Norwest Venture Partners, merchant banking firms based in Minneapolis, Minnesota, and Palo Alto, California, respectively. Norwest Venture Partners makes equity investments in early stage and emerging growth businesses focused on information technology related industries. Norwest Equity Partners invests in management-led buyouts of more mature businesses. Together, these firms comprise the private equity investment business of Wells Fargo & Co., a $272 billion financial holding company based in San Francisco, California.

I appear here today on behalf of ABASA, the ABA Securities Association. ABASA is a separately chartered trade association subsidiary of the American Bankers Association ("ABA"), formed in 1995 to develop policy and provide representation for those bank and financial holding companies involved in, among other things, merchant banking and investment banking activities. My testimony today also reflects the views of the ABA.[1]

I commend you, Messrs. Chairmen, for holding this hearing to focus on capital markets developments after passage of the Gramm-Leach-Bliley Act ("Act"), particularly the merchant banking rules issued during the last quarter by the Board of Governors of the Federal Reserve System ("Board") and the Department of the Treasury ("Treasury") and the re-proposed capital rule issued by the Board, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC).[2] Many of ABASA's members regard the authority to engage in expanded merchant banking activities as the single most important new power granted by the Act. As a result, ABASA has a strong interest in ensuring that its members are able to engage in merchant banking activities to the full extent allowed under the law.

As the Subcommittees are well aware, ABASA strongly opposed the original capital proposal issued by the Board, as well as the interim merchant banking rule issued by the Board and Treasury, in March of 2000.[3] Indeed, during the 106th Congress, ABASA testified before the House Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises concerning its opposition to the proposed rules.

Since that time, the Board and Treasury have revised the proposed interim rules

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[1] ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

[2] Final merchant banking rules adopted by both the Board and the Treasury (Docket No. R-1065, 66 Federal Register 8466 (January 31, 2001)); Re-proposed capital rule issued by the Board, OCC and FDIC (Docket No. R-1097, 66 Federal Register 10212 (February 14, 2001)).

[3] See Docket Nos. R-1065 and R-1067, 65 Federal Register 16460, 16480 (March 28, 2000).

and adopted final rules, effective February 15, 2001. In addition, the Board, along with the OCC and the FDIC, has issued a revised capital proposal, with comments due on April 16, 2001.

As more fully expressed below, ABASA is pleased that the regulators have addressed many of its concerns and comments, and that additional flexibility has been incorporated in many instances. We are particularly pleased that the 50 percent capital charge and the restrictions placed on merchant banking activities conducted through private equity funds have been modified substantially. While ABASA continues to believe that a supervisory approach is the most appropriate method for addressing any special capital requirements for merchant banking activities, we are most concerned about, and continue to be opposed to, assessment of a special capital charge for equity investment activities authorized ***prior*** to enactment of the Gramm-Leach-Bliley Act.[4]

In addition, Messrs. Chairmen, ABASA seeks your support in sponsoring legislation that would amend the cross-marketing prohibitions imposed by the Gramm-Leach-Bliley Act on merchant banking activities. Under current law, the cross-marketing prohibitions unfairly disadvantage those FHCs not affiliated with insurance underwriting firms that seek to engage in merchant banking activities. ABASA strongly urges revisions to the Act to allow all FHCs to engage in such limited cross-marketing activities.

[4] It should be noted that in addition to applying to merchant banking investments, the capital charge would apply to non-financial equity investments made: (1) pursuant to section 4(c)(6) and 4(c)(7) of the Bank Holding Company Act ("BHCA"); (2) overseas, pursuant to the Board's Regulation K; (3) through Small Business Investment Companies (or "SBICs"); or (4) by state non-member banks pursuant to section 24 of the Federal Deposit Insurance Act ("FDIA").

Special Capital Charge

The proposed rule would adopt a three-tier or sliding scale approach for assessing capital against equity investments made by FHCs and bank holding companies ("BHCs"). The capital charge would be in addition to the capital otherwise required to be held under bank holding company capital requirements. This separate capital charge would take the form of a deduction from the organization's Tier 1 capital. The size of the deduction would increase as the equity investment portfolio increased relative to the organization's Tier 1 capital, as described below.

Specifically, if equity investments in nonfinancial companies make up less than 15 percent of an organization's Tier 1 capital, an 8 percent Tier 1 capital charge would be assessed against all such equity investments (except, as noted below, those made through small business investment companies ("SBICs")).

The second tier provides that if equity investments in nonfinancial companies make up 15 percent or more but less than 25 percent of an organization's Tier 1 capital, a 12 percent capital charge would apply to the amount of such investments exceeding the 15 percent threshold.

Under the third tier, a 25 percent capital charge would apply to the amount of equity investments in nonfinancial companies that equal or exceed 25 percent of an organization's Tier 1 capital.

In addition to the new, merchant banking equity investments that may be made under Gramm-Leach-Bliley, there are four other pre-Gramm-Leach-Bliley types of banking organization equity investments in nonfinancial companies that also must be counted in determining whether the 15 percent and 25 percent thresholds have been exceeded:

1. Equity investments made through SBICs;
2. Non-controlling equity investments made under sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act;
3. Portfolio equity investments made under Regulation K; and
4. Most equity investments by state banks under section 24 of the Federal Deposit Insurance Act.

Although SBIC equity investments count towards the aggregate 15 percent and 25 percent calculations, no capital charge or deduction is applied to any such SBIC investment unless the total amount of such SBIC investment by itself exceeds the 15 percent threshold. To the extent that the separate 15 percent SBIC investment threshold is exceeded, such "excess" SBIC equity investments are subject to the aggregate capital charge.

As noted above, the capital deduction would be applied on a marginal basis. For example, if an organization's equity investments in nonfinancial companies equaled 27 percent of that organization's Tier 1 capital, 8 percent of the carrying value of the investments would be deducted for those investments that represent less than 15 percent of Tier 1 capital (other than SBIC investments). For those investments that represent between 15 and 24.99 percent of Tier 1 capital, a 12 percent capital deduction would apply (other than to SBIC investments, except to the extent that such SBIC investments by themselves exceeded the 15 percent threshold). For those investments that represent 25 percent or more of Tier 1 capital, a 25 percent capital deduction would apply (other than to SBIC investments, except to the extent that such SBIC investments by themselves exceeded the 15 percent threshold).

ABASA is pleased that the Board, with the assistance of the OCC and the FDIC, significantly reduced the 50 percent blanket capital charge originally sought to be imposed on all equity investment activities. While ABASA still maintains that the optimum method for dealing with nonfinancial equity investments would be to adopt a supervisory approach as we originally advocated in our testimony to the Congress and in our comments to the Board,[5] we recognize that a special capital charge ranging from 8 to 25 percent of Tier 1 capital is a significant improvement over "the one size fits all" 50 percent capital charge originally proposed.

We are particularly pleased that the Board considered our arguments against "the one-size-fits all approach." The newly proposed sliding scale approach addresses, in large part, many of our concerns by assessing capital according to the level of nonfinancial equity investments made by an organization. Thus, as the level of such investments increases, so too, would the required Tier 1 capital deduction.

We remain concerned, however, that any special capital charge assessed against FHCs engaged in merchant banking activities will further exacerbate the inequities between FHCs and non-FHCs engaged in merchant banking activities. The legislative history describing the merchant banking provisions of the Gramm-Leach-Bliley Act indicates that Congress intended that those investment banking firms affiliated with securities firms and insurance companies that opt to become FHCs should be permitted to continue to engage in merchant banking activities in substantially the same manner as had always been permitted.[6] Conversely, Congress also intended that bank and financial

[5] A supervisory approach would require FHCs to meet appropriate qualitative standards for managing merchant banking risk in order to qualify for the supervisory approach. In assessing where an FHC is appropriately managing risk under this approach, the regulators would look at all relevant facts and circumstances, including internal capital allocation models, valuation policies, reporting systems, equity investment risk management policies, and so forth. An FHC's internal capital allocation model could be used to measure and "backtest" capital adequacy with respect to merchant banking investments in a manner that could be readily monitored and validated by the regulators. Significant failures of the model could result in additional capital requirements for merchant banking investments, on a case-by-case basis.

[6] House Rep. No. 106-74, 106th Cong., 1st Sess. at 123; S. Rep. No. 106-44, 106th Cong., 1st Sess. at 9.

holding companies should not be placed at a competitive disadvantage relative to investment banking firms not affiliated with any depository institution, but should be allowed to engage in merchant banking activities to the same extent as those other firms.[7]

Despite Congress' stated intentions, the newly proposed special capital charge against merchant banking activities, even as reduced under the revised proposal, would preclude FHCs from engaging in merchant banking activities on the same terms and conditions as their non-bank affiliated competitors. These provisions also might discourage securities and insurance firms from becoming FHCs, because the price, in terms of limits on merchant banking activities, may be too steep. The result: financial holding companies will be precluded from engaging in merchant banking activities on the same terms and conditions as their non-bank affiliated competitors. If they choose to engage in merchant banking it will be with a capital charge not borne by their non-bank competitors.

Most importantly, ABASA continues to oppose any assessment of a special capital charge on non-merchant banking equity investments, which have been permissible for banking organizations for many years preceding the Gramm-Leach-Bliley Act. The banking industry has a long history of engaging in such equity investment activities through SBICs,[8] under Regulation K,[9] and under the authority of sections 4(c)(6) and

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[7] Id.

[8] Since 1958, commercial banks have, through their SBIC corporations, provided equity capital, long-term loans and management assistance to new and established small business firms. Bank-owned or bank-affiliated SBICs generally provide the largest proportion of financed dollars to small businesses. For 21 of the last 22 years, such SBICs have made a profit on their venture capital investments, averaging an annual rate of return of 13%.

4(c)(7) of the Bank Holding Company Act and Section 24 of the Federal Deposit Insurance Act.[10] To date, those activities have produced strong returns with minimal losses and have taken place over a relatively long period of time, involving both up and down markets. There is simply no evidence that additional capital is warranted for equity investments authorized for banking organizations ***prior*** to passage of the Gramm-Leach-Bliley Act. At the very least, investments through SBICs should be excluded from both the activity-level calculation and special capital charge.[11]

Should the regulators insist on going forward with their proposal to assess capital against merchant banking activities authorized for banking organizations prior to passage of the Gramm-Leach-Bliley Act, ABASA would strongly encourage the regulators to grandfather all equity investments made prior to March 13, 2000. Without such a determination, many of the investments made previously will be rendered uneconomic – not because of any change in inherent worth but solely because of an unanticipated change in regulatory treatment that results in greater unexpected cost.[12]

Moreover, grandfathering these investments avoids the burdens associated with implementing a phase-in of the special capital charge over a period of time for those equity investments made prior to March 13, 2000. As the proposal notes, these

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[9] Many banking organizations engage in equity investment activities abroad through a variety of vehicles. Limits on these activities include limiting the investment to no more than 40 percent of the equity of a company, with no more than 20 percent consisting of voting equity.

[10] Bank holding companies may make limited, non-controlling equity investments under authority of Sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act. In addition, state nonmember banks may, under certain circumstances, engage in equity investment activities under Section 24 of the Federal Deposit Insurance Act.

[11] The agencies have suggested that even if equity investments made prior to March 13, 2000 are grandfathered, the adjusted carrying value of the organization's investment portfolio made in grandfathered investments will nevertheless be used to determine the appropriate marginal capital charge on any investments not grandfathered.

investments involve only modest amounts at most banking organizations and will be liquidated over time. Modest investments liquidating over time would tend to argue against a phase-in of capital charges.[13]

Private Equity Funds

As the Subcommittees are aware, the new type of merchant banking equity investment may be made through pooled funds or directly in portfolio companies. The interim rule seemed to recognize that investments made through a specially-defined type of pooled fund, "a private equity fund," in which an FHC, by definition, may only be a minority investor should have fewer restrictions than investments made directly.

ABASA concurred with the Board and Treasury that merchant banking equity investments through private equity funds should have fewer restrictions than those made directly because fund investments inherently raise fewer regulatory concerns than do direct investments in portfolio companies. Proportionally less of the FHC's capital is at risk and majority participation in the private equity fund by unaffiliated investors imposes significant market discipline on investment decisions. The unaffiliated investor participation also helps ensure that the FHC's investment is made for bona fide investment purposes, rather than to allow the FHC to engage in prohibited commercial activities.

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[13] While the definition of "nonfinancial equity investment" appears on its fact to capture investments made by FHCs under the "complementary" authority of Section 4(k) of the Gramm-Leach-Bliley Act, ABASA assumes that the special capital charge will only apply to equity investments authorized under either section 4(k)(4)(H) of the BHCA, section 4(c)(6) or 4(c)(7) of the BHCA, section 302(b) of the Small Business Investment Act ("SBIA"), Regulation K, or section 24 of the FDIA (other than section 24(f)). To read this proposal otherwise would require the special capital charge to be assessed against any FHC investment in data storage and general data processing companies and electronic information portal services permitted under the complementary authority of Section 4(k)(1)(B). Such an assessment could negatively affect the ability of FHCs to engage in e-commerce. ABASA would oppose such a reading of the proposal.

Having recognized these legitimate reasons for less restrictive treatment, the interim rule needlessly imposed many of the same burdensome restrictions on portfolio investments made by a private equity fund in which an FHC has invested than it imposed on direct portfolio investments made by an FHC. That is, the rule's restrictions applied to the FHC's investment in the private equity fund itself, *and* then also "looked through" the equity fund to the portfolio investments made by the private equity fund and imposed many of the same restrictions on the fund's investments.

ABASA strongly objected to these "look through" provisions. The restrictions needlessly deterred FHCs from investing in private equity funds, and created a significant disincentive to the inclusion of FHC investors in many private equity funds offered by non-FHCs. ABASA believed the Board and Treasury could not have intended that result and commented extensively on that aspect of the interim rule.

We are pleased that the final rules applicable to private equity funds have been simplified and clarified in ways that address many of ABASA's concerns. Significantly, the restrictions on direct portfolio investments will no longer be applied on a "look through" basis to private equity fund investments unless the FHC controls the private equity fund. For example, where an FHC does not control the private equity fund, the restriction on routine management[14] will not apply to the private equity fund's investment in a portfolio company.

In fact, the only "look through" provision remaining in the final rule for non-controlling investments in a private equity fund involves the length of time such a fund

[14] Both the Gramm-Leach-Bliley Act and the final regulations prohibit the routine management or operation of a portfolio company "except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition."

may hold an investment. Specifically, investments in private equity funds and the fund's own investments in portfolio companies may be held for only15 years, even if the FHC's investment in the fund is non-controlling. While this 15-year holding period is longer than the 10-year holding period applicable to direct merchant banking investments in portfolio companies, ABASA continues to maintain that it is unnecessary to require any holding period limit on investments made by a private equity fund that is not controlled by an FHC.

Another significant revision to the private equity fund provisions addressed an ABASA concern involving the issue of control. The original proposal lacked a clear standard for determining when "control" of a private equity fund existed. "Control" is an important concept with respect to private equity funds as it has significant ramifications for both the fund's operations and the FHC investor (and the application of the "look through" restrictions). For example, if an FHC "controls" a private equity fund, the FHC is prohibited from routinely managing a portfolio company in which the private equity fund has invested. In addition, as discussed below, an FHC is prohibited from cross-marketing its subsidiary banks' services through portfolio companies held by a private equity fund controlled by the FHC.

The final rule provides that an FHC will be deemed to control a private equity fund if the financial holding company, including any director, officer, employee or principal shareholder of the FHC:

- Serves as general partner, managing member, or trustee of the private equity fund;
- Owns or controls 25 percent or more of any <u>class</u> of voting shares or similar interest in the private equity fund;

- Selects, controls, or constitutes a majority of the directors, trustees, or management of the private equity fund; or
- Owns or controls more than 5 percent of the voting shares of the private equity fund and at the same time acts as the private equity fund's investment adviser.

While the Board has clarified its definition of control through these four conclusive presumptions, we find the attribution rules related to the control determination quite troublesome. Specifically, ownership of shares of a fund by an officer or employee of a holding company is equated with ownership of shares by the holding company itself. Such an attribution of ownership of shares to the FHC goes beyond any attribution rules previously set forth by the Board in its Regulation Y. We also continue to maintain that general partnership, in and of itself, should not be considered "control".

Other significant revisions to the final rules applicable to private equity funds involve cross-marketing activities. Specifically, the final rule now makes clear that FHCs may cross-market interests in private equity funds to high net worth investors. FHCs also can cross-market the services of its subsidiary banks through portfolio companies held by a private equity fund so long as the FHC does not control the private equity fund.

Despite the easing of these cross-marketing restrictions contained in the final rule, more relief is needed. However, such relief requires legislation.

Other Provisions of the Final Rule

The final rule adopted by the Board and Treasury was significantly improved in other respects, providing additional flexibility in a number of areas. I would like to outline a few of these improvements.

Aggregate Investment Limits. The final rule removed the fixed dollar amount caps on the rule's aggregate investment limits. ABASA had objected strenuously to the aggregate investment limits, particularly the fixed dollar caps. Further, and most importantly, the final rule specifically provides that the aggregate investment limitations contained in the final rule will sunset automatically once the capital rules for nonfinancial equity investments are adopted.

Holding Periods. Additional flexibility was also provided with respect to the rules on holding periods. Specific holding periods continue to apply -- ten years for direct investments in portfolio companies and fifteen years for investments made through qualifying private equity funds. However, extensions now are permitted if Board approval is obtained up to 90 days before the end of the holding period. This 90 day pre-approval requirement is a significant improvement over the one year pre-approval requirement in the interim rule. Further, the disincentives to obtaining an extension have been pared back from those in the interim rule. All disincentives were eliminated save one: the capital charge requirement, which itself was pared back to require that the FHC hold capital against the investment in an amount set by the Board that must be above the highest capital charge applicable to the requesting FHC under the capital rules, but in no event less than 25% of the adjusted carrying value of the investment.

Routine Management. The rules on what constitutes "routine management" also were improved with additional flexibility provided here as well. Rather than an absolute bar on all officer and employee interlocks, the final rule establishes a rebuttable presumption that routine management exists where there are officer or employee interlocks. While routine management continues to be permitted only for a limited period of time, here, as well, additional flexibility was provided. Rather than obtain Board approval to routinely manage a portfolio company for more than six months as required under the interim rule, the final rule requires only written notice to the Board when routine management will exceed nine months.

Affiliate Transactions. For purposes of affiliate transaction limitations, the Gramm-Leach-Bliley Act establishes a rebuttable presumption of control when an FHC owns or controls more than 15 percent of the equity of a portfolio company. In its comment letter to the Board and Treasury, ABASA requested that the rule establish explicit safe harbors from this affiliate transaction rebuttable presumption. The final rule now has three specific safe harbors that establish an automatic rebuttal of the presumption, without the necessity for Board approval or notice.

Legislative Changes are Necessary to Level the Playing Field

Under the Gramm-Leach-Bliley Act, an FHC is permitted to engage in merchant banking equity investment activities if, among other things, it is affiliated with either a securities firm or an insurance underwriting firm. Presumably, the theory behind these requirements is that affiliation with either of these firms evidences some degree of sophistication with the financial markets.

The Gramm-Leach-Bliley Act generally imposes cross-marketing restrictions on FHCs engaged in merchant banking activities. The Act prohibits a depository institution controlled by an FHC from marketing any product or service of a company in which the

FHC has made a merchant banking investment. The reverse is also true: the company in which the FHC has invested may not market the products and services of the FHC's affiliated depository institution to its customers.

A carve-out from this prohibition is provided, however, for merchant banking investments made by insurance companies owned by an FHC. Thus, insurance underwriting firms that affiliate with depository institutions are able to cross-market, through Internet websites or through statement stuffers, depository institution products to or through the company in which they have made a merchant banking investment. Products and services offered by the company in which the insurance underwriting firm has invested also may be marketed through Internet websites or statement stuffers via the depository institution that is affiliated with the insurance underwriting firm. Nearly all of ABASA's members are FHCs that may make merchant banking investments because of their affiliation with securities firms, while very few own insurance companies that could engage in the type of insurance company merchant banking permitted by Gramm-Leach-Bliley. As a result, our FHC members could not take advantage of the website/statement-stuffer exception, while other FHCs with insurance company merchant banking operations would be permitted to do so. There is simply no rational or public policy reason for this plain competitive inequity. The ability to cross-market through Internet websites is important to banks. Current business practices often require an FHC to invest in an Internet firm in order for its banks' products to be posted on or linked to that firm's website. The new merchant banking authority granted to FHCs would appear to preclude such an investment unless done through an insurance company owned by the FHC.

Some banking organizations have avoided this problem to a limited degree by investing in Internet firms through SBICs. The Board is also considering adding Internet activities to the list of "complementary" activities permitted under Section 4(k) of the BHCA.[15] These solutions are of limited use, however, and are clearly not a permanent solution. Consequently, ABASA urges the Congress to expand the website/statement stuffer carve-out currently applicable to merchant banking activities engaged in by insurance company subsidiaries of FHCs to all FHCs engaged in merchant banking activities -- ownership of an insurance company should not be a condition for such sensible cross-marketing relief.

Conclusion

In conclusion, ABASA appreciates the opportunity to once again share with you our views regarding the rules and their impact on merchant banking – an activity that is of fundamental importance to the financial services industry, corporate America and consumers.

[15] See Docket No. R-1092, 65 Federal Register 80384 (December 21, 2000).

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TESTIMONY OF PETER A. GRAUER

On behalf of

Credit Suisse First Boston
The Financial Service Roundtable
The Securities Industry Association

Hearings on Merchant Banking Activities
House Committee on Financial Services
April 4, 2001

Testimony of Peter A. Grauer
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Introduction

Good morning Mr. Chairman. I want to thank you for holding these hearings today and allowing me to appear before the Committee. I am presenting testimony today on behalf of Credit Suisse First Boston ("CSFB"),[1] as well as The Financial Services Roundtable and the Securities Industry Association ("SIA").

My name is Peter Grauer and I am a Managing Director in CSFB's Private Equity[2] Group. I joined CSFB in November 2000 when the Firm merged with Donaldson, Lufkin & Jenrette ("DLJ"). This was my second tour at DLJ. Prior to this, I ran a merchant banking boutique, Grauer & Wheat, Inc., for three years. I began my private equity career at DLJ in 1980 as a Vice-President in DLJ's Venture Capital arm. In 1985, I moved to DLJ's Merchant Banking group as a Managing Director and in 1995, I became the founding partner of DLJ Investment Partners, a private equity fund that invests in mezzanine securities. Prior to DLJ, I spent eleven years at Citibank, N.A., concluding my career as a Vice President and senior credit officer. In sum, I have spent over twenty years in the merchant banking business of which only for the past five months have my activities come under the regulation of the Bank Holding Company Act

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[1] CSFB is a leading global investment and commercial banking firm serving institutional, corporate, government and individual clients. CSFB's businesses include securities underwriting, sales and trading, investment and merchant banking, financial advisory services, investment research, venture capital, correspondent brokerage services and online brokerage services. It operates in over 76 locations across more than 37 countries and 6 continents, and has some 28,000 staff worldwide (including over 16,000 in the United States). CSFB is a business unit of the Zurich based Credit Suisse Group ("CSG"), a leading global financial services company.

[2] Consistent with industry practice, the terms "merchant banking" and "private equity" are used interchangeably throughout the testimony.

with the CSFB merger. Based on this history, I believe that I can present a unique perspective to the Committee on what constitutes traditional merchant banking practices and whether the Joint Rules we are discussing today permit these practices to continue.

As you may know, in March 2000, CSG and CSFB were each designated as financial holding companies ("FHCs") pursuant to the Gramm-Leach-Bliley Act ("GLBA"). CSFB Private Equity ("CSFB-PE") is a subsidiary of CSFB and, accordingly, is now subject to the Rules on Merchant Banking jointly promulgated by the Federal Reserve and Treasury in January of this year ("Joint Rules"). As a result, we have completed a full review of these Rules in the context of their application to a preexisting merchant banking operation that has a wealth of experience in the making and management of merchant banking investments of all types, and through all types of vehicles.

CSFB commends the Federal Reserve and Treasury for the significant improvements that the Joint Rules reflect from the original Interim Merchant Banking Rules put out in March 2000. The Joint Rules in their current form respond much more accurately than the Interim Rules to the economic and practical realities of a merchant banking operation. We appreciate the Federal Reserve and Treasury's willingness to be open-minded and work with the industry to improve these Rules. In the same spirit, we look forward to further refining the Rules as the Agencies gain greater expertise in private equity activities.

While we recognize how far the Agencies have come, unfortunately, we still believe that, considered on a whole, the Joint Rules present an unnecessarily burdensome array of restrictions that are neither mandated by safety and soundness concerns, nor in keeping with the language or spirit of the GLBA. There are a number of provisions of the Joint Rules that still do not fully reflect the manner in which private equity investors such as CSFB-PE conduct their businesses. We urge that the Federal Reserve and Treasury work cooperatively with Congress and industry participants to address these issues.

We believe that, more than any other provisions of the GLBA, the merchant banking restrictions have impeded non-bank financial firms from becoming financial holding companies. In evaluating the new Joint Rules, it is important to note that neither our competitors in the traditional securities industry, nor our competitors in the provision of venture capital and the making and management of private equity investments (e.g., Kohlberg Kravis & Roberts; Thomas H. Lee; The Texas Pacific Group; AIG; The Blackstone Group; Hicks, Muse, Tate & Furst), seem to have overcome their aversion to FHC status under the GLBA. To us, this is the acid, market test on whether the Joint Rules have enabled or impeded a two-way street between the investment and commercial banking industries. In our view, the unwillingness of major private equity market participants to elect FHC status -- including securities firms which were in the forefront of advocating enactment of the GLBA -- serves to underscore the continuing difficulties which the Joint Rules raise and presents the real possibility that FHCs may be operating at a significant disadvantage in the marketplace.

Today, I would like to raise certain items under the Joint Rules for the Committee's further review. I believe that resolution of these issues could go a long way to building an effective two way street consistent with Congressional intent under the GLBA.[3]

[3]The House Report provided, "[T]he Committee intends section 6(c)(3)(H) to permit investment banking firms to continue to conduct their principal investing in substantially the same manner as at present. The Board shall take into account that investment banking firms affiliated with depository institutions should be able to compete on an equal basis for principal investments with firms unaffiliated with any depository institutions so that the effectiveness of these organizations in their investment banking activities is not compromised." (H. Rep. 106-74, part 1, p.123 (1999))

Background.

By way of background, CSFB-PE is a combination of CSFB's pre-existing private equity activities merged with the activities of DLJ Merchant Banking Partners. The combined entity, CSFB-PE, is the sponsor of merchant banking, venture capital[4], "funds of funds"[5], mezzanine[6], real estate[7] and other private investment funds[8] with aggregate committed capital in excess of $22 billion, resulting in the world's largest manager of merchant banking assets. CSFB-PE's merchant banking activities have long been a strategic core business, reflecting over 30 years experience in the venture capital business.[9] CSFB-PE's leveraged corporate private equity funds (which invest directly in large private equity opportunities) have made more than 100 investments with an average transaction value of $475 million across a broad range of industries (including retailing, railroads, healthcare, telecommunications and industrial manufacturing), generating a 15-year compound annual internal rate of return in excess of 80%. This does not include smaller venture capital transactions or investments in third party funds, mezzanine securities or other types of assets. CSFB-PE's investor base includes a broad spectrum of the largest corporate pension funds, insurance companies, high net worth individuals and

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[4] A "venture capital" fund is a pool of capital used to make equity investments in companies with growth potential. The proceeds of the financing are used to start or expand a company.
[5] A "fund of funds" is a pool of capital that, instead of being used to make direct investments in companies, is distributed among a number of other funds managers, which in turn invest the capital directly.
[6] A "mezzanine" fund offers subordinated debt financing to companies (the level of financing that is subordinated to the senior debt but is senior to equity). Mezzanine financing shares characteristics of both debt and equity financing.
[7] A "real estate" fund is pool of capital that invests in real property interests.
[8] A "private investment" fund refers generally to any pool of capital used to make equity investments in private companies.
[9] This includes DLJ Merchant Banking Partners.

endowments. CSFB-PE is also often a minority co-investor alongside other leading private equity buy-out funds.

Federal Reserve/ Treasury Joint Rules.

While we were pleased at many of the modifications made by the Federal Reserve and Treasury in promulgating their final Joint Rules on merchant banking, we remain concerned that the Rules fail to capture the realities of the current marketplace for private equity investing. In our view, the merchant banking provisions of the GLBA are essential components of that landmark legislation and any regulatory implementation of those provisions that undercuts the Congressional intent and focus of that legislation should be scrutinized with great care.

It is important to start from the premise -- which is entirely borne out by CSFB-PE's experience -- that active merchant banking, properly managed, poses no greater risks to FHCs than many other activities that regulated financial institutions are permitted to engage in *without* restrictions (e.g., bank loans to debtor corporations). Moreover, merchant banking has provided a dynamic and growing source of capital funding for large and small business operations -- both "old economy" and "new" -- throughout the United States. Our historical returns further illustrate that merchant banking is a consistently profitable activity over a period of many years, including periods when the economy as a whole and many financial institutions have not performed well. Indeed, merchant banking investments (unlike publicly traded equity securities) are not directly subject to the short-term volatility of the financial markets, in which an earnings shortfall of a few pennies per share can cause a security to lose 25-40% of its value. Moreover, the conduct of merchant banking activities has not led in any way to a breakdown or weakening of the separation of banking and commerce which the GLBA preserves as a hallmark of the U.S. financial system.

In this context, I would like to start today by discussing some particularly nettlesome aspects of the Joint Rules that cause us practical difficulties and do not reflect established industry practice. I will then move briefly to an overview of broader industry concerns.

Specific problem areas under the Rules that we would like to highlight today and that we find raise operational difficulties are largely twofold. First, the restrictions on "routine management or operation" of a portfolio company remain highly problematic and raise particular difficulties for minority investors.[10] Second, the aggregate limit on a FHCs merchant banking investments continues to cause operational difficulty, particularly since the Joint Rules base this limitation on the "carrying value"[11] of these investments, rather than the dollars committed. In my view, these restrictions significantly diminish an important business opportunity for FHCs, and undercut the intent of Congress, *without* adding in any material way to the regulatory goals referred to in the Joint Rules.

Routine Management/ Restrictions on Minority Investors.

CSFB-PE is a growth-oriented investor that has traditionally taken an active role in assembling strong management teams for portfolio companies[12] and working with portfolio

[10] A "minority investor" is a shareholder that owns a small percentage of the equity of a company, and as a result, does not have the ability to control the company's management or board of directors.
[11] The "carrying value" of an investment is the value of the investment as reflected on the holder's balance sheet.
[12] A "portfolio company" is any company – whether a corporation, partnership, limited liability company or other business entity – in which a private equity investor or fund invests and which therefore constitutes part of such investor's or fund's "portfolio".

companies to develop strategic value-creation plans that benefit their investors. It is our philosophy to be an actively involved shareholder with long-term (as opposed to short-term) corporate goals, bringing to our investments all available resources and expertise. In that context, for example, since 1992, CSFB-PE has provided direct assistance to portfolio companies in making more than 30 acquisitions. Further, to provide ongoing guidance and monitor results, representatives of CSFB-PE have served on the boards of many portfolio companies. In conducting our merchant banking operations, we believe that the ability, if necessary, to change the strategic direction of a portfolio company, to change management, to determine how and when to refinance a portfolio company and to control the timing and manner of exit from the investment are each critically important risk-mitigating factors that should be fully preserved under the applicable Rules.

In general, the Joint Rules' restrictions on "routine management or operation" of a portfolio company appear to presume that an investment can be generally protected from bad or improper management through control of a portfolio company's board of directors. However, where -- as is frequently the case -- CSFB-PE only takes a minority position in a portfolio company, CSFB-PE would not have the ability to control the portfolio company's board of directors. In this case, the need for additional contractual and operational protections becomes significantly greater than in the majority-investment context. Traditionally, these protections are obtained through covenants for the benefit of minority investors (which may or may not be represented on the board) that dictate prudent business practices or controls for the portfolio company. The Joint Rules' prohibition on the use of many of these traditional covenants by FHC-affiliated funds would increase the risk associated with a minority investment and cause FHC minority investors to lose an important tool to protect the value of their investments. It may also create an artificial and perverse bias in favor of majority investments.

Based on our experience at CSFB-PE, I would strongly recommend that the Federal Reserve and Treasury revise the Joint Rules to permit FHCs making minority investments to retain the right to utilize a wide range of restrictive covenants for the express purpose of reducing the level of risk to investors. These covenants are intended to ensure prudent management and operating practices and to channel portfolio company business decisions in a cost-effective and revenue-enhancing manner.

While we recognize that the Joint Rules do provide limited examples of covenants that, if granted to a FHC, would not be considered to be "routine management or operation," the regulatory list is limited and incomplete. In my view this list relates fundamentally to what I would consider to be "extraordinary corporate events." The approved list does not go far enough to protect a merchant banking investment, particularly a minority investment that may most need the protection. In fact, the Rules ignore the reality that "ordinary" poor management (particularly in the absence of proper operating and management controls) will diminish value much more quickly than any "extraordinary event" where intervention would be permissible under the Joint Rules.

I believe that the current restrictions on "routine management or operation" of a portfolio company are unnecessary and could result in a significant handicap to our business as asset managers.[**] But even assuming that the prohibition on "routine management or operations" is desirable, there is a broad continuum between "routine management or operations" and approval of extraordinary corporate events. Accordingly, I believe that a far broader range of events and

[**] I should, of course, make it clear that CSFB-PE fully intends to conduct its merchant banking operations in such a way as to comply with the Joint Rules as in effect at the time.

business developments should expressly be subject to a private equity investor's approval without such approval being deemed illegal participation in "routine management or operations". Examples of such events and developments should expressly include:

- All matters affecting the financing of a portfolio company, whether or not in the ordinary course of business.
- All matters affecting the regulatory, tax or liability status of a portfolio company or its equity holders.
- Approval of capital expenditures and major expense items.
- Policies regarding the hiring, firing or setting or changing the compensation of non-executive employees (including incentive plans).
- Any transactions with affiliates or related persons (to ensure such transactions are on arms' length basis to protect investors from the wasting of corporate assets by others).
- Negative covenants relating to any material operations, including, in particular, financial covenants.
- The creation of any subsidiary, partnership or joint venture to conduct any part of a portfolio company's business.

While the Joint Rules have left the door open that these items may be acceptable on some type of case-by-case basis, the fact is that market circumstances will not wait for regulators to make those determinations. If a FHC is forced to consult its regulator to determine whether it can be involved in a transaction, a non-FHC can step up and immediately commit to a deal with such terms. The rights described above are typical of those that private equity funds routinely seek in connection with a minority equity investment in a portfolio company. Indeed, most of them are little different from the covenants that a lender would normally require.[13] In private

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[13] It appears to us that limiting minority rights generally runs counter to accepted industry conventions. Since an equity investment by its nature means that the equity holder is subject to the prior satisfaction of debt in a bankruptcy, many practitioners are questioning why lenders may negotiate covenants related to operational matters, whereas under the Joint Rules the equity holder, which has more risk, is more limited in its ability to do so.

equity investing, these rights would normally be evidenced by covenants contained in a shareholder's agreement or similar contract among the portfolio company, the investor and the other shareholders of the portfolio company. In a minority investment context, the foregoing approval rights are absolutely critical to investor protection. These covenants (particularly financial covenants) would never be considered "routine management" and, as I mentioned earlier, majority investments (where the FHC controls the portfolio company's board of directors) inherently have these protections built in.[14]

Let me stress that the type of covenants we are describing are critical to preserving the capital of our client-investors. CSFB-PE's client-investors are mainly comprised of third party institutional and public and private pension plans as well as high net worth individuals.[15] CSFB-PE manages its portfolio in a manner that seeks to maximize the return to our client-investors and mitigate against losses. We have designed our shareholder covenants to achieve that goal and have specifically represented our policies to investors in offering memoranda. We believe that the types of restrictive covenants described above are vital to protecting the interests of our client-investors.

Finally, apart from the issues facing minority investors, we believe that the prohibition on any officer or employee interlock between a FHC and a portfolio company at the "executive

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[14]Further, it should also be noted that minority investments are often made in syndicated deals where the lead investor offers a "strip" of a deal it has already negotiated with a portfolio company. In this event, it is conceivable that a FHC could be in an awkward position of asking for lesser rights where the terms include substantial protections that stray into what the Rules call "routine management", or requesting substantial structural changes in order to convert its control rights into board representation. One can imagine that if the deal is good enough, there will be plenty of non-FHC players ready to participate without such complications.

[15] Indeed, the typical aggregate investment by CSFB itself in a particular fund sponsored by CSFB-PE is normally in the range of only approximately 12%.

officer" level raises particular difficulties in a number of circumstances. From time to time it has been important for a CSFB-PE entity to provide its direct expertise to a portfolio company in a variety of different contexts.[16] Certain situations -- such as an investment in an earlier stage company or one at a critical juncture in its development -- can require full-time senior assistance in building or restructuring a management team. Investors count on our ability to provide this assistance (especially in times of distress) when choosing to invest in our funds. In some (indeed, many) instances, senior officer involvement can be considered very analogous to a "management consulting" role, that the Joint Rules expressly contemplate would be permissible in the merchant banking context. There is no reason, in my judgment, why the same flexibility should not be brought to bear in respect to appropriate senior officer interlocks, and such flexibility would be entirely consistent with the way in which non-FHC merchant banking/private equity operations are currently conducted.

Aggregate Investment Limits/Carrying Value.

The aggregate percent of capital-based investment limits impact under the Joint Rules raise difficult issues for CSFB-PE. While we are pleased that the Joint Rules now anticipate that these investment limits will ultimately "sunset," we do not believe that market circumstances justify or support the imposition of these caps in any manner. Most fundamentally, since performance-related evidence shows that merchant banking activities conducted by firms with substantial experience do <u>not</u> pose significant risk to a FHC, I believe that a separate restriction on the volume of merchant banking investments is entirely inappropriate. I respectfully submit that the

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[16] This is wholly apart from a determination that "intervention" might be necessary to address a material risk to the value or operation of a portfolio company.

standard capital rules required of a FHC (i.e., all subsidiary banks must be "well-capitalized") should in themselves provide the basis for any appropriate limitation on the volume of merchant banking investments.[17]

If such a limit is nonetheless maintained, CSFB-PE respectfully submits that compliance with the quantitative limit should be based on the "cost" of our investments --which is a fixed amount that facilitates planning of our investments in compliance with an objective standard. Since, under the Joint Rules, the applicable limits are determined by reference to "carrying value" the limits will vary at any given time. This is because we only carry investments on our books at cost until there has been a significant valuation event (such as a public offering or a permanent impairment in value). Therefore, while we can apply the mathematical formula stated in the Joint Rules at any "snapshot in time" to determine compliance with the applicable investment limit at that time, since the limits are tied to "carrying value" we are unable to predict the high end of the value that any of our investments will achieve, particularly in light of the volatility of the equity markets after our portfolio companies go public. In other words, the Joint Rules have the perverse effect of negatively impacting a FHC and its investors for superior performance, since more merchant banking capacity is absorbed by an investment that is successful (i.e., has a greater "carrying value") than one that fails.

I would also respectfully suggest that if quantitative limits are maintained, FHCs should be permitted to exclude from such limits the value of any portfolio company investment in the form of a publicly traded equity securities registered under the federal securities laws or otherwise

[17] It seems particularly inappropriate and overreaching for a non-U.S. entity like CSFB to be subject to an artificial U.S. mandated volume limit that is separate and apart from those limits mandated by its home country regulator, particularly since the Federal Reserve has acknowledged that CSFB's regulators provide comprehensive consolidated supervision & regulation of CSFB as well as its subsidiaries.

tradable under those laws without registration. While merchant banking funds make privately negotiated investments, the securities that make up the investment may at some point become publicly tradable as a result of a public offering. At that point in the cycle of ownership, the fund as a holder of such securities would be entitled to the broad protections offered by the regulatory and reporting requirements of the securities laws and the investment would not be distinguishable from any other position in publicly traded securities. In other words, once a portfolio company goes public and the position is more liquid, I do not think such position should be counted as a merchant banking investment for purposes of the aggregate investment limits.

Additional Industry Concerns.

Beyond the specific issues I have identified above, I wanted to describe a few additional industry concerns.

First, related to the holding periods for private equity investments,[18] the amendments reflected in the Joint Rules should reduce, but will not eliminate, the "fire sale" mentality created by GLBA's holding period limitations. A simple look at the market circumstances over the past few weeks demonstrates why forced sales and formally limited holding periods could be problematic from an investment as well as a safety and soundness viewpoint. Private equity is the ultimate "buy and hold" experience and the resilience of profitability related to merchant banking activities comes from the ability to develop companies over a substantial time period

[18] The Joint Rules limit investments in portfolio companies to 10 years (without prior Federal Reserve approval), and to 15 years for investments in so-called private equity funds.

waiting for the appropriate market windows. It seems particularly inappropriate to require prior Federal Reserve staff review of every proposed merchant banking investment holding which exceeds the regulatory maximum and to impose a capital charge for longer term investments. Requiring such a process will only provide an unfair degree of leverage to portfolio companies in dealing with their venture capital/merchant banking investors if such companies know that a troublesome (i.e., prudent, value-oriented) investor could be forced to dispose of its interest[19] or suffer adverse regulatory consequences. We submit that any abuses associated with holding investments beyond some regulatory benchmark be addressed through the normal supervisory/examination process.

Second, many in the industry view the cross marketing prohibition between a portfolio company and a U.S. depository institution or U.S. branch or agency of a foreign bank as unnecessary as well as inconsistent with market practices. At a minimum, we would recommend modifying GLBA's cross-marketing restrictions to give private equity investments the same types of flexibility given to the investments of insurance companies.

Third, the financial industry is currently reviewing new proposals related to risk based capital standards being circulated by the Basel Committee on Bank Supervision. It would appear that the merchant banking capital standards proposed by the Federal Reserve and Treasury are inconsistent with the new Basel approach and, indeed, have no basis whatsoever in the GLBA itself. While these U.S. standards do not apply directly to CSFB-PE since due to our foreign bank affiliation the Swiss regulators set our capital requirements, we also have to deal with capital charges on certain merchant banking investments that are higher than international

[19] Such an event may require negotiating the consent of the portfolio company or other investors and cause the merchant banking investor to be at a severe disadvantage.

requirements. We generally believe that the U.S. regulators (as well as the Swiss) should adopt standards consistent with Basel without burdensome additional charges for merchant banking or other activities. Uniform cross-border capital requirements will only improve the efficiency of the global financial industry.

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In closing, I very much appreciate the opportunity to raise these points with you, as a senior officer of an entity that, until recently, functioned outside the GLBA framework. I can appreciate - perhaps more than most - the significant and potentially harmful impact of the imposition of rules and limitations which, for all of their good and well-appreciated intention, simply do not "translate" well to the actual operations of a merchant banking/private equity business. While again we greatly appreciate the efforts of the Federal Reserve and Treasury staffs to improve the Joint Rules, we still believe that even in their current form they give significant advantages to our non-FHC competitors. We do not believe that this was the Congressional intent behind GLBA and we look forward to a further dialogue with Congress and the regulators to remedy this situation. I would, of course, be pleased to discuss these matters with you and answer any questions.

Thank you for your consideration.

STATEMENT OF
THE SECURITIES INDUSTRY ASSOCIATION

BEFORE
THE SUBCOMMITTEES ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT-SPONSORED ENTERPRISES, AND FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
OF THE
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON THE
PROMOTION OF CAPITAL AVAILABILITY TO AMERICAN BUSINESSES

April 4, 2001

The Securities Industry Association ("SIA") appreciates this opportunity to present its views on the merchant banking rules issued jointly by the Board of Governors of the Federal Reserve System ("Board") and the Treasury Department ("Treasury") on January 10, 2001, and the merchant banking capital proposal issued by the Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation on January 18, 2001. SIA brings together the shared interests of more than 740 securities firms, investment banks and broker-dealers that operate throughout the United States and North America. SIA member firms are active participants in U.S. and foreign securities and capital markets and in all phases of corporate and public finance. Many of SIA's member firms are affiliated with banking organizations and, thus, affected by the merchant banking regulations.[1]

At the outset, SIA wishes to thank Chairmen Bachus and Baker and the Subcommittees for holding this important hearing. As the Chairmen and many members of the Subcommittees know, SIA and its member firms have been deeply concerned about the capital requirements and other regulatory restrictions imposed by the Board, Treasury and other agencies on the equity investment activities of bank-affiliated securities firms and, consequently, SIA has been an active

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[1] The U.S. securities industry manages the accounts for more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates more than $300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about SIA is available at our Internet web site, http://www.sia.com.)

participant in the public policy debates regarding these restrictions. SIA first shared its concerns about the rules in detailed comment letters that it filed with the relevant agencies last spring and then in testimony last June before the Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises.

Those hearings helped to highlight and draw attention to the serious concerns that SIA and many others in the securities and banking industries had regarding the Board and Treasury's initial approach to regulating merchant banking activities. In particular, SIA voiced the view that the rules, as proposed last March by the Board and Treasury, would have had a significantly adverse effect on the ability of securities firms within financial holding companies ("FHCs") to make merchant banking and other permissible non-financial equity investments on the same scale and to the same extent as securities firms that are not part of a FHC family. For this reason, SIA worried that the rules effectively closed the "two-way street" between the securities and banking industries that is at the very core of the Gramm-Leach-Bliley Act ("GLB Act").

In response to the concerns voiced by SIA and others, and as a result of the significant and timely efforts of the members of the Subcommittees, the Treasury, the Board and the other bank regulators have made a number of positive changes to the merchant banking regulations. SIA thanks the members of the Subcommittees for their help in effecting these changes and the regulatory agencies for addressing in their final merchant banking rule and capital proposal some of the significant issues raised by SIA.

Thus, much has changed since SIA last presented its views before the Subcommittee on Capital Markets; unfortunately, not enough. As detailed further below, SIA continues to have significant concerns about the final merchant banking rule adopted by the Board and Treasury and the revised capital proposal. As a general matter, the final rule and the revised capital proposal continue to present a highly complex and overly burdensome array of restrictions and limitations on merchant banking activities that, in SIA's view, are neither mandated by legitimate safety and soundness concerns nor in keeping with the language and spirit of the GLB Act, which sought to promote venture capital activities. In addition, in a number of respects, these rules still do not reflect fully the manner in which securities firms conduct their venture capital activities.

The regulatory agencies continue to operate on a premise, which SIA submits is faulty, that merchant banking poses substantially greater risks than other permissible activities. This premise ignores the fact that securities firms, including those affiliated with banks, have a long and exemplary record of successfully making and managing merchant banking investments. Indeed, it is quite notable that even the recent large declines in the U.S. equity and venture capital markets have not led to *any* breakdowns or significant problems at securities firms that are actively engaged in merchant banking activities.

Moreover, the regulators ignore the fact that Congress was fully aware of the risks posed by merchant banking activities, and it adopted a full set of measures in the GLB Act to guard against these risks. As an initial matter, Congress granted merchant banking authority only to FHCs, which by definition have depository institutions that meet certain well-capitalized and well-managed standards; entities that do not meet these high capital and management standards cannot even engage in this activity. Congress also prevented merchant banking investments from being held by depository institutions; adopted special rules under sections 23A and 23B of the Federal Reserve Act to govern transactions between merchant banking portfolio companies and commonly controlled depository institutions; and imposed a moratorium that, at least for the next four years, prevents the financial subsidiaries of depository institutions from engaging in merchant banking activities. Congress nowhere indicated that these restrictions needed to be supplemented with additional restrictions, especially rules as burdensome and complex as the ones that the agencies have set forth currently.

In addition to addressing the risks associated with the activity, Congress expressly authorized securities firms affiliated with FHCs to engage fully in the business of merchant banking. Congress further emphasized that such firms should be permitted to conduct merchant banking activities in substantially the same manner as their competitors that are not affiliated with banking organizations.

The current merchant banking rules do not achieve these goals. SIA respectfully submits that the regulators' safety and soundness concerns can be addressed by a less restrictive and complicated set of rules that defer to the industry's prudent, time-tested and well-functioning internal risk management systems and capital allocation models and supplemented by appropriate levels of supervisory guidance and oversight. Such a set of rules also would accord, in a way that the current rules simply do not, with the mandate of Congress in the GLB Act.

SIA appreciates the opportunity afforded by this hearing to continue this dialogue about the merchant banking rule and capital proposal. SIA encourages the regulatory agencies to re-examine their rules, particularly as they gain further understanding of the business of merchant banking. We encourage the agencies to ultimately fashion rules that truly permit full, fair and effective competition in the capital markets by all of the participants in a unified financial services industry, in precisely the manner that Congress intended when it enacted the GLB Act.

I. The Final Merchant Banking Rule

With respect to the final merchant banking rule, SIA commends the Board and Treasury for revising several of the restrictions found in their interim rule governing FHC merchant banking investments. In particular, SIA is pleased that the agencies have removed the dollar cap on total merchant banking investments and established a "sunset" provision that will eliminate the cap that is based on Tier 1 capital once the Board issues final capital rules. These twin restrictions -- for which there was no support in the statutory language or legislative history of the GLB Act -- had been of paramount concern to SIA and its members. SIA also supports the decision by the agencies to expand the definition of "private equity fund" and to adopt safe harbors that allow FHCs to make certain merchant banking investments without being subjected to affiliate-transaction limitations.

A. *General Concerns*. Although it regards these changes as moves in the right direction, SIA continues to believe that the final merchant banking rule -- particularly when its provisions are considered in their totality -- presents an unnecessarily complex and burdensome regulatory scheme. The final rule, for example, contains a variety of intricate regulatory definitions and restrictions that will make doing business under and compliance with the rule difficult, expensive and time consuming for affected firms.

An example of the complexity of the rule is its treatment of "private equity funds." The final rule -- in SIA's view, quite appropriately -- imposes fewer restrictions and limits on portfolio investments made by FHCs through private fund vehicles. The rule, however, has a five-part definition for private equity funds, and then it imposes different sets of operational, recordkeeping and reporting restrictions on funds that meet this definition and those that do not. In addition, the final rule places different sets of limits on funds -- both those that qualify for private equity fund status and those that do not -- that are "controlled" by FHCs from those funds that are not. Thus, a single FHC may face four different sets of restrictions that apply to its fund investments: one for private equity funds that are controlled by a FHC; a second for private equity funds that are not controlled by a FHC; a third for funds that do not qualify for private equity fund status and that are controlled by a FHC; and a fourth for funds that do not meet the private equity fund definition and that are not controlled by a FHC.

These complex rules, of course, create a myriad of business and compliance difficulties for FHCs. One example may be illustrative: a FHC may intend to form a private equity fund in which the FHC owns only a 20% stake and that would be a qualifying fund under the rule. But, if for some reason, the FHC ended up owning more than a 25% equity position in the fund -- in which case the fund would no longer qualify as a private equity fund -- the final rule would impose on the now non-qualifying fund additional investment and operating restrictions. Accordingly, the FHC would be obligated to go back to the fund's investors to explain that additional restrictions apply to the fund, which restrictions could affect the fund's investment strategy, flexibility and returns. Under this scenario, fund investors, quite naturally, may not wish to invest in a vehicle that is subject to these additional restrictions and could withdraw their investment positions. This is just one example of how these overly restrictive rules could lead to unintended results.

Similar complexity is found in the final rule's limits on relationships that involve FHCs having "routine management or operational control" over a portfolio company. The final rule has restrictions on the types of covenants and agreements that FHCs may use to restrict the activities of portfolio companies -- restrictions that, as pointed out in detail in the testimony of Peter A. Grauer of Credit Suisse First Boston, prevent the type of covenants that are commonly used by securities firms to protect their merchant banking investments. The final rule also contains a variety of restrictions on the types of FHC employees and officers that may be involved in the portfolio company. SIA submits that FHCs require greater flexibility than is afforded by these provisions. FHCs have no intention, interest in or expertise in running the day-to-day operations of portfolio companies in a manner that would contravene the "banking and commerce" demarcation of the GLB Act. FHCs, however, do require the ability to impose various activities restrictions on and establish certain employee relationships with portfolio companies to protect their investment positions in such portfolio companies.

SIA respectfully submits that the statutory objectives of the GLB Act and the safety and soundness concerns of the Board and Treasury can be best addressed through a combination of (a) rules that are far less restrictive and complicated than what has been adopted, and

(b) appropriate supervisory guidance, such as the Supervisory Letter that the Board issued in June 2000. It is plain that securities firms that are not part of a FHC family do not face the types of detailed and burdensome restrictions that are set forth in the final rule. As a consequence, and because merchant banking is such an important part of the business of many securities firms, the final rule promulgated by the Board and Treasury may deter some securities firms from becoming FHCs and may limit affiliations between securities firms and banking companies.

B. *Particular Issues*. Particular aspects of the final rule also trouble SIA. To cite one example, the final rule retains the interim rule's arbitrary limits on the ability of FHCs to hold investments beyond 10 years (or 15 years for private equity fund investments). These pre-set holding periods are plainly at odds with the flexible limits mandated by Congress in the GLB Act. The GLB Act permits FHCs to hold merchant banking investments for such period of time to "enable the disposition thereof on a reasonable basis consistent with the financial viability" of the investments and specifically avoids placing any pre-set time limit on how long investments may be held. The legislative history clearly supports this reading.

By imposing a rigid and artificial time frame on holding investments, the final rule not only ignores the unequivocal congressional directive but also may cause FHCs to sell certain investments prematurely, rather than when financially optimal, to avoid having to apply to the Board for an extension and to avoid the mandatory additional capital charge on investments held for longer than the prescribed time period. This outcome does not make sense from a safety and soundness perspective.

Similarly, SIA remains concerned about the yet undefined reporting requirements in the final rule. In promulgating their final rule, the Board and Treasury have reaffirmed that FHCs will be required to submit quarterly reports on their merchant banking portfolios and annual information with details on particular merchant banking investments, including anticipated exit strategies. SIA believes that detailed reporting requirements will impose needless costs on merchant banking activities, are unnecessary given the other forms of regulatory supervision to which FHCs are subject and flatly contradicts the GLB Act's dictate to the Board to reduce the regulatory burden that it inflicts on FHCs. SIA also is concerned about the requirement to disclose divestiture plans, which it believes serves no legitimate regulatory purpose and could unnecessarily limit a FHC's flexibility. For these reasons, SIA urges the Board and Treasury to streamline the number and scope of the reports that will need to be filed by FHCs.

II. The Capital Proposal

As with the final merchant banking rule, the revised capital proposal represents a measured improvement over the Board's original proposal of March 2000. The revised proposal -- by replacing the excessive 50% capital deduction with a sliding scale deduction based on the ratio of total non-financial investments to Tier 1 capital -- imposes a less onerous capital requirement on banks, bank holding companies and FHCs engaged in merchant banking and other non-financial equity investment activities than the Board's original proposal. In addition, SIA agrees with the agencies' decision not to apply the capital deduction to investments made through Small Business Investment Companies ("SBICs"). Despite these improvements, SIA believes that the instant proposal continues to unduly restrict and interfere with the merchant banking and other equity investment activities of bank-affiliated securities firms.

A. *Internal Capital Models*. SIA continues to believe strongly that the Board and other bank regulatory agencies should allow firms to rely fully on internal capital allocation models to control the risks of non-financial investment activities. Each institution's internal capital model can best measure and capture the complexity of that firm's merchant banking and non-financial investment program, accounting for the risks and capital needs that are specific to the nature and level of the firm's portfolio investment activities. In addition, internal models can be fine-tuned on a continuous basis to accommodate developments and changes in economic, investment and portfolio conditions in a manner that the proposed rules simply cannot.

The regulatory agencies express concern in their rulemaking proposal about the differences in the level of sophistication of models at various organizations; SIA submits that this issue can best be addressed through supervision and examination. If a particular institution's capital allocation model, in conjunction with other aspects of its risk management program, is found to be inadequate by examiners, then that institution -- and only that institution -- should be required to hold additional capital commensurate with the level of its merchant banking investment activities and the deficiencies found in its capital model. This individualized approach has the decided advantage of ensuring that each institution develops and maintains sound internal capital and risk management systems and of targeting supervisory and examination resources to precisely those institutions that evidence material capital allocation and risk management deficiencies.

In addition, reliance on an internal model/supervisory framework serves to encourage institutions to improve continuously risk management systems and capabilities so as to produce more sophisticated, reliable and accurate capital measurements. By contrast, the approach taken by the agencies in their rulemaking -- by applying the same capital charge to all institutions that make the same level of merchant banking and non-financial equity investments as a percentage of their Tier 1 capital -- penalizes institutions regardless of how carefully they monitor and manage their portfolio investment activities.

The agencies acknowledge that reliance on internal models represents a preferable method for determining the capital adequacy of an organization and yet reject such reliance because they regard internal models to be "untested." SIA submits that, in taking this position, the agencies have ignored the fact that securities firms and banking organizations have for many years actively participated in the venture capital markets relying exclusively on internal risk management systems -- including capital allocation models, valuation policies, internal reporting and similar safeguards -- without any additional external capital requirements of the sort proposed now. The industry's current risk management and capital allocation systems have allowed securities firms to make non-financial equity investments prudently and properly for decades, through both substantial bull and bear markets, without significant problems.

B. *Investments Made Pursuant to Pre-Existing Statutory Authorities*. SIA also is disappointed with the decision of the regulatory agencies to apply the proposed capital charge to investments held under statutory authorities that pre-dated the GLB Act (such as section 4(c)(6) of the Bank Holding Company Act ("BHC Act")). As SIA and others have pointed out both to Congress and the relevant regulatory agencies, bank-affiliated firms have long made investments under section 4(c)(6) of the BHC Act and other statutory authorities without any risks to safety and soundness. For this reason, investments made under section 4(c)(6) should be excluded from the capital charge in the same manner as investments made through SBICs.

In addition, SIA strongly believes that, regardless of what regulatory capital standard is ultimately adopted, the retroactive imposition of any additional capital requirements to the existing equity investments that are already on the books of securities firms that are affiliated with bank holding companies and FHCs is fundamentally unfair, unjustified and unnecessary.

Imposing a capital charge on these investments, without any evidence that such investments pose a safety and soundness risk, would penalize institutions for engaging in long permissible activities.

SIA respectfully submits that imposing a capital charge retroactively is akin to altering the rules in the middle of a game, and doing so could have adverse consequences. Specifically, the capital charge would change the economics of existing equity investments, lessen the profitability of investments and may even turn some otherwise profitable investments into unprofitable ones. As a result, at the worst, changing the capital requirement for these investments could lead some institutions to sell certain perfectly safe and prudently managed investments, which sale could have an adverse impact not only on the bank, bank holding company, or FHC that holds the investment but also the portfolio company whose shares are being sold.

SIA will submit other detailed comments on the capital proposal in a comment letter that will be submitted to the agencies later this month.

III. Conclusion

SIA is pleased with a number of the changes made by the regulatory agencies to the initial merchant banking rule and capital proposal that were issued last March, but SIA strongly believes that more changes can and should be made. SIA hopes that this hearing -- like the previous hearing held by Chairman Baker and the Subcommittee on Capital Markets -- will push the Board, Treasury and the other regulatory agencies to re-examine their rules and to rely to a far greater extent on the industry's existing practices and the regulatory agencies' ample supervisory authority. SIA looks forward to continuing the dialogue with Congress and the regulatory agencies regarding these merchant banking rules and, ultimately, to crafting rules that will advance the goals of financial services reform, safeguard safety and soundness of FHCs and their affiliated depository institutions, and truly achieve the "two-way street" contemplated by Congress in the GLB Act.