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CAPITAL MARKETS AND THE NEW ECONOMY

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, SECURITIES AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON BANKING AND
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

JUNE 7, 2000

Printed for the use of the Committee on Banking and Financial Services

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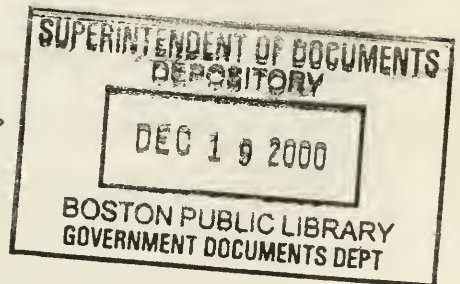
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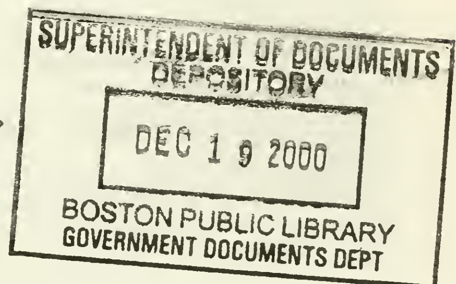
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CONTENTS

Page

Hearing held on:
June 7, 2000 1
Appendix:
June 7, 2000 49

WITNESSES

Wednesday, June 7, 2000

Alford, Harry C., President and CEO, National Black Chamber of Commerce, Inc. 30
Gensler, Hon. Gary, Under Secretary for Domestic Finance, Department of the Treasury 3
Lackritz, Marc E., President, Securities Industry Association 28
Mercer, Lee W., President, National Association of Small Business Investment Companies 32
Meyer, Hon. Laurence H., Member, Board of Governors, Federal Reserve System 7
Walker, Jeffrey, Managing Partner, Chase Capital Partners, on behalf of The Financial Services Roundtable 36
Whaley, John P., Partner, Norwest Equity Partners and Norwest Venture Partners, Wells Fargo, on behalf of the American Bankers Association and the American Bankers Securities Association 34

APPENDIX

Prepared statements:
Baker, Hon. Richard H. 50
Jones, Hon. Stephanie T. 58
Kanjorski, Hon. Paul E. 59
LaFalce, Hon. John J. 61
Waters, Hon. Maxine 78
Alford, Harry C. 124
Gensler, Hon. Gary 81
Lackritz, Marc E. 113
Mercer, Lee W. 127
Meyer, Hon. Laurence H. 90
Walker, Jeffrey 168
Whaley, John P. 131

Additional Material Submitted for the Record

Baker, Hon. Richard H.:
FDIC letter to Hon. Alan Greenspan, May 22, 2000 51
National Venture Capital Association, policy statement, June 6, 2000 54
LaFalce, Hon. John J.:
U.S. Small Business Administration letter, June 7, 2000 63
Office of Advocacy, U.S. Small Business Administration letter, May 22, 2000 69

CAPITAL MARKETS AND THE NEW ECONOMY

WEDNESDAY, JUNE 7, 2000

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Lucas, Biggert, Terry, Toomey, Kanjorski, Bentsen, C. Maloney of New York, J. Maloney of Connecticut, Capuano, and Waters.

Chairman BAKER. I would like to call this hearing of our Capital Markets, Securities and Government Sponsored Enterprises Subcommittee to order and note that we do have several Members who have indicated they are on their way and they should be here momentarily.

I would like to express my appreciation to all of our witnesses who will appear during the course of the hearing this morning for their attendance, given the length of notice that was provided, particularly to those of our first panel. I appreciate your courtesy in appearing here today.

In response to inquiries from a number of the media, and I am sure our first panel will also be appreciative, there will not be discussion of any matters related to Government-sponsored enterprises during the course of this hearing today for the public record.

It is, however, to discuss the ramifications of proposed regulations pursuant to the passage of the Gramm-Leach-Bliley Act of this Congress. Certainly, every Member of Congress was greatly relieved, after two decades of very difficult work, to see the passage of this important legislation and hoped that it would not only reconcile disputes of long-standing proportion, but, as well, create new opportunities for business expansion for creation of employment opportunities and better service to consumers.

Our reason for conducting the hearing today is to understand more fully the implications of the proposed regulation and to ensure that the two-way street that the Congress envisioned being constructed will not be limited to a one-way street or, perhaps worse, converted to a parking lot.

I am confident at the same time, however, regulators have carefully come to the conclusions that warrant the proposal before the subcommittee today, and that there are sufficient reasons to be concerned about the new business risk, whether it be management

risk or credit risk, that may be created by the partnering of activities not historically engaged in a relationship.

However, the application of the proposed capital provisions are of particular concern in that it would appear to increase the cost for many enterprises that have been successfully engaged in business conduct for many years without the necessity of such capital adequacy requirements. The subcommittee simply wants to understand the reasons.

Mr. Kanjorski and I have, in our efforts of the modernization of the Federal Home Loan Bank, been particularly concerned about the flow of capital, the adequacy of capital, to all regions of our country, and to ensure that capital markets can function efficiently and take full advantage of the technologies that are available in the market today.

Whether it is a coffee shop or an internet IPO, having access to financial resources is the hub and core of continuing the enormous economic prosperity this country has enjoyed. It is the subject matter of this subcommittee and certainly of the Banking Committee to have a full understanding and make full inquiry into any regulatory intervention that might impede, unintentionally or not, in that continued expansion.

For these reasons, the subcommittee is conducting this hearing this morning, and I want to, again, express my appreciation to the Federal Reserve and to the Treasury for their courtesies in working out their schedule to appear here today. We fully understand the controversy surrounding the proposal, and we want to be constructive in this hearing and fully understanding, and giving the opportunities for parties to be heard, but certainly do not wish to, in any way, inhibit appropriate steps necessary to protect taxpayers from unwarranted loss. Thank you for your courtesies.

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

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Chairman, I would like to ask unanimous consent to enter into the record Mr. LaFalce and Mrs. Jones statements.

Chairman BAKER. Without objection.

Mr. KANJORSKI. Mr. Chairman, I thank you for the opportunity to speak before this hearing today. I will submit my full statement for the record, and I will try to speed up my remarks, because we have some very important witnesses from whom we want to hear.

We are familiar with the fact that last year, when we passed the Financial Services Modernization Act, we tried to keep separate banking and commerce. It is very important, as these rules and regulations are promulgated, that this intent of Congress be adhered to.

As we go through this hearing today, I am particularly interested in the effect the new regulations will have on small business investment companies that are presently in existence, and the new ones that are being created in the New Markets Initiative of the President.

It is very important that we work to limit the risk and provide for safety and soundness in the banking system, but we also have a commitment to our communities, and to particularly our dis-

tressed economic communities, to make funds available through these new vehicles that the President has set forth in the New Markets Initiative. As a matter of fact, toward that end, shortly before we began our Memorial Day recess, I joined President Clinton, Speaker Hastert and Ranking Member LaFalce at the White House to announce a bipartisan compromise agreement on legislation that would enact the best elements of the New Markets Initiative and the Renewable Communities proposal. Thanks to the efforts of Chairman Leach, our committee has already marked up and favorably reported the America's Private Investment Companies Act, one piece of the New Markets Initiative.

I hope, although we have in the last few weeks seen some contentiousness, both in the other body and in our own body, that we can put this to rest for a few moments to enact this absolutely necessary legislation. This bill will help the lower 40 percentile of the distressed economic communities of America that have not necessarily shared in the success of our economic system in the last eight years.

With that in mind, looking forward to the testimony of this distinguished panel, Mr. Chairman, I thank you.

[The prepared statement of Hon. Paul Kanjorski can be found on page 59 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Lucas.

Mr. LUCAS. Nothing.

Chairman BAKER. Does any other Member wish to make an opening statement?

Mrs. Biggert.

Mrs. BIGGERT. Mr. Chairman, this really isn't an opening statement, but I would just like to say that last week, the Federal Reserve Board lost Nancy Goodman to an accident. She has been with the Board for many years in Chicago and I think she will be a great loss to the Federal Reserve and to the City of Chicago and the suburbs. Thank you.

Chairman BAKER. Thank you very much.

Any other Member wish to make opening remarks?

If not, at this time I would like to call on our first witness, the Under Secretary for Domestic Finance, Department of Treasury, Mr. Gensler. Welcome back, Mr. Gensler.

STATEMENT OF HON. GARY GENSLER, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. GENSLER. Thank you, Mr. Chairman, Ranking Member Kanjorski, Members of the subcommittee. I thank you for the opportunity to appear here today, and if I could submit the full testimony for the record and summarize.

Chairman BAKER. Absolutely. Without objection.

Mr. GENSLER. I am also pleased, if I might say on a personal note, that my daughter is out of school, my eldest daughter, and so Anna Gensler, behind me, is here to see a little bit about how Congress works and a little bit of what her daddy does.

On a more serious note that the subcommittee has come together on, the Administration strongly supports the financial modernization legislation that moved forward, and I don't think that anyone

doubts how hard we all worked, together with this committee across both sides of the aisle and with the Senate, to get that balanced bill forward to allow for greater innovation and greater service to communities, to consumers and to the economy at large.

One of the key pieces of that legislation was to allow banking organizations to compete with securities firms and securities firms to buy banks, what has been called sometimes the two-way street. We fully support that concept.

At the same time, however, Congress intended to limit the mixing of banking and commerce and to assure that merchant banking activity, when conducted, would be conducted in a safe and sound manner. So, the legislation was intended to promote this new activity, but at the same time there was a recognition of not mixing banking and commerce and promoting safety and soundness.

The new merchant banking authority under the Act significantly expanded the ability of banks to conduct investments in what I will call private equity investing, which is a little broader category than the term "merchant banking," which would also include venture capital investments.

When we looked at the rules, we recognized that Congress' intent is clearly to allow also venture capital investing.

We are in the midst of rule writing right now, and the staffs are still analyzing the comments, so this hearing is a constructive step for the Federal Reserve and Treasury in terms of finalizing those rules, but at this juncture, we are really still considering many of the comments, and there have been very important comments that were received.

So today I think that we can provide a background, if that would be helpful, on how we came to the rules, and a little bit about private equity investing itself.

Private equity investing has been a feature of capital markets for centuries. Private equity investments generally are understood to be investments usually by professional investors, not retail investors, in private companies. Often they are startup companies like venture capital, or in leveraged buy-outs or other middle market companies. The market itself has grown dramatically. In the last twenty years, it has grown from about $5 billion to now over $400 billion in size in terms of the market. So it is a significant and important market to the economy that we wish to continue to foster.

The most important things to understand, though, about these investments in this market is that: One, they are higher risk. They are equity investments to start with, but even amongst those, they are higher risk. Two, they are long-term investments. And three, they are generally illiquid. They don't trade. You can't open up the newspaper and see where these investments trade.

While we are in the midst of the rule writing, we think that it is important to be careful that in the longest running economy we not let today's confidence lead to complacency about the fundamental risk of these higher-risk, longer term, illiquid investments.

Now, by its nature, when I say that it has these risks, I would add also some, or risks, just to comment. In terms of being illiquid, they tend to be unregistered shares in private companies. Sometimes they are public companies, but even when they are public companies, they tend to be controlled investments, and by "con-

trolled investments," that means they are not readily sold 100 shares or 1,000 shares at a time.

They also tend to be held for a long period of time, looking to be sold in the public market or the merger market. So they largely depend on the future state of the stock market or the future state of the merger market.

In terms of financial institutions' role in this sector, they have been engaged for several decades. In fact, with the passage of the Small Business Investment Act in the late 1950's, banks, and then later investment banks, got into this business, and in a limited way in the 1960's and 1970's. They have had a much more dramatic involvement, both investment banks and commercial banks, in the last two decades, with various changes in laws in the late 1970's.

Today, if one looks at the involvement, particularly of commercial banks, they had some authorities. Even before the Gramm-Leach-Bliley Act, they had some authorities called Edge Act corporations, 5 percent holdings at the holding company, and also the Small Business Investment Act that we talked about earlier.

Banks today have roughly $35 billion to $40 billion of investment in this area. Investment banks, from our statistics, seem to be a little bit higher than this. But each of these combined represent in aggregate only about 20 percent of the overall pie. So about 80 percent of these investments are outside of banking and investment banking organizations today, with a little less than 10 percent of the overall market currently in banking organizations.

Now, financial modernization removed many of the restrictions of the Glass-Steagall Act, and one of the important restrictions allowed the two-way street we talked about earlier. The Administration fully supports this. As I said earlier, Congress enacted this bill with two caveats: First, that private equity investment would be undertaken in a way that was not a backdoor way into banking and commerce. It is very difficult to say you can't own the factory, but you can own shares in the factory as long as you hold it for resale in the future. I mean, that is the sort of blurry line in between.

The United States has the most efficient capital markets in the world. The allocation of capital in our market, and the allocation of risk in that market, are not confused by the affiliations or relationships between financial and commercial enterprises. We separate those who allocate capital from those who compete for capital in this Nation, and when we look at the history of finance in other countries, even in G–7 industrialized countries, we see, oftentimes, there are banks that can have long-term, many decades' holdings in major corporations in their countries.

We think our capital market is deeper and more efficient, in part, because we have had that separation; and Congress shared that view in passing the Act last year.

The second caveat was around safety and soundness. So, accordingly, the Act itself had a series of steps to assure that merchant banking was not this backdoor roll into banking and commerce, and also assured safety and soundness. In terms of the rules, the Federal Reserve and Treasury published two rules, one jointly called the interim rule, which assessed the intent of Congress and put in place five or six key areas that are outlined in the testi-

mony; these five or six key areas really are designed to assure, for example, separation related to risk management, and related to the involvement in day-to-day management of these companies.

A lot was involved, including setting the board of directors up, being involved in hiring and firing the major participants in the company and the major corporate decisions, but not the day-to-day decisions of running the corner grocery store or even the big factory.

The second rule, which was actually under the Federal Reserve's authorities, but which Treasury was consulted on and supported, relates to capital. That is the area that has gotten really many more of the comments than the first of the two rules.

In terms of capital, it was really a focus on safety and soundness recognizing these investment are higher risk, longer-term, illiquid investments, and what is the appropriate level of capital for an institution to have to back these investments?

The rule says 50 cents. Just to comment on what that means, that means that for a dollar of equity investment—and I want to clarify, that the rule is only about equity investment, it is not generally about loans—for a dollar of equity investment, you can have 50 cents of your own money and actually borrow 50 cents from outside. This contrasts, I would say, to the predominant way to finance these investments in about 75 or 80 percent of all private equity investments in this country.

So of the $400 billion, something a little over $300 billion is invested by private, limited partnerships. And when pension funds and endowment funds put money with the leading venture capitalists, with the leading leverage buy-out folks, they say we don't want you to borrow money against this. We will give you a dollar of equity, and you put that dollar of equity to work in portfolio companies. That would be, in essence, 100 percent capital for 100 percent investments.

What the Federal Reserve here is saying, you can have 50 cents of borrowing for 50 cents of your own money and then put it to work.

In contrast, the current Federal Reserve capital rules say that you could actually have $24 of borrowing for every dollar of your own money and put $25 to work.

I don't think there is anyone who will testify today who will say that is economically what they see this business to be. There is some debate about whether the regulatory capital number should be changed.

Again, we have received a lot of comments. The Federal Reserve has received a lot of comments. We are going to be looking at all of those seriously. There tend to be more comments with regard to the capital rule, but there are comments on both rules.

We look forward to this hearing to help us move forward and try to finalize these rules in a thoughtful way and express the intent of Congress.

Chairman BAKER. Thank you very much, Mr. Under Secretary. I very much appreciate your daughter being with you today. She apparently is keeping you in very good behavior today so I am glad she is here with you.

Mr. GENSLER. She often does.

[The prepared statement of Hon. Gary Gensler can be found on page 81 in the appendix.]

Chairman BAKER. Thank you.

Our next participant this morning is a member of the Federal Reserve Board, Mr. Laurence Meyer. Welcome very much. We appreciate your courtesy in facilitating our hearing this morning.

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

Mr. MEYER. Thank you. Chairman Baker, Mr. Kanjorski, other Members of the Subcommittee on Capital Markets, I appreciate the opportunity to be here today.

I hope you will understand that with the comment period just over last month, members of the Board now have and must have an open mind regarding our proposals and the comments. We will reserve judgment until we have seen a summary and analysis of the public comments.

In addition, the Federal Financial Institutions Examination Council will be discussing bank capital requirements on equity investments. That discussion, of course, will be considered by the Board in developing its final rule on holding company capital requirements on these assets.

Clearly, the most important, but also the most controversial aspect of the proposal is the capital treatment of equity investments for regulatory purposes. Given that Under Secretary Gensler discussed the private equity market and the involvement of banks and bank holding companies in that market so thoroughly, and also explained many of the other proposed rules in his opening statement, I will focus on the proposed capital rule in my oral statement.

In focusing on capital, let me underline that in developing our proposal and considering the public comments, we were and are mindful of our responsibility to balance the need for safety and soundness for banking organizations with other aspects and goals of the Gramm-Leach-Bliley Act, the Small Business Investment Act, and the Bank Holding Company Act. The tradeoffs involved will no doubt be central to your questions and our future deliberations.

While most banking organizations have not used their pre-GLB Act authority to purchase equities, the size and growth of private market equity holdings at a small number of large banks has been quite substantial. Indeed, equity investments by banking organizations had begun to attract our attention as supervisors well before last November. The banks significantly engaged in equity investing have been quite successful in the business, but our analysis highlighted the potential riskiness of highly levered equity investment.

Our analysis, summarized in my statement, suggests that the risk of a portfolio of private equity securities is quite significant, with high hurdle rates required to make a commitment, and substantial losses on individual parts of the portfolio. Returns have been very good in the recent years of economic expansion and strong growth, but one of the iron laws of finance is that high nominal returns mean high risk. The high returns are compensation for taking the high risk.

It is important to note that commenters do not generally disagree with these observations about the risk of equity investment. Nor do they disagree that the economic role of equity capital of the owners of any business is to absorb risk, in other words, to absorb loss.

Well, what is the banking organization's ability to absorb risk? In short, depository institutions and bank holding companies are required to hold only as little as 4 cents of equity for every dollar of risk assets, although the largest U.S. banks and bank holding companies have equity-to-risk asset ratios, that is tier 1 ratios, of 7 to 9 percent.

If assets contract in value by these amounts, the entity is insolvent. Let me underline this point. A dollar contraction in asset values produces a dollar contraction in equity capital. Banking organizations have very little tolerance for loss because they hold such modest equity. Small declines in asset values would therefore eliminate large proportions of their small equity base.

In addition, you should understand that banking organizations engaged in equity investment have the option to count as income a substantial portion of the increase in value of their equity investments, even if the firm does not realize this profit by selling the securities. This increase in value, even though unrealized and subject to decline, is then permitted to count as capital for the firm and can be used to support its growth.

In effect, under our current capital rules, a banking organization could leverage these paper gains 25 times. The existing regulatory capital structure, which permits equity assets to be funded with over 90 percent borrowing and permits paper profits to increase the equity base for additional leverage, does not appear consistent with the risks associated with private equity investments.

Virtually all of our research supports that conclusion. We interviewed banking and securities organizations to determine best practices in the private equity markets, and now have supplemented that information from other sources. All of the information suggests that banking and securities organizations allocate very high levels of internal or economic capital to their private equity business, between 25 and 100 percent, with the median above 50 percent—a clear testimony to the high risk that these firms associate with private equity investments.

We also learned that virtually all of the rest of the participants in the private equity market, in contrast to banking and securities organizations, fund their equity investments dollar for dollar with their own equity.

Based on the cumulating evidence, we proposed a 50 percent capital requirement on portfolio equity investments held under any authority at any location in a bank holding company. This proposal reflected our judgment that the nature and extent of the risk of holding private equities was the same, regardless of the authority used or where the securities were held.

Since publishing our proposal, each of the two major rating agencies, Standard & Poors and Moody's, have issued reports discussing banking organizations' private equity activities. Both supported our capital proposal.

Moody's report said that, "it was prudent for venture capital activities to be funded with a high equity component." And Standard

& Poor's felt that a 50 percent equity allocation was "about right if the bank's portfolio is mature and diversified; less diversified portfolios could need up to 100 percent."

Such positive support generally has not been the case with those organizations to which the higher capital charge would apply, despite their general agreement about the riskiness of private equity investments.

They stipulate that, in fact, they impose high internal or economic capital charges on equities, but banking commenters argue that they would have considerably less difficulty with the proposed regulatory capital treatment for their equity holdings if we treated the rest of their assets in the same way. That is, base regulatory capital charge on all assets on their economic or internal capital allocations.

They argue that the regulatory capital requirement on a significant volume of banking organization assets exceeds the economic charge. Therefore, the sum of the proposed higher regulatory capital on equities, and the existing regulatory capital on all other assets, would exceed the total economic capital on all the assets.

The commenters that have raised this issue have argued that the Federal Reserve is engaged in cherry-picking, picking out the risky assets for higher capital charges without providing relief for lower risk assets. Thus, they urge the Board to wait until there is broader reform in the Basel Accord that would address these concerns.

However, the practical problems we face are that here and now, private equity holdings are large, growing rapidly, and the restraints on further growth are being relaxed, while practical reform of the Basel Accord is at least three years in the future. A difficult set of tradeoffs and choices are thus created.

When the time comes to make those choices, a factor we must consider is the effect of ongoing capital arbitrage that is undermining the existing regulatory capital structure. Banks in recent years have developed methods to move off their balance sheet those assets whose economic risk, as determined by the market, implies an economic capital charge that is less than the regulatory capital requirement, retaining those assets whose economic capital is equal to or higher than the regulatory requirement.

Recognizing the realities of the economic pressures, the banking agencies have permitted these kinds of transactions when banking organizations can meet the market test. It is difficult to estimate the capital savings made by these institutions from capital arbitrage and compare it to the potential cost of the higher regulatory capital on equities.

The cost of the additional capital charge on equities may exceed measurements of the effective arbitrage on capital requirements. Nonetheless, capital arbitrage is surely one of the variables we will have to consider in the final decisionmaking.

A related issue in interpreting distinctions between economic and regulatory capital is the desire of banking organizations for excess regulatory capital. It appears clear that banking organizations want to hold a level of capital above regulatory minimums, in part, to obtain the imprimatur of being classified as well capitalized and, in part, to receive higher ratings from the rating agencies and a lower cost of funds from the market.

Thus, an underlying theme of commenters is the concern that the proposed capital charge would reduce the margin by which they would be well capitalized for regulatory purposes, implying that they may be required to raise additional equity capital to retain the desired excess.

Stepping back from the detail, the commenters have raised important questions about the merchant banking capital proposal and have also offered a number of suggestions. The Board will carefully evaluate these comments and suggestions and modify the proposal, where necessary, and in the public interest. The subcommittee would expect nothing less.

Chairman Baker, that is the end of my statement.

[The prepared statement of Hon. Laurence H. Meyer can be found on page 90 in the appendix.]

Chairman BAKER. Thank you very much, Governor Meyer.

I appreciate both of your comments.

Mr. Gensler, if I am, in the very large picture, understanding the concern, it would not be with regard to a particular institution's investment, that investment being ill-advised causing that particular bank to have financial difficulty, but it would be, in a broader market sense, that many institutions would engage in a lot of new activities, and perhaps our concern is focused on the consequences of deposit insurance costs as a result of ill-advised new activities.

Is that sort of the big picture view of what our concerns are?

Mr. GENSLER. I think that the broader view is these new activities can be very profitable and can be very beneficial to our economy, and they have been these last twenty years. In part, this growth in private equity capital is very constructive, but the broader picture is this is a risk business. I was on Wall Street for eighteen years. I saw some of these deals that worked and some that didn't work, and that risk must be supported by equity behind it; and second, that it must be done in a way to separate banking and commerce, that is, not a backdoor way. You wouldn't own a factory, but you can invest in a factory as long as it is held for resale. And so those are the two bigger picture points.

Chairman BAKER. If we took the banking and commerce issue off to the side, because some of us have different views on some of these subjects, and stuck only to the question of insulation of risk, that ultimately what is causing the concern is not whether a particular institution fails or has losses, but the implication of a broad-based set of losses, for whatever reasons, may be totally unrelated, that create pressures on the insurance fund as a result. I mean, ultimately, I think we are not in the regulatory business to save individual institutions. We are here to keep the system working; is that fair?

Mr. GENSLER. I think that that is absolutely right, and certainly the Federal Reserve would comment on this as well. But this approach to safety and soundness regulation of banking organizations relates ultimately back to protecting the taxpayers, if—hopefully an event doesn't occur, but if an event were big enough to erode the FDIC insurance fund standing behind those various organizations.

Chairman BAKER. This would be viewed perhaps as sort of an early intervention mechanism so that there are resources to pre-

clude losses from trickling down to an area where we don't want them to go, which leads me to the conclusion, since you have identified apparently significant risk with your regulatory conclusion, it is not appropriate to be talking about significant adjustments in deposit insurance coverage in light of these potential risks that you are discussing. That is just a conclusion I am reaching.

Second, I think what I find problematic—two things. One is that in order for the institution to engage in the equity activity in the first place, you must be well capitalized. Then you must deduct the value of the investment from your capital and still maintain the well capitalized status. So we are, to some extent, requiring that you be fully capitalized before you engage in this activity; is that correct?

Mr. MEYER. That is true with respect to well capitalized. The deduction applies only to the securities subs of the bank, but it doesn't apply to the financial holding company.

Mr. GENSLER. Right. So it only applies actually to the depository institution.

Mr. MEYER. Right, the depository institution, exactly.

Mr. GENSLER. These new activities, the new authorized activities that Congress authorized, at least for the first five years, would not be conducted under a bank. So the well capitalized is the bank.

Chairman BAKER. OK. Great.

Second, with regard to currently authorized activity, which institutions have engaged in for many years, and I have always had a problem, Mr. Meyer, in understanding—Governor Meyer—the legitimacy of allowing up to the 25 percent equity holding in a domestic corporation while we allow up to 40 percent in a foreign corporation. I have never understood the risk measurement in that structure.

What has been demonstrated in market history? Are there broad-based losses or is there something going on that, from your view, that has been missed and why the new rules would now apply to what has been, I believe, a very successful and important part of our economic history with the pre-Gramm-Leach-Bliley activities in merchant banking? Can you explain to me what warrants this new capital requirement in light of the history of that provision?

Mr. MEYER. Sure. When we began to think about the new activities, we asked ourselves whether there was any fundamental difference between the riskiness of new merchant banking activities and some of the existing merchant banking activities under existing authority—in the SBICs, under the Edge Act and the 5 percent investments in the bank holding companies. In our surveys we found that there really wasn't any difference.

Now, the fact of the matter is that with respect to these existing authorities, banks have been managing them prudently because they allocate such high amount of internal capital to these activities. So what you want to think of our approach as doing is identifying industry best practice: establishing that as a foundation for our regulatory treatment, in part, to ensure that new organizations which come into this activity, will be bound to the same prudent behavior that we have seen so far in the industry.

There is really no basis for a different treatment of the new activities, as far as we can tell. There shouldn't be any differentiation in how they are treated from existing activities.

Chairman BAKER. That is my final concluding point, because we do have Members wishing to ask some questions.

It would appear to me there is an extraordinary difference in the risk associated with various enterprises. If it is an internet IPO, which has no history of profitability, no likelihood of profitability, and a significant investment in that activity, given the mania that exists today for those investment opportunities, as opposed to a light industrial firm that has been in business for some number of years who simply wants to expand its capacity, the identifiable risk with those is markedly different, yet the capital criteria would be the same.

That is the last element of concern, is that it—perhaps there should be some mechanism to have the capital adequacy related to the underlying business risk as opposed to a hard and fast rule, and then to separate that from existing enterprise or investment activities for which there is a long-standing history of no risk to the taxpayer.

I don't expect you to comment. I just was expressing that.

Mr. MEYER. It is a very good point. The commenters have raised points like this. That suggests going down a road somewhat like what we are talking about in Basel with respect to loans, some kind of internal risk-rating approach.

The problem is that, at this point, the underlying methodologies that banks use to allocate internal capital aren't that sophisticated and don't completely allow, I believe, banks to make all of those distinctions. So I think at the beginning we need some simpler framework, but that is something that we will have to explore as we think about the proposals, whether or not there is any basis for any differentiation between different types of private equity investments.

Chairman BAKER. Well, I know it is not intentional, but I really worry about the consequences of this on the SBIC side of the ledger. I think it is potentially significantly adverse, and that gets to activities that may otherwise not have access to capital.

I have run over my time significantly.

Mr. Kanjorski.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Gensler, Governor Meyer, I apologize for having to step out during your testimony.

I just want to focus further on the capital, on both the aggregate investment limit and the capital proposal.

On the capital proposal, it would appear that the prior law, prior to the GLB, or the Gramm-Leach-Bliley Act, bank holding companies were allowed to make an investment of about 5 percent of assets in merchant banking activities, equity investments, and there was a time limit on the holding period, but it was a relatively longer holding period.

According to your testimony, Governor Meyer, at that time the capital requirement was 4 cents on the——

Mr. MEYER. That is the minimum.

Mr. BENTSEN. The minimum was 4 cents. And between the bank and the regulators they were given some latitude above that 4 cents, whether or not the regulators felt that the investment required additional capital?

Mr. MEYER. Well, two things. Although the minimum is 4 percent, most of the large banks hold between 7 and 9 percent. They tend to hold above the minimum. One of the aspects in the supervisory process is making sure that the appropriate capital is held relative to the risk of the asset, and banks have been holding considerably above that in relationship to their merchant banking assets as part of their internal capital allocation processes.

Mr. BENTSEN. But this new proposed rule by both Treasury and the Fed would set an across-the-board 50 percent capital requirement?

Mr. MEYER. As a minimum.

Mr. BENTSEN. As a minimum?

Mr. MEYER. A minimum requirement.

Mr. BENTSEN. That seems like a fairly substantial increase over 8 percent. In looking at the testimony, I realized that a recent survey of the market demonstrated capital ratios were somewhere between 25 and 100 percent, and so you came up with 50 percent. I mean, why would you go from 8 to 50 and not 8 to 25 with regulatory deference in terms of pressing larger financial holding companies to maybe lift capital requirements—or set aside additional capital if the regulators felt that there was greater risk?

Mr. MEYER. Well, the median of firms we surveyed was well above 50 percent. We had to look at those cases. There were some cases when they were lower than 50 percent, and sometimes those were not in banks and the firms who had those lower capital requirements tend to be concentrated in the nonventure capital portion, not startups, but more established firms that are less risky, and therefore would require less capital.

So we did think that best practice, for the kinds of activities that banks have predominantly engaged in, would be, as a minimum, the 50 percent, based on the survey.

Mr. GENSLER. Maybe if I can say a few words. One, at Treasury, and I know throughout the Administration, we share the goal of this committee to promote the economy through this very important part of the equity capital markets. It helps promote venture capital. It helps promote, in many regards, the regeneration of many companies.

We share this goal as it relates to small business investment and the importance of the small business investment company.

We are in a bit of a new environment in that banking organizations have new authorities, and that those new authorities, particularly, will bring them into broader and more extensive investments in these activities. As we said in the testimony, you add up all of the banks today, they are engaged in their current authorities and they represent about 9 percent of this overall market in the economy, an important, but still modest area.

We would envision that will grow with the new authorities going forward, and trying to address that growth moving forward is this capital rule, which is actually a Federal Reserve capital rule, but we have been engaged with them to try to do it. And I think the

third observation is, because so much of this relates to the economy and relates to the level of the merger market and the stock market, it is hard to see forward when we have had such a strong economy for ten years and a strong stock market for twenty years.

Mr. BENTSEN. My time is up. I want to get one quick question in.

I appreciate that fact, and obviously we are going to have ups and downs in the economy in the future, and it is going to affect the merchant banking activity, and mergers and acquisitions. It would seem to me that capital ratios—you would want capital ratios to fluctuate, or the regulators to have flexibility to adjust capital ratios with respect to fluctuations in the economy, just as regulators do within the banks, rather than setting some set level.

The only other thing, I don't know if the Chairman will indulge me with this or not, there has been concern raised that these new rules will impede the ability of a two-way street, and that some who are engaged in this activity who might create a financial holding company now would feel that they would be further restricted than the current rules apply to them in merchant banking. Do you see it that way or do you think that is just the price of admission?

Mr. GENSLER. What I would say is that we fully share the goal of the two-way street. We are going to look at all of these comments closely. There are some very detailed ones that will probably not come up at this hearing about the interim rule and the effect of how private equity funds are managed. We are going to look at that, really to promote the goal that I think we all share of the two-way street, that investment banks could buy banks and banks could be engaged in this activity.

Mr. MEYER. Yes. We spent a lot of time surveying security firms, particularly because we had a lot of experience with banks under existing authority, but we—at the Federal Reserve—didn't have the same experience with best practices at security firms. And we came away with a view that, again, we were establishing a capital treatment that would be consistent with best practices in terms of economic capital allocations of the security firms, and therefore, we would not be discouraging a two-way street.

We will be reviewing this to be sure as we consider the comments, because we certainly do not want to interfere with the two-way street.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

Gentlemen, along the lines of what we have been discussing, has the Treasury or Fed done any potential impact studies on these rules? I come at that from the vein of, if you are on the margin of the portfolio, what kind of potential bank divestitures from certain of these activities will these rules promote? Have you done any of that kind of forward analysis?

Mr. MEYER. Well, it is our view, because we have proposed a capital treatment consistent with internal capital allocations, that it would not have any adverse impact on the activities under any of the existing authorities, in particular, and would allow the expan-

sion of merchant banking activities along the lines that Congress intended when they passed the Act.

Mr. GENSLER. Again, the interim rule that has a series of risk management practices was meant to be wider than the market today. When many of these investments today are sold in three, four, five, maybe seven years, the holding periods were meant to be wider than that. In terms of engagement in the day-to-day management, to put into practice the ability to appoint the board of directors and to hire and fire senior management and the like were all meant to be wider than industry practice.

In terms of our sense in moving forward, it is not to lead anyone to divest any of these businesses. In fact, if you look at the public market analyst reports on this rule, since it has been published, there are no public experts who think that one of the five to ten major banks in this business is going to have to divest its businesses, but you would have to speak to them directly on that.

Mr. LUCAS. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Lucas.

Ms. Waters.

Ms. WATERS. Thank you very much. Governor, I would like to ask you to continue the discussion of the multibank initiatives in relationship to affordable housing.

It is my understanding that these investments have been very low risk and enormously successful in States like California and New York and other States. What now does this 50 percent requirement do to the opportunities for investment in housing?

Mr. MEYER. I am not sure exactly what specific investments you are talking about. To the extent that they are lending activities, they don't come under this. To the extent that they are some of the community development activities that are under the public welfare rules, they are not covered by this.

We only cover specific authorities. There are only three that we cover, SBICs, Edge Act and 4(c)(6) authority in the holding company. There are other kinds of activities, many of them related to community development activities, that are simply not covered by these rules. It has no implication for those.

Ms. WATERS. So as far as you know and understand it, to this point, there would be no great change or risk involved with affordable housing?

Mr. MEYER. No, but I think I would need something more specific. I don't think so. Could you be more specific about the particular programs you are looking at? If you could communicate those to me, I would look into that more directly.

Chairman BAKER. Would the gentlelady yield on that point?

Ms. WATERS. Yes.

Chairman BAKER. One area that I think you might like to focus your attention, because it does come under the purview of the reg, would be activities conducted with an SBIC where there certainly could be housing impact that would be the subject of her concern.

Mr. MEYER. Sure. Yes. I think that is absolutely true.

Ms. WATERS. Well, I suppose you could have small business activity for development, housing development.

Chairman BAKER. Even management services, for example.

Ms. WATERS. Or management services that could be impacted by this.

Mr. MEYER. Right. Once again, with respect to the SBICs, we didn't see that either the risks in SBICs were different than the risks in these other authorities or in the new activities, or that they were treated differently in terms of how banks currently manage the risks.

We don't believe that this new rule, as it applies to SBICs, will undermine this activity or discourage it in any way. It was not our intent to do so.

We recognize that SBICs have played a very important role in promoting small business financing, and that banks have played a very important role in that process. It was certainly not our attempt to undermine this.

Again, we will be looking over the comments carefully to make sure that we have not inadvertently done so.

Ms. WATERS. Thank you.

Chairman BAKER. Thank you, Ms. Waters.

Mrs. Biggert, would you be prepared for a question?

Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman.

Thank you, gentlemen, for testifying today.

I would like to explore a little bit further this question of the capital requirement and the other limitations that are imposed on this activity.

Clearly, the intent of Congress was to limit this, restrict this, activity to the holding company and not the depository institution. Right? I mean, that is acknowledged and there are rules that require that. These investments have to be disposed of within a certain period of time. There can't be any active management. So it is truly a merchant banking activity. It is truly happening at the holding company level, not at the depository institution. It can only be done with firms that are already adequately capitalized in the first place.

So I guess I am just hoping to explore a little bit the question of whether it is really necessary to impose both what seems like a fairly onerous capital charge of 50 percent, and I know you don't believe that is onerous, but in addition, we have this limitation on the total amount of activity that can occur as well as a percentage of the capital. My concern is that perhaps we are making it too expensive to engage in this business. Is it worth looking at different kinds of investments and weighting the capital requirement differently based on some measure of the quality of the company being held or the security being held?

Is there not a danger that by imposing these restrictions on the holding companies that we really are establishing, at significantly different levels, burdens on holding companies versus securities firms and we really have not achieved the intent of reducing that?

Could you comment on those points?

Mr. MEYER. Well, first of all, with respect to a level playing field between activities conducted within banking organizations and those in unaffiliated security firms, once again we did a very careful survey. We looked at what was the practice among banking organizations with respect to their existing merchant banking activi-

ties, and we looked very carefully at how those activities were managed within security firms and we found, for the most part, a considerable commonality in that. So the kind of capital charge that goes into the regulation, the 50 percent charge, is consistent with internal capital allocations at both banking organizations and at unaffiliated security firms. I don't believe that the proposed capital charge will interfere with the level playing field.

Again, I think it is really important to look at this as an attempt to identify best practice and spread it throughout the banking industry, particularly as new entrants come in to this particular business.

Mr. TOOMEY. Can I just follow up on that particular point, though? That sort of goes back to the point the Chairman made earlier. If we are confident that the industry generally maintains adequate levels of capital, then why is it necessary to impose that on every player? It would seem to me if an individual player were to have an inadequate level of capital, then they have a risk of loss to their shareholders and that shouldn't be our primary concern. Our primary concern should be systemic risk; right?

Mr. MEYER. Absolutely, but I think there is a role for minimum capital requirements. We have imposed minimum capital requirements throughout our banking organizations today.

Second, there is a role for risk-sensitive capital requirements and we see, indeed, in Basel, that there is a trend throughout to make capital requirements more risk sensitive.

So I think the issue is not whether we need capital requirements, and not whether they should be risk-sensitive, but, did we get the risk sensitivity right? That is a legitimate point. Is the capital charge appropriate in light of the risks?

We tried to do a careful survey to make sure that that was the case, but we will be reviewing this in light of the comments.

Mr. TOOMEY. You mentioned it is appropriate to ask the question, you know, is the capital climate right for the risk? Is it appropriate to distinguish between the different kinds of risks that can be taken even in a merchant banking activity?

Mr. MEYER. That is a very good point, and part of the problem is whether or not current banking organizations, as they manage these risks and as they do their internal economic capital allocations, have the ability to make those differentiations today. I think ultimately we want to go in that direction. Is that the first step we want to take, or do we want to evolve in that direction as the methodologies improve within banking organizations for getting that job done?

It is still a very good point. We will be looking at that as we consider the comments.

Mr. TOOMEY. If I have time for one last brief question if you could comment on. Again, given that we have restricted this to holding companies, we have said there has to be a 50 percent capital requirement, is it also necessary to limit the amount, the total amount, that can be done? If it has only been done in these institutions, if it is a well-capitalized business, historically it has been profitable and a safe business, why do we also have to say you can't do more than X of that?

Mr. MEYER. Another very good question.

When we imposed that aggregate cap requirement, one of the reasons we did so was that we did not yet have in place a capital rule, even as the financial holding companies are allowed to begin these new activities immediately. So we saw this as at least a transitional measure that gave us some comfort as we were moving ahead with the capital proposal.

In addition, we did mention in our announcement and in our proposal that we also thought it might be prudent to get some experience with supervising these new activities and to have an aggregate cap that limited the explosive growth in these investments during this transitional period. But the aggregate and cap is likely to be transitional.

Mr. TOOMEY. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Toomey.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much.

Mr. Meyer, I missed just a part of the ending of your testimony when I had to leave, but I think you make a good argument, and you may have made a convert as to safety and soundness of the system. But, I have some reservations. I question the 50 percent rule as it would apply to SBICs, because I can not see how it could really cause a safety and soundness problem. And, I question why it would not be possible to exclude them from the final rule and allow them to operate as they do now, directed and constructed to perform a public purpose.

Mr. MEYER. We certainly recognize that important public service through the SBICs, but we also recognize, and I am sure Congress does, too, the importance of promoting safety and soundness with respect to those activities.

Indeed, one might argue that by doing so, we ensure that those activities will continue to thrive within the banking organizations and will continue to make the important contribution they do to financing small business.

Mr. KANJORSKI. If I could please just interrupt you there. That argument would work, but SBICs have such flexibility that they can either buy into a startup organization on the equity side or on the credit side. If they make loans and do it on the credit side in order to accomplish the same purpose, they avoid your rule.

Mr. MEYER. Yes.

Mr. KANJORSKI. But, they do a second thing. They weaken that new structured organization to have a very poor balance sheet, very low equity and very high debt.

Mr. MEYER. We do believe there is a very considerable difference between the riskiness of the typical private equity venture capital component that goes into SBICs and the typical loans that firms make in their lending activities, and this is demonstrated by the fact that banks, in their internal capital allocations, allocate such high economic capital to these private equities.

Mr. KANJORSKI. I would like the Federal Reserve and Treasury to really look at the ability to carve out the new SBICs that we will be creating under the New Markets Initiative that are targeted to distressed communities.

Chairman BAKER. Would the gentleman yield on that point? I want to ask you a question to further understand your last line of questioning.

The response was we believe that the traditional lending process is far less risky than the equity position with the SBIC. That is because the traditional loan is well collateralized. The trouble is the SBIC doesn't have the collateral to post for the loan, and the consequence will be the reduction in risk, I believe, but it will also mean a reduction in capital to the SBIC, because they won't be able to participate. They normally don't participate in the lending process adequately. I think that is the point the gentleman is raising.

Mr. KANJORSKI. And, they are so small in size. We are talking about a couple of billion dollars here in the total market that Mr. Gensler is talking about.

In addition, taking all this into consideration, how does your rule impact on the amount of obligation the banks had in Long-Term Capital Management? Are they still able to go into that organization full force with their limited reserves of, what, 6 or 8 percent? I am not sure of the total capital structure, but I do not think there was more than 4 percent in actual equity in the organization. The rest were loans, maybe $4 billion in capital and $96 billion in loans, a lot of which were made by banks.

Mr. MEYER. Most of the direct involvement of banks was not, in fact, in loans, but was in derivative positions that banks thought were pretty secure, because they were marked to market and collateralized, and they found out otherwise. They did not do adequate risk management with respect to those positions. As you know, we put out supervisory guidance after that and have worked very hard, and the banking industry has worked very hard to tighten their risk management with respect to HLIs.

But might I point something out, because you bring up a very interesting point. How did Long-Term Capital Management get into trouble? Maybe one of the ways they got themselves into trouble was they were so highly leveraged. How highly leveraged were they? 25-, 30-to-1? Well, let's go back to see for banks. Four percent capital? That is 25-to-1 in terms of the minimum capital requirement. Is that the way you want banks to be involved in private equity investments?

Mr. KANJORSKI. No, I started my comments by noting that you had persuaded me.

Mr. MEYER. OK.

Mr. KANJORSKI. I used to play the role of a judge. I would always say to a lawyer, "Look, when you won your point, maybe you should not push it."

Mr. MEYER. We will take it.

Mr. GENSLER. If I might, Congressman, just to try to answer one of the questions that you asked, the proposed capital rule, as written, does not cover the new markets activities that you mentioned. So I just wanted to clarify. It is very specific that it covers certain authorities and it only covers those authorities. It does not cover those new ones.

Mr. KANJORSKI. So we are only really worried about the 400 or 500 licensed SBICs that are in existence, and we could probably

analyze what total risk is out there, looking at safety and soundness. I would suggest that it is probably less than a $2 billion risk area. If that is the case, why do you move that up to 50 percent when, in fact, we are not really doing anything? The banks can turn right around and get into playing the market with Long-Term Capital Management?

Mr. MEYER. Just one point. It is true that banks are limited with SBICs to 5 percent of their capital, but that is at cost. If you look at it in terms of their carrying value, and you take into account the unrealized gains, there are banks that have three times as much as that exposure relative to their capital. So it is not that small. At least in a couple of the really largest banks, it is a fairly large activity. It is very concentrated.

Mr. KANJORSKI. I am not worried about the banks and SBICs, because I tend to think that they really have not carried out the intent of the SBIC to begin with. They are really just funding until you get to the IPO, and they are really playing the market. But I am really worried about the actual economic development SBICs in the little areas that are trying to develop communities. These are the ones in which I would not care if you instituted a ceiling. I know there is one major bank in New York that derives a major part of their return from their SBIC just by playing the financing before the IPO. In contrast, I am worried about a small $8- to $10-million SBIC in Hazard, Kentucky, that sometimes needs loans. It needs the capacity to go on either side of the transaction and have a bank follow up. Those would be the problem areas.

Well, I appreciate it. You may have won a convert. I am not sure.

Mr. MEYER. Thank you.

Chairman BAKER. Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

To follow up on the 50 percent capital that Mr. Toomey had brought up, internally the banks weigh capital requirements for each investment differently. For example, a mezzanine financing investment would carry a lower capital allocation than a new e-business venture, because of its lower potential risk and return. So doesn't the 50 percent capital charge—would that force the holding companies then to steer away from the less risky ventures with the lower return and then toward the higher return, albeit risky, ventures to justify that type of capital allocation?

Mr. MEYER. Two things there. That wouldn't be the case if 50 percent were truly the minimum, and, for example, for the riskier venture capital startup kinds of activities, that the internal capital allocations were well above that 60 percent, 80 percent, 100 percent, as we sometimes find. That is one point.

Second, you, I think, indicated that banks regularly internally allocate different capital charges against mezzanine and startup, and so forth. That wasn't entirely what we found in our surveys. We did find one bank that did that, but we didn't find that practice was all that common. I think that is where banks will be headed, and when banks head in that direction, and develop the methodologies and the internal capital allocation systems to a more sophisticated degree, then I think the capital regulations can go in the same direction.

Mrs. BIGGERT. But that is true with security firms, that there is a wider range, what, 25 percent to 100 percent?

Mr. MEYER. There was a range from different security firms, and to some extent it can reflect the considerations that you have indicated, but we do have a problem right now in that not many organizations are prepared to implement that kind of a system with that degree of differentiation across the merchant banking assets.

Mrs. BIGGERT. Well, what about a range of capital requirements based on risk? Is that a possibility?

Mr. MEYER. I think all of this has to be considered as we review the comments, and as I indicated, I think it is plausible to believe that that is a direction which we would evolve toward even if we didn't begin first off with such a system. But we will have to consider that.

Mr. GENSLER. If I might just add, the nature of what we call the private equity market or merchant banking market is higher cost finance. Companies turn to other forms of finance generally before this, because it costs more. So there is something in the marketplace itself that brings companies that tend to be a bit riskier, whether they be startups or leveraged buy-outs where there is a great deal of debt.

So there are different levels of risk, but by the nature of private equity, it is always a bit more risky than, for instance, public equity. This overall market, again, is largely financed by pension funds, endowments and the like, and largely outside of investment banks and commercial banks. And investment banks and commercial banks have a great deal to add, and we want to promote that, but when Henry Kravitz gets money from a pension fund, it is a dollar of equity for a dollar of investments.

Now, in this case the Federal Reserve has found another level, which is the 50 cents level. We are going to consider all the capital rule's comments. Congressman Kanjorski mentioned hedge funds earlier. It is interesting, pension funds and private endowment funds, and so forth, generally look at their investments in this area as what they call alternative investments. They put them usually in the same basket as their investments in hedge funds. Just to give you a context of the risk parameters that most pension funds look at, not always, but generally they put them in the same basket.

Mr. MEYER. One other point. If we got it right, and that is what we have to continue to look at, if we got it right, and the 50 percent is legitimately an appropriate minimum, and there are investments that are riskier, then in the supervisory process we would have to work to make sure that banks were allocating, hopefully, more capital to the riskier projects. So the question is, did we get the minimum right? That is the real issue.

Mrs. BIGGERT. But then what about the less risky? It seems to me that you want them to—that they will go to the more risky and not to the lower risk.

Mr. MEYER. What you are saying is if we didn't get the minimum right, that there are many assets that have even lower risk, and if that is the case, then the point is exactly right, that will prevent banks from being able to take on those investments and earn a competitive rate of return and we will get the same kind of capital

arbitrage that we are worried about with respect to the loan portfolio. So that is exactly what we will have to consider.

Mrs. BIGGERT. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mrs. Biggert.

Mr. Maloney.

Mr. MALONEY. Thank you, Mr. Chairman. I want to thank Governor Meyer and Secretary Gensler. Thank you for being here.

Governor Meyer, this question really is—two of them are for you and follow-up on several of the other questions that have been asked. I want to look at this merchant banking rule from the perspective of distinguishing merchant banking from some of the strategic investments and strategic alliances that banks have already made and are arguably going to continue to make.

Under the Financial Modernization Act, there are three different sources of authority for them to do that. One is in the Act itself, the merchant banking provisions for financial holding companies, and this conversation has touched on that already. But the Act also has, "financial incidental or complementary statutory authorities for financial holding companies," and the underlying National Bank Act contains the "losely-related or incidental to banking authority for banks, and State banking laws have similar provisions."

So the two questions are, one, can the Board agree that strategic investments and joint ventures in high-tech and e-commerce activities already approved by the OCC for banks, and banks subsidiaries pursuant to the National Bank Act or by State banking authorities, will not be considered merchant activities, merchant banking activities? And the second related question is, can the Board further agree that holding company strategic investments in high-tech and e-commerce activities—companies that have already been approved under the Bank Holding Company Act or that will be approved now for financial holding companies under the Financial Modernization Act's financial incidental or complementary statutory authorities are, again, not merchant banking activities and should not be treated as such for examination or other regulatory purposes?

Mr. MEYER. As you know, the merchant banking rules, including the capital proposal, do not apply to investments in financial firms, and that is part of this.

Mr. MALONEY. Right.

Mr. MEYER. So it does not apply to those activities that have been ruled incidental to banking, closely related to banking or financial. And the idea is, therefore, not to interfere specifically with those strategic investments that banking firms make, that are integral to their operations and to the financial services that they provide to clients and other financial institutions.

Now, when you talk about more generally e-commerce, we can get into kind of a murky and a little blurry area. I have tried to indicate it is not certainly the intent to interfere with those very important strategic investments that banking firms are making in these areas.

Mr. MALONEY. Just to follow up, Mr. Chairman, I think that is the heart of the issue, and as you review these regulations, I think that is what—I would ask that you take a very close look at that,

because if you hold it too close to the vest, certainly some of the activities that banks do now in that incidental category are going to be covered, but the issue is will they have the freedom to take advantage of the changes in the market, the changes in what really is banking as the high-tech field and the e-commerce field evolve.

So I would encourage you to make sure there is adequate room there for the banking industry to move in that direction without those movements and without that activity being considered merchant banking.

So, there is a question of a murky or gray area, and my reading, as it stands now, is that it is probably too tight and does not provide adequate flexibility.

Mr. GENSLER. We will certainly take a look at that, because it is a very important area. Our goal is clearly that if it is financial in nature, it does not come under this. The word "strategic" is sometimes used in a broader sense, like having a close relationship with a client sometimes is strategic. And that is where we feel that it was Congress' intent not to have this mixing of banking and commerce. But clearly where it is financial, it is not meant to be under this rule.

Mr. MALONEY. Thank you very much.

Chairman BAKER. Thank you, Mr. Maloney.

Since all Members on our side have been recognized, Mr. Capuano, you are next.

Mr. CAPUANO. Mr. Chairman, I just want to echo a few comments that have already been made. First of all, I am really, really thrilled to be back here talking about the financial modernization bill so quickly. I just can't wait to do this for about twenty or thirty more years.

I guess I wonder in many ways how many people in this room would have had different thoughts about that bill had they known that these regulations were going to be written the way they were, but so be it.

I have heard a lot of talk today about safety and soundness to the system; great stuff, interesting, important stuff. I have heard a lot of stuff about risk-sensitive capital requirements. I love that term, risk-sensitive capital requirements. That is great. That is your job, possibly my job.

I am also here to be interested in socially sensitive capital requirements, such as making capital available to nontraditional areas of the economy that otherwise don't have access to capital, such as affordable housing, such as minority-owned businesses, such as businesses located in distressed areas, which is one reason why I am so involved with empowerment zones, with APICS, with the New Market issues. I think that stuff is great stuff. I also want to make sure that we don't do anything to discourage that, and I actually take a lot of encouragement from the comments that I have heard today already that you will review this to make sure that those types of activities are not adversely affected, because I do think that even if they are riskier, even if they are put in the same basket as hedge funds and the like, they are more important to our economy, to individual members of the system than to the greater economy, because it doesn't make a whole lot of difference to me if the whole world is financially well-off if I have a signifi-

cant segment of the population that is left behind. And a significant segment of the population would be if we walk away from affordable housing, minority-owned businesses, and so forth, and so forth.

So I really don't have a question. I did, but those questions have been asked and answered, and I appreciate them. My comment is to emphasize as strongly as I can that you take those issues into account when you review these requirements, particularly the 50 percent capital requirement.

Mr. Gensler, I look forward to you coming forward with a 50 percent requirement on hedge fund investments by banks. I hope that day comes soon. Thank you.

Mr. GENSLER. Congressman, we share your philosophy and your goal about promoting all the activities, and that is why we have worked so hard with this committee on so many activities around the Community Reinvestment Act, and around new markets activities, and we look forward to continuing that.

We don't think that this proposed rule does impinge in the community reinvestment field, as was answered earlier, or on these potentially new legislative initiatives that the President and Congress are working closely on.

Chairman BAKER. Thank you, Mr. Capuano.

We do have a couple of Members who want to do a follow-up question, I being one. Just as a matter of clarification, Governor Meyer, and you may want to get back to me on this if it is not something right off the top of your head, I understand that as a supervisory practice, not as a regulatory—or potentially not part of the rule, but the Fed has already begun to treat community development corporations as a merchant banking activity. Can you affirm for me that that has been the practice, or is that not yet the practice?

Mr. MEYER. I am not aware of that. Indeed, I think most of the things that I think fall into that community development corporation have this public welfare connotation to them, and those are not covered. That is not part of the activities that are covered by the merchant banking rules, because those are not part of SBICs. They are not in the Edge Act kinds of investments, and they are not in the 4(c)(6).

Chairman BAKER. Right. I was clear that in the proposed reg that it was not contemplated, but that as a matter of supervisory field practice it was a way in which this analysis was done.

Mr. MEYER. I will look into that.

Chairman BAKER. And I have a series of other rather specific questions. I will get those to you within a few days.

Mr. MEYER. All right. I appreciate that.

Chairman BAKER. Further, I don't know that it is the appropriate way to state this, but I think you can perceive from Members' participation today that there is a sincere interest in doing something right. Now, defining right in this particular instance is very difficult. There seems to be a lot of hues of gray in this issue, and we don't want to assist an effort that results in losses to taxpayers. At the same time, we felt like, as Mr. Capuano expressed, we had finally resolved the issue of financial modernization, and we appear to be sort of back in the discussion again.

To that end, if appropriate, either a report, a briefing, a hearing, some other follow-up step to this hearing at the appropriate time before final promulgation of the regulation would be something we would request, and we can talk about the mechanism that is most appropriate. We don't want to be in the business of rule writing, but we—generally, I think there is a consensus. We would like to know where this is going before we read it as the final step, because there is extraordinary interest in seeing that the system works properly.

So just as a matter of communication, you let me know what you would be comfortable with as a process, but we very much would like to have a follow-up meeting or something to this hearing once determinations have been close to being finalized.

Just some housecleaning business. Ms. Waters left a statement for the record, and to note all Members' statements will be included in the record for those who choose to leave them.

[The prepared statement of Hon. Maxine Waters can be found on page 78 in the appendix.]

Chairman BAKER. National Venture Capital Association and the FDIC both have comments they would like to be included in the record.

[The information referred to can be found on page 51 in the appendix.]

Chairman BAKER. That concludes my business.

Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, just for emphasis purposes, in the statement I entered into the record for Mr. LaFalce today, he enclosed a letter from Aida Alvarez, the Administrator of SBA, dated June 7. I just want to read one of the paragraphs so that we can make sure our witnesses listen to it. "Today, commercial bank investment represents a major component of the SBIC program. Banks participate in the program through SBIC subsidiaries, bank-owned SBICs, and also provide a significant portion of the capital for independent SBICs. Currently, there are 101 bank-owned SBICs with $5.3 billion of capital. This represents 28 percent of the program's licensees and 62 percent of its total private capital. While large relative to the SBIC program, the banks' investments are still minuscule in terms of the banking industry's capital resources."

[The information referred to can be found on page 63 in the appendix.]

I just want to highlight that this type of activity represents, if I am correct in remembering Mr. Gensler's testimony, about 1.5 percent of all the venture capital involved with the banks. That is pretty small as far as safety and soundness is concerned.

I want to make sure that taking this into consideration, we do not do something to disarm the small army we currently have to help develop some of these distressed communities and areas. Thank you.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Lucas, do you have a follow-up?

Mrs. Biggert, do you have a follow-up?

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. I have a couple of quick questions.

Governor Meyer, I had a chance to read through your testimony. As I understand the cap, the limitation, it is 30 percent or $6 billion; and net of private equity investment, it is $4 billion. But the gross cap is $6 billion, the lesser of 30 percent or $6 billion, 30 percent of Tier 1 capital or $6 billion. Is that correct?

Mr. MEYER. That is right.

Mr. BENTSEN. In your testimony, you said there really are a limited number of banks engaged in this activity right now, maybe 10 or so banks of any significance of investment.

Mr. MEYER. Right.

Mr. BENTSEN. And the investment range is from $1 billion to $8 billion. If you had a bank, a financial holding company that was at $8 billion, would they then have to ramp back, or would they be grandfathered under this?

Mr. MEYER. No, because these caps only apply to the new activities under the new act.

Mr. BENTSEN. But if you are at $8 billion, you would in effect be frozen at where you were?

Mr. MEYER. No, because those are existing activities. There are no caps on those. They can grow without reference to these caps in the future.

The only thing that counts are the new activities that are expressly permitted in the holding company by the Gramm-Leach-Bliley Act.

Mr. BENTSEN. Would only the new activities be subject to the new capital requirements as well?

Mr. MEYER. Yes. Oh, no, no. What we did for the capital requirements was different. We said that since the risks appear to be the same for existing activities, the capital requirements should apply to all merchant banking activities.

Part of this is because increasingly banks manage their risk on a consolidated basis and across legal entities. They manage their merchant banking assets in a similar way, and they ought to be regulated in a similar way.

Mr. GENSLER. Part of it actually was just really the nature of the rules. There is one rule that we are doing jointly that was put out on an interim basis in March, and then there was the capital rule. The interim rule is only on the new activities, only on the new activities, and that cap that you referred to was seen as in a transitional basis, one, until the capital rule was in place and we learned more about this, and possibly, two, we gauged the experience.

So it was really of a transitional nature in that first rule in part to get to the second rule.

Mr. BENTSEN. I had another question on this, but I appreciate what you all are trying to do, and I don't know where I come down on this. I appreciate the fact that you see growth in this sector as part of the new bill, the new act, and the fear of some systemic risk occurring. I mean, the venture business and the merchant business is all up, and at some point it will be down, even though there is long-term growth. So I don't want to sound overly critical of this.

Governor Meyer, further in your testimony you go into a rather fascinating discussion of regulatory capital arbitrage that only the Federal Reserve could write.

Mr. MEYER. Thank you, I think.

Mr. GENSLER. Interesting words, fascinating and regulatory capital arbitrage.

Mr. BENTSEN. I guess it is arbitrage throughout life, but if I understand it correctly you are saying that currently you could argue that regulatory arbitrage, capital arbitrage, results in the movement of stronger assets, lower-risk assets off the balance sheet, possibly to the detriment of the capital ratio as a result.

Could one make the argument that if you impose a new higher capital ratio in merchant banking that you might be forcing institutions to take advantage of arbitrage to make up for that higher capital cost and thus creating perhaps a worse situation?

Mr. MEYER. If we didn't set that capital charge appropriately, and set it too high so that there were many merchant banking activities for which economic capital allocations would be well below that, that would be the danger.

Mr. BENTSEN. So you believe that——

Mr. MEYER. But we tried not to do that. We tried not to do that, but that is a legitimate issue to raise. That is what we have to think about to make sure that we got it right.

Mr. BENTSEN. Mr. Chairman, one more thing, with your indulgence.

Mr. Gensler, I know a number of your staff from Treasury, some of your staff seems to be getting much younger. I didn't know if you would want to introduce who your staff member is with you today.

Mr. GENSLER. She is the lead of my junior staff at home. It is Anna Gensler, my eldest daughter, who is ten and who is out of school and wanted to see a little bit of how Congress worked.

Mr. BENSTEN. You are a very good father for bringing her here today.

Thank you, Mr. Chairman.

Chairman BAKER. And she is a very nice child for putting up with lengthy testimony.

Mr. Capuano.

Mr. CAPUANO. I just think that that is close to getting pretty close to child abuse, so I think you should be aware of that.

Chairman BAKER. Gentlemen, Mr. Gensler, we certainly appreciate your participation here today. We hope our hearing is constructive in your efforts, and we certainly want to continue our communication on this important subject. Thank you very much.

I am advised that we still have some time before we expect the first vote to occur, and hopefully if we can move along we can get all the testimony concluded before the hearing is disrupted.

I wish to welcome all the participants in our second panel to this hearing. I certainly appreciate your responsiveness, given our lead time in putting the hearing together. Each of you and your organizations have been very cooperative in providing yourselves to be available.

In the order I have been presented this morning, our first witness would be the President of the Securities Industry Association, Mr. Marc Lackritz. Welcome, Mr. Lackritz.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thanks, Mr. Chairman. It is a pleasure to be here before the subcommittee today, although I must tell you that I have a sense, kind of like Yogi Berra used to say, of "deja vu, all over again."

Very quickly after the Gramm-Leach-Bliley Act was passed, we are back here again arguing about what, in fact, it actually said and what it, in fact, intended to say. So it is deja vu all over again in the sense also that we now are dealing with regulatory agencies that, in fact, are proposing regulations vastly outside, far outside, the scope of the legislation that was passed; far outside the legislative intent that was passed, and, frankly, that will have the effect of shutting down one lane of the two-way street that the legislation was supposed to provide for.

Just to summarize, we really believe that the merchant banking rules send a powerful signal now to the securities industry that the regulators are still taking a pre-Gramm-Leach-Bliley view of the financial services marketplace in which bank affiliated securities firms will continue to be treated differently from firms that are not part of financial holding companies. These rules will have a significantly adverse impact on the ability of securities firms within financial holding companies to make merchant banking and other permissible investments on the same scale and to the same extent as securities firms that are not part of a financial holding company family. And, because merchant banking is a such a very important part of the business of many securities firms, the existence of these rules will deter securities firms from becoming financial holding companies, because of the roadblocks on one lane of the so-called two-way street.

The three aspects of the rules that are most troubling are the 50 percent capital charge, the total cap on merchant banking investments and the holding period restrictions.

Gramm-Leach-Bliley was historic, we think, because it was supposed to enable securities firms and banks to affiliate freely with each other and to ensure that securities firms, once they became partners with banks, would not be artificially restricted in their activities.

I would just note that in the legislative history of the Act, specifically on both reports, on both sides of the aisle—on both the House and the Senate, the conference report stated that the merchant bank provisions are intended to permit securities firms, "to continue to conduct their principal investing in substantially the same manner as at present."

We think these new rules go well beyond what Congress authorized in the Act and destroy the two-way street that is the core of the Act. For example, the 50 percent capital charge and the aggregate investment limit on merchant banking investments are artificial restrictions not found anywhere in the Act and never contemplated by Congress in your extensive deliberations on merchant banking.

Other aspects of the rules, such as the rigid holding period limitation, are plainly at odds with the more flexible approach that Congress specifically directed the Fed and Treasury to take.

Moreover, these limits on merchant banking activities are entirely foreign to securities firms that are not affiliated with banks. As a result, these limits place securities firms that are part of the financial holding company families or that become financial holding companies at a competitive disadvantage by artificially restricting their activities—artificially restricting their merchant banking investments, and making it prohibitively more expensive for them to provide venture capital to entrepreneurs and growing companies.

For this reason, many securities firms will be discouraged, if not effectively barred, from acquiring banks and becoming financial holding companies, which was at least a significant part of the objective of Gramm-Leach-Bliley. In short, rather than opening this two-way street, the merchant banking rules recreate the very sorts of roadblocks to an efficient and integrated financial services industry that the Members of this subcommittee and others in Congress worked so hard to eliminate in the enactment of the Gramm-Leach-Bliley Act.

Now we heard earlier that Fed and Treasury both testified that these rules are really supposed to formalize existing industry practice. This is not the case, and let me be clear on this point. These rules do not reflect prevailing securities industry practice. Our own experience is that merchant banking practices are far more diverse than the Fed and Treasury have asserted, and that, as a consequence, the rules don't accurately reflect these varied and prudent activities. The capital charge is the very best example of this.

The Fed is proposing across the board a 50 percent capital charge on all merchant banking investments, because it believes that securities firms and others typically maintain higher internal capital positions to support their merchant banking activities.

Our experience is that while some securities firms do maintain higher levels of capital for merchant banking positions as opposed to other assets, these levels vary quite significantly from firm to firm and, even within the same firm, from investment to investment depending on an array of factors.

Furthermore, even if it is correct that some securities firms have higher capital levels for equity investments as part of their internal models, these internal models also apply lower capital charges to other assets; and this sort of cherry-picking, which is what the Fed has sort of done, we think is totally inappropriate, because it doesn't allow for those kinds of adjustments.

The Fed and Treasury also indicated in their rulemaking that they believe that the restrictions they placed on merchant banking activities are warranted due to the risks posed by this business, but the record of the securities industry participating in the merchant banking business has been very, very good. A successful record was achieved precisely because firms have developed extensive internal controls and management information systems for making, managing and monitoring their venture capital investments.

Such established, prudent and time-tested policies and systems should not be disturbed by new rules that inflict arbitrary limits on the amounts firms may invest, on how long firms may hold their investments, and on how these investments may be counted against regulatory capital.

We think actually there are alternative approaches that are much more effective, but we think the best approach would be for the Fed, which has ample supervisory authority over financial holding companies, to utilize flexible standards and to rely on the very internal capital models that it cites in the rulemaking. Such a course would allow the Fed to differentiate poorly managed firms from others and would encourage and reward institutions that develop sound internal merchant banking practices and risk management models.

In conclusion, Mr. Chairman, we believe these regulations are totally unwarranted by the legislative history, totally unsupported by the facts and very anticompetitive in their impact. We believe that merchant banking authority is one of the most important powers in the Gramm-Leach-Bliley Act for securities firms affiliated with financial holding companies. We look forward to working with this subcommittee, the Congress and the regulatory agencies to craft new merchant banking rules that advance the goals of financial services reform and safeguard safety and soundness to financial holding companies and their affiliated depository institutions. Thank you, Mr. Chairman.

[The prepared statement of Marc E. Lackritz can be found on page 113 in the appendix.]

Chairman BAKER. Thank you for your participation this morning and your comments.

Our next participant would be Mr. Harry Alford, President of the National Black Chamber of Commerce. Welcome, Mr. Alford.

STATEMENT OF HARRY C. ALFORD, PRESIDENT/CEO, NATIONAL BLACK CHAMBER OF COMMERCE, INC.

Mr. ALFORD. Thank you, Mr. Chairman.

Chairman Baker, Ranking Minority Member Kanjorski, subcommittee Members, thank you for allowing me, Harry C. Alford, President and CEO of the National Black Chamber of Commerce the opportunity to speak before you concerning the proposed rule changes R–1065 and R–1067 for merchant banking capital requirements.

The National Black Chamber of Commerce was incorporated in Washington, DC., in May of 1993. Today we have established an infrastructure of 185 affiliated chapters located in thirty-six States and six nations. We have direct reach to 64,000-plus business owners and are the largest black business association in the world. Having completed the task of building a large and viable infrastructure, we are now focusing on key issues that affect entrepreneurs in our communities.

All surveys and studies reveal that the key issue concerning small businesses and black-owned businesses are no exception. It is capital access. There is a great lack of capital access for small businesses and the need to increase the channels or opportunity pools is ever present. We need more capital. It is the lifeblood for business startup and business development. Any action or conditions that lessens capital access is a threat to jobs, health care, education, and even national security. Small business drives this economy, and the nutrient of capital access is always the great variable in the success ratio of such entities.

On March 17, 2000, the Board of Governors of the Federal Reserve System and the Secretary of the Treasury issued joint regulations relating to the merchant banking provisions of the Gramm-Leach-Bliley Act. The proposed rule relating to the capital adequacy of bank holding companies, BHCs, and financial holding companies, FHCs, if enacted, would limit the overall amount of merchant banking activities BHCs and FHCs might engage in, including investments in small business investment companies, SBICs.

SBICs were created by Congress to provide venture capital financing for small businesses. In addition to Congress, this Administration has supported SBICs as an instrument for job creation in low- to moderate-income areas. These two rules could counter the intent of Congress and the vision of this Administration by significantly slowing down the activity and the amount of investment in such venture capital pools.

The proposed rule changes would unjustly require BHCs and FHCs to deduct 50 percent of the total carrying value of their merchant banking investments, including SBIC investments, from their Tier 1 regulatory capital for purposes of calculating both their risk-to-capital ratio and their leveraged capital ratio. The net result of the proposed capital adequacy rules would be to increase the percentage of equity capital BHCs and FHCs must have to support SBIC investments from 8 percent to 50 percent. This would be a 525 percent increase in the equity capital charge BHCs have traditionally incurred when making investments to SBICs. The proposed stringent capital requirement will work as a strong deterrent for FHCs and BHCs who might otherwise continue to invest in SBICs.

Traditionally, regulators have used such requirements to deter bad practices such as predatory lending. Significantly raising the charge-off scares investors. Thus we are shocked, quite shocked, at this practice now being applied to mainstream investment pools that fuel the development for small business and create jobs by the thousands.

The 106th Congress will be recorded as the session that promoted small business investment and inner-city renaissance. In the era of New Markets Initiative, American Renewal Act and other new pieces of ingenuity, these proposed rule changes have the effect of being the sole fly in the buttermilk.

We strongly urge this subcommittee and the 106th Congress to use its powers to squash this direct threat to the SBIC program.

In addition to the SBIC threat, the proposed rule changes would greatly decrease opportunities that banking institutions may have in meeting their Community Reinvestment Act, CRA, obligations. The rules would take away a key tool to investment in low to moderate-income areas, which the SBIC program provides.

In conclusion, we feel these rules would undermine congressional intent and cause great harm to our constituency. All who believe that capital access is important to business development and job creation should oppose them.

Thank you so much for your time, and let me say that from a small business perspective these rules are mean-spirited and onerous. They are antibusiness.

[The prepared statement of Harry C. Alford can be found on page 124 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Alford; very good statement.

I welcome next Mr. Lee Mercer, President of the National Association of Small Business Investment Companies. Mr. Mercer.

STATEMENT OF LEE W. MERCER, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. MERCER. Thank you. Mr. Chairman, after Mr. Alford's statement, I am not sure what I am going to add to it, but I will try to add a couple of points, and so to you and Mr. Kanjorski and other Members of the subcommittee, I thank you for the opportunity to be here on behalf of the SBIC program.

We are appearing with respect to the capital adequacy proposal. That is what I will comment on. And I will summarize my testimony and just ask that the full testimony appear in the record.

Chairman BAKER. Without objection.

Mr. MERCER. I mean, you have heard it said already that the bank investment in SBICs is a significant source of capital, over 60 percent of the private capital and over 24 percent, I think, now over the past two years of capital invested in independent SBICs.

So the rule, which has a potential to have a significant negative impact on that, will be substantial.

Now, I have heard Treasury and Fed allude to the fact that it is a small amount of money in the overall scheme of things, and that is true. SBIC venture capital is probably, at most, 10 percent of the venture capital under management, depending on what you characterize as venture capital.

But in terms of numbers of transactions, SBICs, according to SBA's estimates last year, represented about 50 percent of the transactions. So if you view the private small business community in our country as a pyramid, where very small companies need smaller amounts of capital, the SBIC program is supporting the base of that pyramid upon which the balance, the huge balance, of this private equity industry, which is so successful, relies, because most small businesses can't start off digesting a $7 million or $10 million investment. They need $250,000, $300,000, $500,000, a million dollars, and that is the heart of the SBIC program. So for our small businesses, it is a substantial source of capital in this country, and nowhere is there an impact analysis done on that.

For the reasons stated in our testimony, we believe the SBIC program should be exempt from the rule, or at the very least that there is a lot more homework that has to be done before a capital requirement change is applied to the SBIC program. I won't recite them all, but I do want to make some points which relate to some of what I have heard here today.

I am not sure that it is true to say that banks have new authority. At least with regard to venture capital, they certainly have expanded authority, but they have been operating venture capital activities in the SBIC program for many years, and quite profitably. And the significance between expanded and new is quite important, because according to what we heard here today they have been managing those activities in a very prudent way.

So I guess I would ask Treasury and the Fed what exactly has changed to suggest that they will not be managing them prudently in the future as they go forward?

Second, some of the statements made in the published rule, in my mind at least, indicate either a lack of understanding this or an unwillingness to accept that constraints, other than their own arbitrary rule, can have an effect on risk. And I quote: "Risks associated with"—and we will insert 'merchant banking activities'—"do not vary according to the authority used to conduct the activity."

That is simply just a ridiculous statement. It assumes, quite frankly, that no other regulation can have an effect on risk.

In the SBIC program, there are regulations regarding the licensing requirements and the criteria for becoming an SBIC. There are restrictions on the percentage of capital that can be invested. There are examinations by SBA. So to suggest that other authority can have no effect on risk is to probably suggest that we ought to throw out all of the regulatory agencies that have any impact on this.

All of these things address risk, and risk would be greater without them.

The proposed rule also treats equity and convertible debt as the same. And I guess I would ask, how can that be? It implies, if you will, carried to its logical conclusion, that an investment in a convertible instrument, a debt from IBM, would subject me to as much risk as it would be if I bought the stock of IBM. It just does not follow.

Certainly there are—and others have commented on the fact that there are different categories of risk associated within activities that are considered, "merchant banking activities."

Finally, I guess I would say that there is no discussion of what I will call portfolio management—or what others called portfolio management theory and its impact on risk. That basically talks to the diversification of a portfolio and how that has an impact on risk, and, you know, for leveraged SBICs there are definitely diversification requirements, and bank SBICs impose their own diversification requirements on themselves, but it would seem to me that that ought to be addressed as well.

I will close with just a question. What will be the final result if the rule were to become final today? What would the impact on the SBIC program be?

My feeling is that less money would be invested in SBICs by banks. Why? There are several reasons, but one of the reasons would be banks having to allocate capital between an SBIC and what I will call a Gramm-Leach-Bliley activity would probably allocate it to a Gramm-Leach-Bliley activity. Why? The SBIC is subject to more regulation than the Gramm-Leach-Bliley activity for the same type of investment. The SBIC has to be licensed. Its managers have to be subject to qualification requirements. It undergoes examinations. It is subject to the restrictions to invest only in U.S. companies, only in small companies, only in U.S. companies that have 50 percent of their assets and 50 percent of their employees are over 50 percent in this country. So if it were—if for no other reason, you would say the capital is going to go where there is the least amount of restriction, and I think that would be a fair result if I were managing a bank. That is probably what I would do.

So I guess I would close by saying we are of the opinion that one size does not fit all. For reasons that have been articulated perhaps better than I can here today, by several Members of the subcommittee, we believe that the SBIC program ought to be exempt from this capital requirement. Thank you very much.

[The prepared statement of Lee W. Mercer can be found on page 127 in the appendix.]

Chairman BAKER. Thank you, Mr. Mercer.

Our next witness is Mr. John P. Whaley, who is Partner in Norwest Equity Partners and Norwest Venture Partners, Wells Fargo, and testifying today on behalf of the American Bankers Association and the American Bankers Association Securities Association. Welcome, Mr. Whaley.

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

Mr. WHALEY. Thank you, Mr. Chairman. Norwest Equity Partners and Norwest Venture Partners are both merchant banking operations, and they comprise the private equity investment business of Wells Fargo & Company.

As you mentioned, I appear on behalf of ABA Securities Association, or ABASA, and the American Bankers Association.

Mr. Chairman, many of ABASA's members regard the merchant banking authority as the single most important measure of the Gramm-Leach-Bliley Act. We oppose the recently proposed regulations of the Fed and Treasury. They raise many issues. I will highlight three of them: how the proposed rules undermine congressional intent, the negative impact of the 50 percent capital charge, and the unnecessary and burdensome restrictions on merchant banking through private equity funds.

The first of these three points is that the Fed and Treasury have gone far beyond effectuating congressional intent. One of the clearly stated purposes of the law was to create a two-way street among financial services providers. The proposed merchant banking rules undermine that intent. The restrictions, particularly the 50 percent capital charge and the aggregate investment limits, effectively guarantee that there will not be a two-way street.

Securities firms will not become financial holding companies. Foreign banks will conduct their merchant banking activities from offshore locations. Bank and financial holding companies will be precluded from engaging in merchant banking activities on the same terms and conditions as their competitors.

These regulatory restrictions, beyond those delineated by Congress, are not needed. Statutory provisions prohibiting routine management of and unlimited holding periods for investments ensure the separation between banking and commerce.

Congress also adequately addressed risk concerns by authorizing merchant banking activities only through holding companies for the first five years, and by permitting them only to financial holding companies with well-capitalized and well-managed banks and

by requiring financial holding companies to have appropriate risk management systems.

Furthermore, the banking industry has a long history of merchant banking. Those activities have produced strong returns with minimal losses over a relatively long period of time, involving both up and down markets.

For all these reasons, it is inappropriate for the Fed and Treasury to raise additional barriers that Congress never intended. Let me give you two prime examples. The first is the proposed 50 percent capital charge on all merchant banking investments, which would apply not only to new merchant banking authority, but to all such investments, including those made under existing authority.

The 50 percent capital charge is plainly excessive. It would require eight times more capital for merchant banking activities than is currently required. This will negatively impact not only the newly authorized merchant banking activities, but also those authorized prior to Gramm-Leach-Bliley.

There is also no grandfathering of existing investments. Thus, organizations will have their overall capital requirements raised without contributing one additional dollar of equity investment.

A 50 percent charge could render uneconomic many existing investments, not because of any change in inherent worth, but solely because of an unanticipated change in regulatory treatment.

The Fed suggests that the 50 percent capital charge is drawn from internal capital allocation models used by investment banking firms. In fact, however, the regulators have cherry-picked the high capital allocations from internal models and ignored all the lower capital allocations assigned these same models.

The capital proposal also will have a significant practical impact. Holding companies will be forced to replace capital depleted as a result of the 50 percent charge. This will be necessary to maintain growth opportunities and to satisfy regulatory and market demands for large capital cushions.

The second example of undermining congressional intent is the unnecessary and burdensome restrictions on merchant banking through private equity funds. The proposal recognizes that merchant banking investments when constituted of a less than 25 percent interest in a private equity fund should have fewer restrictions than those made directly. This is appropriate because investments made through a minority interest in a fund inherently raise fewer regulatory concerns than do direct investments.

Having recognized this distinction, however, the proposal does not go nearly far enough. Most of the restrictions that apply to direct merchant banking investments apply to investments made through minority interests in private equity funds. That is, restrictions apply not just to the financial holding company's minority investment in the private equity fund, in most cases they also look through to the fund's investment in portfolio companies.

ABASA strongly objects to these look-through restrictions. They are evidently intended to prevent the financial holding company from using a private equity fund to operate a commercial company as part of the financial holding company's business, but that will not happen because of the limits that the proposed rule already im-

poses on a financial holding company's investment in a private equity fund.

Specifically, in addition to the 25 percent limit on the financial holding company's investment, the fund may not become an operating company, must hold diversified investments, must establish a plan for the resale of investments and must not be used to make investments that evade or are inconsistent with the merchant banking statutory provisions.

With these restrictions in place, there is simply no need to have any of the proposal's restrictions look through to another fund's investments. These restrictions will needlessly deter financial holding companies from investing in private equity funds and create a real disincentive to include financial holding companies as investors in many such funds.

In conclusion, ABASA appreciates the opportunity to voice its strong objections regarding these proposals and their impact on merchant banking, an activity that we believe is of fundamental importance to the financial services industry, corporate America and consumers. We urge Congress to tell the regulators that the proposed rule as presently drafted undermines congressional intent. Thank you.

[The prepared statement of John P. Whaley can be found on page 131 in the appendix.]

Chairman BAKER. Thank you, Mr. Whaley.

Our next participant is Mr. Jeff Walker, General Partner, Chase Capital Partners, who is here today in his capacity representing the Financial Services Roundtable. Welcome, Mr. Walker.

STATEMENT OF JEFFREY WALKER, MANAGING PARTNER, CHASE CAPITAL PARTNERS, ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

Mr. WALKER. Thank you, Mr. Chairman.

Chase Capital Partners is the primary private equity investment vehicle for Chase Manhattan Corporation. We started our business—in fact, I started in 1984. We have invested in over one thousand companies, such companies as Star Media, and Geocities, and 1-800 Flowers, and La Petite Academy, a minority-oriented fund called Quetzal, which we just raised to $250 million, to focus on the minority community and the entertainment and media space. We are a global, integrated partnership with 160 professionals investing through seven offices around the world.

We have a diversified portfolio across industry and across stage of investment. We see everything and see a lot. We have been through many different cycles.

We have earned over 40 percent rates of return on our investments over the last sixteen years compounded per annum. At the same time we have been very consistent in our use of strong controls within our own organization, and we have enjoyed good relationships with the regulators over the last sixteen years.

With respect to the Gramm-Leach-Bliley bill, you can describe me as happy and frustrated; happy, because after sixteen years of working to try to get a two-way street going between ourselves and our competition, I thought we were there. We have competition of the investment banks, the foreign banks, the private partnerships,

but we still have been able to achieve in our firm 40 percent rates of return, in the overall industry excellent rates of return even with one hand tied behind our back. I am frustrated, because just as we got to the finish line, the Federal Reserve and the Treasury saw fit to add rules and regulations that put commercial bank private equity groups back again at a disadvantage. I don't think that was Congress' intent.

Fifty percent capital requirements, maximum exposure restrictions, holding period limitations and changing the rules covering investments that were booked in the past will cause banks like ours to possibly cut back our commitment to the area. We are talking about doing it already.

With a higher capital allocation and portfolio limitations, fewer dollars will be allocated to the private equity and venture capital areas by commercial banks. If we had operated under the current proposed regulations over the last sixteen years, I believe a number of the companies that our industry financed would never have received funding. Also, the commercial banks would have been significantly less profitable, because our activity has been extremely profitable for them.

We need to be careful of regulations that cause unintended negative consequences. We talked a lot recently, this panel, about capital allocation and focusing on and cherry-picking one particular area of capital. When you don't focus on how much should we allocate to credit cards, how much should we allocate to loans—we have had arguments within our own organization about are loans more risky in our portfolio than a set of private equity investments? Private equity you can make two, three, four times your money. On a loan, you can make interest rate. So what really is appropriate risk-taking? It is still something that we are all discussing in our organizations. There is no one right answer right now.

Commercial banks have led private equity and venture capital business for forty years investing through the SBICs and other vehicles, in companies all over the country. We have developed organized business investment systems and sophisticated portfolio management tools; stringent due diligence standards and synergistic networks that add value and help our portfolio companies grow to succeed. We bring more to the table than just money, and people come to us for that reason.

If the Federal Reserve and the Treasury are concerned that new entrants might use the Gramm-Leach-Bliley Act to enter the private equity business and not run their activities with the appropriate safety and soundness in mind, then I suggest that they look at the Small Business Administration. They spent the last forty years figuring out what the appropriate standards are, and we live under them. You can apply the same entrance and operating standards like the SBA does, such as evaluating backgrounds of professionals running the business, operating procedures that are currently in place and length of time in the business.

If the regulators are concerned that there might be overconcentration of private equity assets in a bank's portfolio, then I submit they are not focusing on the correct issues. Quality of the professionals running the operation and diversification of the portfolio

are more relevant to a successful private equity enterprise limiting losses, and those issues can be better addressed on a firm-by-firm basis through appropriate periodic reviews rather than using a blunt instrument of capital requirements and portfolio size limitations.

Many groups in the private equity industry, from commercial banks to investment banks to SBICs and private partnerships, are concerned about the negative consequences of these regulations. Chase and the Financial Services Roundtable have submitted letters urging the Federal Reserve and Treasury to reconsider the proposed regulations and have suggested alternatives.

Financial Venture Capital Association, of which I am a member, just submitted a letter last night to you, Mr. Chairman. It supports our views, and I would like to quote one relevant paragraph: "The association concurs with the view that regulatory actions which impose unnecessary burdens on venture capital and private equity investing are not in the best interests of the U.S. capital markets and are not consistent with the spirit, if not the letter, of Gramm-Leach-Bliley. The Association also questions the assumptions apparently underlying the joint regulatory actions, which, in its experience and that of its members, do not accurately reflect the character and risks of this investment business. We further question the need for artificial uniform limitations on the conduct of these activities. To the extent that the Board and Treasury actions are prompted by regulatory concerns about the risks associated with these investments, properly managed venture capital and private equity investment and portfolios historically have not presented excessive risks, the sort warranting the potentially drastic capital charges proposed by the Board, or potentially significant operating restrictions contained in the interim rules."

Our industry and Chase has a long track record, through many economic cycles, of successfully investing in private equity, from supporting startups of companies that are building the pipes that support the internet, like the Digital Island; companies that are analyzing the human DNA, like Genomic Solutions; companies that are one of the largest employers in Harlem, like Urban Box Office, which we have invested in. We actually helped create internet business in New York City five years ago by doing the initial startup for the incubators there.

Using this blunt sword of the proposed Federal Reserve regulations will decrease the chance that companies like these will be financed. Allow us to compete on a two-way street with the investment banks, foreign banks and private partnerships.

Thank you, Mr. Chairman.

[The prepared statement of Jeffrey Walker can be found on page 168 in the appendix.]

Chairman BAKER. Thank you, Mr. Walker.

Before I ask my first question, I perhaps should give a little background on my perspective. I have been a very strong advocate for the most bold approach under Gramm-Leach-Bliley discussions possible and feel like we moved from the 1930's to about 1986 with its passage, and I had really hoped to come back and move us to about maybe 1998 or somewhere in there.

Having said that, I have gotten the feeling from letters, and certainly testimony this morning, that we all passed Gramm-Leach-Bliley and, in transportation terms, thought we had provided resources to four-lane every two-lane bridge in America. When the regulations came down, they not only said we should not four-lane these bridges, because you know that is going to increase the amount of traffic and activity, which means more risk, but we really ought to think about taking out the two-lane bridges and get rid of the risk altogether and just build parking lots. It is very frustrating.

On the other hand, I want to be the first to acknowledge—and I made that background statement, so my question is properly understood—we have inherently opened the door to new business relationships, that there will be new entries into the market who do not have the track record of your organization, Mr. Walker, and who may be engaged in IPO startups as opposed to equity participation and business activities simply wishing to expand with a proven track record of profitability. There are varying degrees of risk that exist with these decisions.

Now, I make the assumption that financial management always goes into a question of investment with the idea that we want it to be profitable. I have not met anyone yet who says we do this to lose money, and that would be a unique way of approaching this. So if you have internal risk management tools to make the correct judgment about profitability, then you have a layer of regulatory standards which hopefully protect the public from ill-advised investments.

What value does the proposed regulation provide to that procedure?

The only conclusion I can come to at this point, after listening to everyone, is that there are, or will be if we don't have this regulation, new entries into new fields of business without a history of activity that may invest in activities we can all agree are at the outside of the risk curve.

Can't we give the regulators that and say that the current regulations are not sufficient to gauge that particular type of activity and request some alternative? For example, rather than say, "Go away," and, "This doesn't make sense," what can you recommend, Mr. Walker, to me to say to the regulators?

We recognize there are some areas of concern that perhaps current regulation would not properly constrain; or is it your view, based on your experience, that the current regulatory structure is sufficient for post-Gramm-Leach-Bliley?

Mr. Walker. I have been dealing with SBA, the Federal Reserve and OCC, and Price Waterhouse and internal auditors for sixteen years, and we go through extensive analysis of our systems, our support, our evaluation procedures, our portfolio management tools, the backgrounds of all of our professionals; and I suggest that those standards are very high and should stay high.

And I think they should, as I said a little earlier on the new entrants, maybe adopt some of the Small Business Administration's guidelines and standards which are pretty good; maybe add a few more if they would like to make sure that those entering the busi-

ness have the qualifications so that they can make reasonable financial investment decisions.

Chairman BAKER. Let me put a finer point. As profitability gets pressure and a bank that is not of the sophistication of your shop, a regional or smaller institution, I think the view of the regulators is not that a particular bank creates a holding company that enables them to facilitate investments that don't work, but on a broad economic basis there are lots of people entering into this activity who don't have the internal risk management tools and are being pressured to do so as interest rate returns narrow. So they are going to look for new fields of business. With the old savings and loan problem, you had to find ways to get that rate of return up, and so there were a lot of things going on with deposits in the 1980's.

That is the focus. They don't want to open the doors to unbridled investment opportunity and find themselves with a lot of folks doing a whole variety of things that they have no experience in conducting.

Is there any legitimacy to that concern?

Mr. WALKER. Absolutely. The SBA has turned down people who were not qualified.

Chairman BAKER. Is there any response to the rule—and I fully understand the market's perspective on this rule, but what can we tell the regulators that is responsive to their concerns; or is it ill advised?

Mr. LACKRITZ. One approach is that the Fed has ample supervisory authority over financial holding companies. From that standpoint, it does have the power on a case-by-case basis to deal with these kinds of situations. I think that is one very important power that they should use, because it is more flexible than a blunt instrument of a regulation that, as you said, Mr. Chairman, there are varying degrees of risk so why should everything have a 50 percent capital haircut.

The second issue is the firms. Generally speaking, financial services are developing—as Mr. Walker and Mr. Whaley said—internal risk management models now. The right way to go is to have the regulators relying on the internal risk management models that the firms are developing with the regulators' role being assuring themselves that the models are appropriate models and that they work right.

The problem, according to the regulators, is that we are not far enough along in terms of implementing those, and new firms that come in may not have the capacity to set up the sophisticated risk management models. The firms that have that in place, that is a good way to go.

Chairman BAKER. Does anybody else want to make a comment?

Mr. MERCER. Just to concur and maybe expand a little bit, certainly they have the authority to go into any bank and apply a different capital requirement depending on the qualifications of those managing the activity, according to the type of subset of merchant banking activity that that particular bank is going to be involved in, and certainly by adopting, as Mr. Walker suggests, some of perhaps the SBA's criteria in doing some of that examination.

I think one of the risks involved in an arbitrary allocation of 50 percent is to give comfort, if you will: I have allocated 50 percent, therefore, I am safe. I mean, that is the worst kind of comfort that one should take from being involved in this activity.

I am sure neither Mr. Whaley nor Mr. Walker would say, just because we have 50 percent capital, we are safe and we don't have to have diversified portfolios, we can take it to Atlantic City and let it ride on double zero. That is not going to happen, but that is the risk you get if one becomes convinced that 50 percent equals safety.

Chairman BAKER. Mr. Alford.

Mr. ALFORD. I think Governor Meyer's concern about the leverage of 25-to-1 certainly deserves debate and concern, but, 2-to-1 is a bit extreme.

Mr. WHALEY. I echo Jeff's comments that we have dealt with the regulators for many years at Norwest and have done so very effectively; and that I think to have the Fed oversee this activity as a continuation of what has been done in the past would make some sense.

I just also add that we have been a very significant contributor to Wells Fargo's profits, and we really are operating under a 6 percent capital allocation as Wells Fargo does it. So I think there has been a lot of discussion about risk, and I would tell you that a single investment in a single early stage company has a lot of risk, but history has shown that a professionally-managed portfolio of investments over time dramatically decreases that risk and that you can look at the financial results that have come out of the bank-affiliated venture firms and you can see that it is, I think, overblown in terms of concern.

Chairman BAKER. My experience on new ventures is that you get the loan if you don't need it; otherwise, it is tough to find.

Mr. Kanjorski.

Mr. KANJORSKI. I am sort of awed by your testimony, Mr. Whaley, and by Mr. Walker's testimony. Did you assume when we passed the Financial Services Modernization Act that nothing would change in terms of the requirements? You seem so surprised. As a legislator, when I supported the Act, I realized that we were changing the playing field, but we were going to rely on Treasury and the Federal Reserve to redefine the requirements so that safety and soundness would be protected. Do you not think that was the intent of Congress?

Mr. WALKER. I can't read into the intent of Congress. What I was hoping for was that we would be given a level playing field and put on the exact same competitive level with investment banks and foreign banks and our potential merger partners, so they would be motivated to combine with us. And we were still operating on a fairly sound and safe basis. So we would not change the way we operated our business, which was safe and sound, and we continue that process.

Mr. KANJORSKI. I accept that. With a 40 percent return over sixteen years per annum, I am jealous.

Did you do an analysis of what your profit actually would have been over the sixteen-year period if, instead of having an 8 percent

reserve, you had a 50 percent reserve? I think you would only have had a 37 percent profit.

Mr. WALKER. We actually report our number assuming 100 percent capital, so that 40 percent is just the return on our gross investment number. So if you leveraged it, it was a much higher rate of return, actually.

Mr. KANJORSKI. You had a higher return than 40 percent?

Mr. WALKER. Yes.

Mr. KANJORSKI. If you were required to put a 50 percent reserve to the 40 percent, the best quick calculation I can make is that you only would have had a 37 percent return per annum. Is that about correct?

Mr. WALKER. I am not sure that calculation——

Mr. KANJORSKI. Well, what would it cost you? If you had to put a 50 percent reserve instead of 8 percent on the leveraged side of the bank's money that was invested, it must be a very small fraction.

Mr. WALKER. If we financed our deals with 100 cents on the dollar capital, we are at a 40 percent rate of return. If it was 50 cents of capital and 50 cents of debt, we would actually earn a higher rate of return; so it would be a 50 or 60 percent. Leverage would help the return.

Mr. KANJORSKI. So with the rule that they are propounding, you would have made 60 percent return?

Mr. WALKER. If on the number that I talked to you about, absolutely. If you evaluate it.

Mr. KANJORSKI. Why 60 percent instead of 40 percent?

Mr. WALKER. I don't think that is the appropriate analysis. I think the analysis is, what amount of capital should the Federal Reserve and the Treasury deem appropriate for Chase.

Mr. KANJORSKI. They are deeming 50 percent reserve for the safety and soundness protection. If, in fact, you are so successful that they required that instead of making a 40 percent return, you make a 60 percent return, I can not understand why you are arguing against it.

Mr. WALKER. Because our business is stand-alone, that is my point. You can't evaluate our business stand-alone if we are part of Chase. The Fed ought to look at Chase's capital needs and how much capital they should have in their 150 different businesses and then analyze that for risk.

In our business, we have to pay taxes. I am quoting a pretax number.

Mr. KANJORSKI. Do you think that the Federal Reserve is sophisticated enough at this period of time to have a model established to really test what you are talking about? Can't test what Chase is doing and what all of these new banks are doing under this Act?

If they have to make a judgment of reserve in the nature of a rule, should they not make it on the conservative side rather than making the mistake of not requiring a sufficient amount of reserve? Then you have some companies that are not as successful or do not have the track record that you have. They are going to get in there and see this opportunity as a potential bonanza, and we are going to drive an extraordinary amount of venture capital that is going

into less sophisticated investments, because of the mass amount that is out there. Will they not eventually get a risk?

Mr. WALKER. My personal opinion is that the Federal Reserve ought to focus, instead of on the micro aspects of managing a bank, on safety and soundness for the financial institutions that are out there; and each bank ought to come up with their own internal capital allocation mechanism across all of its 150 businesses to appropriately manage itself. I don't think that the Fed understands our businesses and the 150 other businesses well enough to tell us how to allocate capital, because we are not sure that we do, either.

Mr. KANJORSKI. Then nobody should tell you. Are you arguing for an unregulated system?

Mr. WALKER. No, I think they should regulate us as a bank and as an overall holding company and not micromanage our business.

Mr. KANJORSKI. What is your solution to their proposal?

Mr. WALKER. I think they ought to eliminate a capital test for a specific business, and I would argue not just for our business, but any business within the institution; and I think they should not have a cap on how much we should be able to put in that business. I think they should watch the safety and soundness of the overall institution.

Chairman BAKER. After there is a failure, then they should come in?

Mr. WALKER. No. Every day they should come in and evaluate how good our management systems are, how good our controls are, what kinds of loss rates we have had.

Mr. KANJORSKI. Would your bank or any of your companies invest in Long-Term Capital Management?

Mr. LACKRITZ. We were.

Mr. KANJORSKI. Nobody there had a billion dollar exposure?

Mr. LACKRITZ. A number of our firms were invested.

Mr. WALKER. But none of your firms, Mr. Walker?

Mr. WALKER. I am not sure. We may have had a loan outstanding to them, but it is not my area, so I don't know.

Mr. KANJORSKI. There was a terribly sophisticated group of guys and tremendous models. It seemed almost like there was no possibility of failure, and yet a series of circumstances happened at a precise moment in time to produce a collapse without some form of rescue going in.

Isn't your testimony reasoning that if they do not pay attention and they do it prospectively, if your management team dissipates, or if something happens then they will come in and allocate some safety and soundness standard? Is your testimony opposed to presuming that if they are too conservative—I listened to all of the testimony today, and let me exclude some—you probably were not in the room. I have a particular interest in the public policy of SBICs, and I think they are no risk to the system for safety and soundness. To exempt them is not a problem.

On the other hand, I do not believe that everybody is the same. I would like to develop a system where there is a weighted value depending on performance. That however, is something that has to happen prospectively. They now have to start a standard. The testimony was that they are grandfathering existing transactions. So they are not going to get into that. It is the future transactions

that are going to be under the regulation. We can check that if that is not the case.

Mr. WHALEY. That is not my understanding of the law.

Mr. KANJORSKI. I think that is what the Governor testified to.

Mr. WHALEY. The capital requirements are going to apply to all of the old existing transactions.

Mr. KANJORSKI. That is a good point. Let us examine it. But the testimony that I heard from several of you, particularly in the financial investment field, is almost the hue and cry I would have expected to hear from the brokers and speculators in 1930 and 1931 when the securities were going to implement limitations on margin lending. "Now you are going to restrict our market. Now we will not be able to buy."

Certainly the brokers would have been screaming, and in reality it seems to me that we have tried to open up the competitive field with full knowledge that there may be some risk to safety and soundness if not properly regulated. I concede that none of us have the expertise to provide that management or regulation now. It does fall to the Federal Reserve and Treasury, and they are struggling with how to do it.

I would hope that more of your comments could be directed to what you suggest they can do, defending that proposition, as opposed to attacking what they have done and leaving it at that. Ultimately, we must have a regulation. Maybe you can help, and I am sure that you have put in your comments and suggestions to accomplish that objective.

I have the impression from your testimony that you thought we passed the Act, and all prior conditions were going to exist. I would say that would be a bonanza for some people and a catastrophe for others, and I think that is where the Federal Reserve and Treasury have a problem. They have to balance out these equities, and I think balance is the intent of Congress, but let us do it intelligently and smartly.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman.

I did hear Mr. Walker mention several companies in New York which have been high-growth, important companies in the district that I represent. I join my colleague, Mr. Kanjorski, in viewing oversight of the safety and soundness of the banking system as my primary responsibility as a Member of this subcommittee, but it seems that some of the rules, as drafted, appear to really overstep the authority granted by the regulators in the financial modernization legislation.

In reading the regulators' testimony, they contend that their 50 percent capital charge for merchant banking activities is reflective of current industry practices, and I would like to ask is that true? Is that the current industry standard?

Mr. LACKRITZ. It is not. I mean, it is reflective of the survey that they may have done in terms of averaging, doing an arithmetic average of what people's internal capital charges were; but it is distortive, because they are proposing a single capital standard of 50 percent across the board, and second, they have taken out one part of an internal risk management model, one asset that is part of an

internal risk management model, and pulled out that element without taking into account lower capital charges on other assets in that model and without putting all of the other characteristics of the model in.

So instead of using a fairly sophisticated and risk-sensitive model, they have adopted an across-the-board 50 percent number, which is arbitrary, and it doesn't reflect the industry best practices at all.

Mrs. MALONEY. Anyone else?

Mr. WHALEY. Wells Fargo has been in the venture capital merchant banking business for forty years, and our capital assessment, if you will, is really 6 percent. It is what it is across the board in all Wells Fargo businesses, and we are no different. And so we are operating with a 6 percent capital.

Mr. WALKER. It is a variety, up and down. The key is, now they are going to talk about loans, and is it 3 or 4 percent or 20 percent; and then we have to go to credit cards, and what are they. You can't look at each business on a stand-alone basis and allocate capital. You have to put it together in a portfolio.

Mrs. MALONEY. What will be the impact of this requirement on the investment in SBICs?

Mr. MERCER. I am Lee Mercer, appearing for the National Association of SBICs.

Logically, you would expect it to have a negative impact. To the extent that you increase the capital charge for any activity, you either have to pull back from the activity or increase your capital. So, logically, you expect for those institutions that can't increase their capital, they are going to have to pull back.

Also, as I indicated, I think the potential is there for it to negatively impact SBICs, because what you will have is a capital charge equal to that for Gramm-Leach-Bliley activities, which are going to be less regulated, if you will, or appear to be less regulated, than the SBIC program.

So if I were in charge of a bank and I were allocating my capital, I would allocate it to the activity that had the greater potential for gain and the least amount of regulation and restrictions associated with it. And that would be a Gramm-Leach-Bliley activity rather than an SBIC activity.

Mrs. MALONEY. Yes, sir.

Mr. ALFORD. That certainly would decrease the amount of capital access or opportunity amongst urban communities. There is a saying that minority businesses have and that is, "Every time I learn how to play this game, they change the rules." That is applying here.

Mrs. MALONEY. I do note that the SBA management contends they are not aware of any failures of bank-owned SBICs in the last ten years.

I would also like to ask, following up on Mr. Mercer's comments, could this encourage FHCs to actually invest in riskier enterprises in order to make a return, because of the high capital requirement? Would it have that effect, do you think?

Mr. MERCER. I would probably defer to the folks from the banks, Mr. Whaley or Mr. Walker.

Mrs. MALONEY. OK.

Mr. MERCER. I would certainly agree with the logic.

Mrs. MALONEY. Could it possibly result——

Mr. WALKER. It is unlikely to motivate a higher risk orientation. It will have the corporate capital allocation reduced for the entire private equity business. We evaluate our investments and will still make good investments.

Mrs. MALONEY. But would be there be an incentive to invest in riskier businesses?

Mr. WALKER. No, we would have less capital allocated to us by the bank, by the institution.

Mrs. MALONEY. One of the areas that concerns me tremendously is the whole new technology in e-commerce. I am just coming from a Joint Economic Committee where that was the focus of the hearing, and I also represent an area called "Silicon Alley," and I note that Mr. Walker mentioned in his statement earlier that he had invested in this area. It has been the highest job growth area in recent history in New York City. The City attributes over 200 thousand jobs to this area; it is just unbelievably large.

What concerns do you have about this particular merchant bank proposal on these high tech and e-commerce ventures?

I might note that the Banking Committee and Congress have encouraged the Federal Reserve and other banking regulatory agencies to take steps to assure that financial institutions are authorized to engage in a wide range of high tech and e-commerce activities that are just really changing dramatically, probably as we speak during this hearing, they are changing so quickly. So I do have concerns about what impact this proposal would have on these high tech and e-commerce ventures, and I would invite anyone to comment.

Mr. WHALEY. Well, it is hard to know what the impact would be, but Norwest Venture Partners is headquartered in Palo Alto and is involved in financing the new economy.

Will dollars be apportioned elsewhere and not to Norwest Venture Partners? It is hard to know. When we go back to Wells Fargo and tell them that they have to charge eight times the amount of capital to fund our activities, they will scratch their heads and say "Maybe your funding should be less robust than it is." That could be an outcome.

Would we decide to get out of the business entirely because of this? I don't think that would be the case, because it clearly—there is nothing here that encourages us to do more.

We thought that this legislation was going to open the gates and let us compete without one arm tied behind our backs, and it has done the opposite. We are now deciding how much should be cut back, how much can we afford, whether we have to make riskier investments. It has had a completely unintended result.

Mr. WALKER. We started up a company five years ago called Flatiron Partners, and it does internet investing in Silicon Alley, and it created Silicon Alley and StarMedia and Kosmo and Geocities and a whole variety of others; and we moved businesses into New York, and we set up Urban Box Office, which is an internet site, one of our largest employers in Harlem. It is bringing jobs back to New York City, and it has made New York alive again.

You can do that time and time again. What this will do is take away commitment to assets in all categories that we have been investing in across the board.

Mrs. MALONEY. Finally, I would like to question an area that is tremendously important in New York City, and that is minority lending. It was touched on earlier, but would anyone like to elaborate on what this capital requirement would have on minority lending, if it would have any?

Mr. ALFORD. I think it would be devastating, ma'am.

SBICs probably have been the sole source of any successful black-owned business, the most being Beatrice International. That was an SBIC loan, as well as Microsoft and FedEx.

But I see where the withdrawal of the activities occurs, African-American businesses only do 1 percent of the sales of this country today. Hispanic maybe 2.5 percent. Those numbers are not going to increase because of this, certainly; we may be obliterated. I really have a fear, and I don't think I am being hysterical about it at all.

Mrs. MALONEY. Earlier, in response to my question, you said this was not the practice that is out there now, and one of the goals of banking modernization was to level the playing field.

And what is the impact on that aspect, if any?

Mr. ALFORD. It doesn't level it at all. I see the APEX as being an answer to upstart businesses, small businesses. These SBICs will take the successful business owner, the one who may be doing $5 million a year in sales, could take him to the realm of $20-$25 million a year in sales, but I see this limiting at that $5 million level and making that company vulnerable to larger companies who may compete with larger businesses.

Mr. WHALEY. The bill, I think, does level the playing field. It is a huge step forward. It is something that we have worked for for sixteen years. Unfortunately, these proposed regulations completely neutered the bill.

Chairman BAKER. Thank you, Mrs. Maloney.

To the panelists, I appreciate your participation here today. As you may have noted when the regulator panel concluded, I requested another opportunity for the subcommittee to interact with the regulators before the final rule is promulgated. In that regard, I would ask each of you and any interested party who has specific recommendations that they would like for us to consider to submit them, perhaps by way of letter to the regulator or other means. I would certainly welcome them, as I am sure other Members of the subcommittee would welcome them.

Clearly, there is universal agreement as to the adverse consequences on SBIC lending and to other, shall I call it "social centers of interest" by the subcommittee. I think there is significant interest among most Members that the effect of Gramm-Leach-Bliley not be stopped or, worse, reversed. And to the extent that I can get Member participation to communicate those views, I certainly would make the effort to do so.

I think the hearing has been most informative and helpful, and I do believe the regulators are having a work-in-progress; I don't believe that they have concluded and reached any final decisions, and so the window of opportunity that we have available to us is

very critical if we are going to gain the benefits that all of us hoped that we gained with the passage of this important act.

I thank you for your participation and our hearing is adjourned.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

APPENDIX

June 7, 2000

CURRENCY

Subcommittee on Capital Markets, Securities and Government Sponsore Enterprises

Richard H. Baker, Chairman

For Immediate Release:
Wednesday, June 7, 2000

Contact: Pat Cave (20
or Brookly McLaughlin (20

Opening Statement
Chairman Richard H. Baker
Hearing on Capital Markets in the New Economy

The Committee meets today to discuss merchant banking, venture capital and private equity in the wake of the Gramm-Leach-Bliley Act. Specifically, I hope to shed some light on the interim and proposed final rules on financial holding company merchant banking activity issued by the Federal Reserve and the Treasury.

As the banking agencies continue to promulgate various regulations required by the Gramm-Leach-Bliley Act it is important we review the potential affects various proposals may have on capital markets.

Gramm-Leach-Bliley paved the way for a two-way-street whereby banks and securities firms could conduct activities in each others respective fields in the pursuit of fair competition in the financial services industry. The framework from which financial institutions are allowed to conduct merchant banking holds great implications for private equity and venture capital investing as well as the future balance between commerce and banking that the Gramm-Leach-Bliley Act sought to protect.

As the Fed and Treasury assess the public comments they've collected on their proposals, I look forward to hearing what industry and consumer concerns have been raised and what compensations are being considered in the proposed rules.

These provisions hold far-reaching affects for financial services and the capital markets. The import and consequences of these rules should not be underestimated and I hope this forum will facilitate the serious discussion that needs to take place before these rules are finalized.

We will hear from Federal Reserve Board Governor Laurence Meyer and Treasury Undersecretary Gary Gensler followed by a second panel of representatives from the finance and business industries. I look forward to the testimony.

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FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

DONNA TANOUE
CHAIRMAN

May 22, 2000

Honorable Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Chairman Greenspan:

The Federal Deposit Insurance Corporation is writing to express its views regarding one aspect of the merchant banking capital proposal issued by the Board of Governors of the Federal Reserve System. In particular, the proposal would significantly increase the amount of capital a bank holding company must hold for certain activities conducted by the bank holding company's state bank subsidiaries. The proposed rule imposes a new capital charge on equity investments made in accordance with section 24 of the Federal Deposit Insurance Act in any company or subsidiary which engages in activities other than the kinds of financial activities permissible for a financial holding company. The proposed rule would cover not only future equity investments, but also immediately impact numerous past equity investments made by state nonmember banks under section 24.[1] The FDIC is concerned that the section 24 aspect of the FRB's capital rule imposes unnecessary burden on banking organizations without achieving any additional measure of protection for the Bank Insurance Fund. With regard to the section 24 aspect of the proposed rule, we believe that the concerns which the FRB has articulated in support of the rule are already fully addressed by existing procedures. Thus, we strongly recommend that section 24 investments and activities should not fall within the scope of the proposed rule.

Congress, in enacting section 24, assigned the FDIC the role of deciding whether the nonfinancial activities of a state bank and its subsidiaries present a significant risk to the deposit insurance fund, and Congress expressly reaffirmed this role by enacting section 46(d) of the Federal Deposit Insurance Act as part of the Gramm-Leach-Bliley

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[1] The language of the proposed rule would cover approximately 50 banking organizations in which the FDIC has issued section 24(d) approvals for state banks to conduct limited real estate investment activities through a subsidiary, as well as approximately 150 banking organizations in which state nonmember banks hold listed equity securities and registered mutual fund shares pursuant to the grandfather provisions of section 24(f).

Act of 1999 (GLBA). In contrast, Congress' reiteration in section 114 of GLBA of the FRB's prudential authority with respect to the depository institutions subsidiaries of bank holding companies expressly excludes subsidiaries of such depository institutions. As a result of Congress' mandate to the FDIC under section 24, any state bank investment or subsidiary that would be subject to the section 24 aspects of your capital proposal has already been subject to rigorous risk analysis by the FDIC.[2] If it is appropriate for the bank to hold additional capital in order to ameliorate any risks of such activity, the FDIC imposes conditions and restrictions requiring the bank to do so as part of the section 24 approval process.

The FRB's main justification for its proposed rule is to limit the potential harm to bank holding companies and their depository institution subsidiaries which could arise from merchant banking and other investment activities. However, the FDIC's section 24 review process has already addressed these concerns with respect to investments covered by the section 24 aspect of the FRB's proposed rule. The FDIC imposes increased capital requirements as necessary to protect the state bank and the Bank Insurance Fund. Moreover, because of the increased capital requirements, the bank subsidiary is less leveraged than it otherwise would be without the capital charge and the holding company's overall financial position is strengthened in view of this additional capital cushion. There may be supervisory concern over whether this additional capital cushion is being used, in essence, to unduly support other, more highly leveraged operations in nonbank affiliates or in the holding company itself. However, many bank holding companies which would be subject to the section 24 aspect of the proposed rule have no appreciable nonbank operations. Even for those bank holding companies which do have appreciable nonbank operations, the solution to concerns over whether such nonbank operations are sufficiently capitalized would more logically focus on these nonbank operations themselves, rather than on the activities engaged in by appropriately capitalized banking operations and their FDIC-approved section 24 subsidiaries.

The FRB's main justification for extending the proposed capital charge beyond financial holding company merchant banking investments under section 4(k)(4)(H) of the Bank Holding Company Act to encompass section 24 investments in nonfinancial companies is that the risk of the investments does not vary according to the authority under which it is conducted. Again, it is not necessary to encompass section 24 investments within the scope of the FRB's rule because the FDIC will impose appropriate capital requirements in connection with its section 24 analysis, and the benefits of such an additional capital cushion strengthen the holding company's financial position. Also, we strongly suggest the FRB's review of the risks incurred by an interview group of firms engaged in the venture capital investment business is unlikely to translate into an accurate capital charge for the different activities which the FDIC analyzes on an activity-specific basis under section 24.

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[2] As you know, Congress, in adopting section 24, also elected to grandfather the ability of certain state banks to invest in listed stocks and registered mutual funds (as well as certain investments in insurance companies). To date, it has been the FDIC's experience that the investment policies pursued by these banks have not presented safety and soundness concerns.

The FDIC supports the FRB's aim to impose whatever safeguards are appropriate to ensure the depository institution subsidiaries of financial holding companies and the deposit insurance funds are not subjected to risks arising from the banking organization's nonbank operations. However, because the section 24 aspect of the FRB's proposed capital rule would be redundant in light of the FDIC's review under section 24, this aspect of the FRB's proposed rule would stand only as unnecessary regulatory burden on the banking organization. The FDIC therefore urges the FRB to eliminate the section 24 aspect from the scope of the FRB's final rule.

Sincerely,

Donna Tanoue
Chairman

National Venture Capital Association

June 6, 2000

The Hon. Richard H. Baker
Chairman
Subcommittee on Capital Markets, Securities and GSEs
Committee on Banking and Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Capital Markets Hearing on the New Economy, June 7, 2000

Dear Mr. Chairman:

At the invitation of the subcommittee, I am pleased to submit this letter on behalf of the National Venture Capital Association (the "Association") expressing the Association's interest in your Subcommittee's hearing on June 7 pertaining to merchant banking, venture capital and private equity investment in the wake of the Gramm-Leach-Bliley Act, including the interim and proposed merchant banking regulations of the Board of Governors of the Federal Reserve System ("Board") and the Department of the Treasury ("Treasury").

The Association represents more than 380 venture capital and private equity firms. Its mission is to foster the understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, and to provide research data and professional development for its members. Association member firms provide the start-up and development funding for many companies that go public. This kind of funding is a major factor promoting innovation and entrepreneurial businesses. In 1999, venture capital funds invested nearly $50 billion in 3,638 companies; 85% of these companies were in information technology, medical/health or life sciences. In just the first quarter of 2000, $22.7 billion in venture capital has gone to 1,557 companies.

Not all venture-backed companies succeed and fewer still become publicly traded. However, some companies that received venture capital support are now household names. Once funded and nurtured through their early stages, these companies have provided once-in-a-lifetime investment opportunities for individual investors, pension funds, charitable foundations and the investing public at large. Moreover, the engine of economic growth has received tremendous benefits from the willingness of venture capital investors to place long-range investments in early-stage enterprises. The success of venture investing is encouraging greater capital flow to these investments. Capital commitments to venture funds grew from $27.7 billion in 1998 to $46.1 billion in 1999. Venture capital firms now have an estimated $135 billion under management, up from $30 billion in 1990.

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The Association has long taken the position that free access to investor capital is an essential element of successful and beneficial venture capital and private equity markets. Congress, in considering the legislation, which ultimately became Gramm-Leach-Bliley, acknowledged the "essential role" of such investment activities in modern finance. *See, e.g.*, Conf. Rep. to Accompany S.900/H.R.10 (Nov.1, 1999). The Association believes that, by allowing the participation of strong banking organizations in the making of equity investments in promising venture capital companies, the enactment of the merchant banking authority in Gramm-Leach-Bliley is an important development in the promotion of capital formation in the United States. Open access to investor capital has been and continues to be a primary need of venture capital enterprises; the expansion of the qualified investor pool to include banking organizations will help ensure the steady availability of new capital to worthy business enterprises, including small businesses.

Past experience in the financial services industry has demonstrated that, with few exceptions, financial organizations engaged in the business of making venture capital and similar investments have done so in a prudent and disciplined manner, properly taking into account the risk posture of individual investments and implementing appropriate review and monitoring procedures for their investment portfolios. Although banking organization participation in the private equity and venture capital markets has been limited by existing financial institutions laws, the banking industry's record in making these investments, where and to the extent allowed, consistently has exhibited a solid combination of responsible investing and highly favorable returns. Other enterprises, such as investment banks and insurance companies, which have not been so limited in the making of these investments similarly have shown a positive track record of performance in their investment activities.

By its nature, venture capital and private equity investing is a highly fluid and diversified business, where investors need adequate flexibility to respond to internal organizational needs, changing economic and market conditions, and the evolving needs of portfolio companies. Gramm-Leach-Bliley, in the Association's view, appropriately recognizes the dynamic character and needs of this business by permitting substantial banking organization flexibility in the making of these investments, subject to compliance with several basic organizational, financial and operational preconditions.

It is against this backdrop that the Board and Treasury recently have adopted interim merchant banking rules, and have proposed new regulatory capital requirements for newly-authorized merchant banking activities as well as nonfinancial investment activities authorized under previously-existing law. These regulatory actions have been strongly criticized by the banking industry, which has raised a number of concerns over the competitive and financial impact of these actions. The Association did not submit comments on the Board/Treasury rules and rule proposals during the initial public comment period, and up to now has not publicly commented on these actions. It believes, however, that the comments of banking industry representatives and trade groups raise important issues of regulatory and financial markets policy which, the Association hopes, the Board and Treasury will carefully consider.

Without commenting on the specific features of the Board/Treasury rules and rule proposals, which have been ably addressed by others, the Association concurs with the view that regulatory actions which impose unnecessary burdens on venture capital and private equity investing are not in the best interests of the U.S. capital markets and are not consistent with the spirit, if not the letter, of Gramm-Leach-Bliley. The Association also questions the assumptions apparently underlying the joint regulatory actions, which in its experience and that of its

members do not accurately reflect the character and risks of this investment business. We further question the need for artificial uniform limitations on the conduct of these activities.

To the extent that the Board/Treasury actions are prompted by regulatory concerns about the risks associated with these investments, properly-managed venture capital and private equity investments and portfolios historically have not presented excessive risks of the sort warranting the potentially drastic capital charges of the sort proposed by the Board, or the potentially significant operating restrictions contained in the joint interim rules (*e.g.*, maximum aggregate investment limits, maximum holding periods for investments, and the like). Investing organizations are highly cognizant of possible risks, and many have established internal capital charges to ensure the adequacy of financial support for these investments. Internal capital models, however, vary widely according to type of investment, character of the investing organization, portfolio objectives and composition, and similar factors, and any efforts to prescribe uniform capital charges for these types of investments likely will increase substantially the costs and burdens associated with these investments. Similarly, the imposition of artificial operational restrictions of the sort found in the joint interim rules may interfere substantially with the essential need of investors for flexibility in the making of qualifying investments and the management of their investment portfolios. Again, responsible organizations customarily have adopted extensive policies and procedures governing their venture capital and private equity investments in the interests of ensuring that the risks associated with such activities are properly identified and managed. These policies and procedures, however, can vary widely among organizations, making it difficult if not impossible to create uniform operational requirements, which are not unnecessarily burdensome and therefore disruptive of open capital formation.

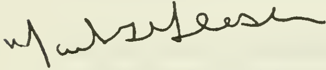
The Association does not take issue with the strong and legitimate interests of the Board and other financial regulatory authorities in ensuring that merchant banking activities are conducted in a safe and sound manner, and do not threaten the stability of individual banking organizations or the banking system in general. At the same time, Gramm-Leach-Bliley itself imposes a number of important prudential conditions on the exercise of merchant banking authority, not the least of which is limiting this authority to well-capitalized and well-managed banking organizations, and prohibiting (at least for five years) depository institutions from engaging in such activities. Further, the Board and other regulatory authorities have ample supervisory authority to address, at an early stage, any investment activities which present excessive risks, either at the institution-specific or systemic level, thus reducing the need for "before the fact" significant capital and operational requirements.

The Association submits that a less intrusive approach to the supervision of merchant banking activities by banking organizations under Gramm-Leach-Bliley, as contrasted with the current attempt to regulate these activities through the imposition of across-the-board capital and operational requirements, may be to require that banking organizations adopt and enforce comprehensive and rigorous investment policies and procedures which are satisfactory in form and content to the Board. In turn, the Board and other regulatory authorities could closely supervise and monitor these activities for compliance with these internally-created policies and general safety and soundness principles. Where the Board, during the course of its supervisory activities, determines that a banking organization is not conducting its merchant banking activities safely and soundly, it has ample authority to take effective and tailored corrective action, such as requiring divestiture of unsound investments, requiring additional capital, requiring changes in organization policies, and other remedial measures. In this fashion, the Association believes, the supervisory interests of the Board and other regulatory authorities can

be met without compromising the flexibility and innovation, which has characterized the venture capital and private equity businesses.

We thank you for the opportunity to express the Association's views, and consent to the placement of this letter on the public record of the Subcommittee's hearings. Please do not hesitate to contact me at (703) 524-2549 if you have questions or desire additional information.

Very truly yours,



President
National Venture Capital Association

Rep. Stephanie Tubbs Jones (D-OH)
Capital Markets & New Markets

Good Morning, Chairman Baker, Ranking Member Kanjorski and Members of this Committee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

I wish to open my remarks by thanking the Chairman for putting forth an aggressive subcommittee agenda. I want to formally recognize both Chairman Baker and Mr. Kanjorski for their diligent efforts and outstanding leadership of this subcommittee.

We must, however, as a committee, continue our work to better ensure sound capital markets. With respect to merchant banking, in the aftermath of Gramm Leach Bliley, the question of what regulatory and organizational approach to bank engagement in activities such as merchant banking is important. There are inherent regulatory consequences, control and safety and soundness issues.

The issue of where bank involvement should be has come to us with mixed messages. On one hand, previously Chairman Greenspan noted that bank involvement in nonbanking activities such as merchant banking should take place in bank holding companies. Conversely, Treasury's response was that national banks should be allowed to conduct nonbanking activities in operating subsidiaries.

As a committee, we have dealt with many banking and financial services concerns dealing with innovation, investment and degrees of certainty. Here again, there should be a greater degree of certainty with respect to laws, regulations and rules. In our complex financial system, shades of gray, or legal or regulatory uncertainty, are major disincentives to investment and makes risk balancing more difficult.

We cannot take this work lightly. Merchant banking, which ranges from venture capital to buyout funds, raised a record-setting $85.3 billion in 1998. There other hybrid forms of merchant banking as well. These include Mezzanine Funds as well as Small Business Investment Companies (SBICs). Thus, their ability to strive and grow have profound impacts on our banking and financial services system.

I hope this hearing today will provide us with clearer perspective into merchant banking and its operations. Moreover, I hope this hearing will provide us with the necessary information to work through the specific issues and regulatory challenges, i.e., fifty percent capital charge, aggregate investment limits as well as the restrictions imposed on the ability of Financial Holding Companies (FHCs) to invest in and manage private equity funds.

Thank you again, Mr. Chairman, for bringing this hearing forward on merchant banking, venture capital and private equity to this committee.

PAUL E. KANJORSKI
11TH DISTRICT, PENNSYLVANIA

COMMITTEE ON BANKING AND FINANCIAL SERVICES

RANKING MEMBER
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON GOVERNMENT REFORM

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OPENING STATEMENT OF
RANKING MEMBER PAUL E. KANJORSKI

SUBCOMMITEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON CAPITAL MARKETS AND THE NEW ECONOMY

WEDNESDAY, JUNE 7, 2000

Mr. Chairman, thank you for the opportunity to speak before we begin today's informational hearing on capital markets and the new economy. We have a distinguished group of witnesses with us, so I will keep my remarks brief.

During last year's debate over the financial services 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 produced economic disorder in their banking system in the 1990s. Ultimately, Congress learned from these experiences and we enacted legislation that maintains these firewalls and prevents the indiscriminate mixing of banking and commerce.

A closely-related issue that we examined in last year's 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 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, the Federal Reserve and the Treasury Department issued interim and proposed regulations to implement the merchant banking provisions of the modernization act. These proposals have generated considerable debate among affected parties and in the press. Of particular concern to me — as well as to many of my Democratic colleagues — is 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 have arisen that provisions contained in the merchant banking rulemaking, such as the 50 percent capital charge on all equity investments, will constrict the availability of financial resources for small businesses. It is appropriate for us to examine this issue today. It is also important for our 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.

THIS STATIONERY PRINTED ON PAPER MADE WITH RECYCLED FIBERS

Although it is constructive for us to hold this hearing today in order to examine more closely the merchant banking rulemaking and gather information about the views of the interested parties about the proposals, we should not neglect our Committee's efforts to ensure that all communities have access to our burgeoning capital markets. Today's hearing is about capital markets in the new economy. One means by which we can ensure that our underserved and distressed communities have access to capital markets for economic development purposes is for the U.S. House of Representatives to pass the Clinton Administration's New Markets Initiative in the upcoming weeks.

Shortly before we began our break for Memorial Day, I joined President Clinton, Speaker Hastert, and Ranking Member LaFalce at the White House to announce a bipartisan compromise agreement on legislation that would enact the best elements of the New Markets Initiative and the Renewable Communities proposal. Thanks to the efforts of Chairman Leach, our Committee has already marked up and favorably reported the America's Private Investment Companies Act, one piece of the New Markets Initiative. Additionally, the Committee on Small Business has completed action on its portions of the New Markets Initiative designed to promote lending to small businesses in low- and moderate-income communities. In the next week, the Committee on Ways and Means is expected to also finish its work on creating tax credits for these investments. I am, therefore, hopeful that we can pass this bipartisan compromise in the House and send it to the Senate before the end of June.

In closing, Mr. Chairman, I look forward to learning more from our panelists today about the complex public policy issues related to merchant banking. I also look forward to working with you and others during the forthcoming debate on the New Markets Initiative on the House floor.

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT- SPONSORED ENTERPRISES
Statement of John J. LaFalce
Ranking Member
Committee on Banking and Financial Services
Hearing on the New Economy
June 7, 2000

We are today to examine the role of the capital markets in fostering growth in the new economy. It is appropriate that the central point of today's hearing will be the impact of the merchant banking regulations that have been proposed and partially implemented by the Treasury and the Federal Reserve.

One of the most contentious issues in the Financial Modernization debate was the proper relationship between banking and commerce. I believe the law found the right balance. There is broad Congressional and public concern about mergers between large financial and commercial firms. We did not permit them. However, the law did deliberately permit continuation and expansion of the involvement of financial institutions in commercial activities and relationships that are a natural extension of their business -- particularly in the high technology area.

I am concerned, however, that the proposed merchant banking and capital regulations may be imposing unnecessarily harsh constraints on activities the Congress clearly intended to promote. Moreover, in some cases constraints are being imposed on activities which have long occurred -- with much benefit and no evident risk. The maximum limit on merchant banking investments, and the 50% capital charge for all equity investments, may unnecessarily stifle sound investments by banking organizations and unnecessarily discourage financial service company relationships with, and investments in, commercial enterprises that flow naturally from their basic business.

I particularly question the necessity of the Federal Reserve's proposal to retroactively apply a 50% capital charge to existing equity investments that were authorized well before the enactment of the new law. I am especially concerned because the Federal Reserve has proposed this increased capital requirement without citing any evidence that these investments -- some of which have been permitted and conducted for decades with substantial benefit -- are particularly risky or volatile.

An example of special concern to me is the SBIC program, which I originally authored. It has been of great benefit to small businesses and local communities. And it has been a great source of profitability for the industry. The earnings history of bank-owned Small Business Investment Companies would not appear to justify the increased capital charge. My information suggests that banks have earned a healthy return-on-equity from their SBIC investments.

earnings history of bank-owned Small Business Investment Companies would not appear to justify the increased capital charge. My information suggests that banks have earned a healthy return-on-equity from their SBIC investments.

In general, I urge the Treasury and the Federal Reserve to take very seriously the comments received on these important regulations. Particular note should be made of the concern that the aggregate limitation and 50% capital charge undermine the new law's so-called "two-way" street - which was intended to ensure that banks, insurance companies and securities firms have equal opportunities to affiliate with one another. The cap could force many securities firms with merchant banking investments at or near the investment cap to avoid affiliations with banks. The Federal Reserve in fact reports that as of mid-May only 5 of the 281 applications for financial holding company status have come from securities and insurance companies.

I have recently learned that the proposed capital regulation may also have a negative impact on affordable housing investments by banking organizations. I urge the Federal Reserve to work with affordable housing lenders to avoid any such result.

While it is appropriate for Congress to consider the impact of the merchant banking regulations on the new economy, it just as important for Congress to ensure that the benefits of the new economy reach all of America's communities, including those that are currently underserved by the capital markets. I was pleased when this Committee approved, on a bi-partisan basis, my America's Private Investment Company bill that will boost investment in underserved communities. I was also pleased be present at the White House when the President announced his agreement with the Speaker on a bi-partisan community development package that includes the APIC bill and other elements of the President's new market initiative. I want to urge the Majority to complete work on the package so that it can be brought to the floor for a vote before the July 4th Recess, as the Speaker has promised.

I am also attaching, as a part of my statement, a letter that I have received from SBA Administrator Alvarez describing the impact of the proposed capital regulation on SBICs, as well as comments from Jere Glover, Chief Counsel, Office of Advocacy, Small Business Administration.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

June 7, 2000

Honorable John J. LaFalce
U.S. House of Representatives
Washington, DC 20515

Dear Congressman LaFalce:

This is in response to your recent letter requesting our comments on the proposed banking regulation (12 CFR Part 225) that would apply a 50 percent capital charge to all investments made by financial holding companies (FHC) in nonfinanical companies pursuant to the newly authorized merchant banking powers in the Gramm-Leach-Bliley Act of 1999. This charge would also apply to investments made by FHCs and national banks in Small Business Investment Companies (SBICs). Applying the proposed capital adequacy rule to investments in SBICs will serve as a disincentive to participation in a Federal government program that represents a critical source of capital to the Nation's small businesses.

In March 1999, Federal Reserve Chairman Greenspan gave a speech at the Federal Reserve System Research Conference on Business Access to Capital and Credit. During this speech, he stated, "Businesses must have equity capital before they are considered viable candidates for debt financing. Equity acts as a buffer against the vagaries of the marketplace and is a sign of the creditworthiness of a business enterprise. The more opaque the business operations, or the newer the firm, the greater importance of the equity base."

A successful and vibrant small business sector is inextricably linked to our national and economic well being. America's 25 million small businesses propel our national economy and generate innovation and creativity. Small businesses create the majority of the new jobs and employ more than half of the private workforce.

The U.S. Small Business Administration was created nearly 50 years ago to ensure a strong and vibrant small business sector. SBA is a voice for small business and provides access to capital and credit, entrepreneurial development, and Federal government procurement opportunities. In the financing area, we identify and develop credit and equity opportunities for borrowers who would not otherwise have access to private credit and capital on reasonable terms. This assistance is necessary to the development of small businesses. Since 1993, SBA has nearly tripled the financing for loans available to small businesses.

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SBICs Supply a Vital Source of Venture Capital to Small Businesses

In 1958, a Federal Reserve Bank study determined that a major capital availability gap existed for U.S. small businesses. To correct this deficiency, Congress specifically authorized banks to invest in SBICs as an exception to laws restricting private equity investing by banks.

The SBIC Program has become an increasingly important source of equity capital for the nation's small growth businesses. In calendar year 1999, bank-owned SBICs are estimated to have accounted for 12 percent of the number of institutional venture capital investments and 8.3 percent of their value.

Investment from Banks is Critical to SBICs

Today, commercial bank investment represents a major component of the SBIC program. Banks participate in the program through SBIC subsidiaries (bank-owned SBICs) and also provide a significant portion of the capital for independent SBICs. Currently there are 101 bank-owned SBICs with $5.3 billion of capital. This represents 28 percent of the program's licensees and 62 percent of its total private capital. While large relative to the SBIC program, the banks' investments are still miniscule in terms of the banking industry's capital resources.

In contrast to the private venture capital industry, bank-SBIC investments are far more broadly diversified in terms of their size, industry, and location, and they often include companies with more modest projected growth rates. For example in 1999, the average size of an investment by venture capital firms was reported to be $9.7 million versus $3.9 million for bank-SBICs. In addition, 86 percent of investments by venture capital firms were concentrated in high technology versus only 25 percent for bank-SBICs. More than 50 percent of venture capital firm dollars were invested in just 2 states, California and Massachusetts, versus 5 states for bank-SBICs, California, New York, Ohio, Texas, and Illinois.

SBICs Also Serve an Important Community Development Purpose

Further, banks held a significant minority interest in 40 percent of the 62 non-bank SBICs that were licensed during the past 2½ years. Their $418 million of investment represented 24 percent of the $1.76 billion in total non-bank SBIC private capital licensed during the period. These non-bank SBICs make particularly small investments, averaging about $870,000 in fiscal year 1999. In many cases, the bank's participation was essential to the SBIC's being able to raise the minimum capital required for licensing. These minority investments often have a significant economic development objective. SBA has spent three years working with bank regulators and participating at numerous banking conferences to encourage SBIC investment by smaller banks.

The rule developed by the Federal Reserve Board and proposed on March 17, would increase the percentage of equity capital that FHCs and their constituent banks must have to support SBIC investments from 8 percent to 50 percent. I believe that these higher capital requirements will increase the cost to banks of investing in these activities and will likely reduce investments in SBICs from their current level. It could also cause these investment entities to raise their hurdle rates of return, thereby further reducing the number and types of businesses served.

The SBIC program has been in place for more than 40 years. Over its long history, it has been modified a number of times to address weaknesses as they became apparent, and it now is a stable, well administered program whose profitability to participants is attested to by the significant increase in applications for licensing. In each of the past 20 years, the bank-owned segment of the SBIC program has been profitable with weighted realized returns on equity over the period averaging 14.2 percent. We are aware of no failures of bank-owned SBICs, and only one of the 176 non-bank regular SBICs licensed during the past 10 years has failed.

Where SBICs are concerned, several significant safeguards already exist that will shield bank investors from economic harm:

1. Congress has recognized that investments by SBICs involve positive social benefits that outweigh the incremental additional risk associated with private equity investing. Further, Congress has already taken precautions to account for any extra risk. The Small Business Investment Act of 1958, as amended, limits a bank's investment in SBICs to 5 percent of the bank's capital and surplus. This is de minimis as compared to overall banking investment strategies and provides an inherent safeguard against excessive losses to the banking organization.

2. SBA's rigorous licensing procedures ensure management competence and increase the likelihood of successful operations. SBA performs an in-depth review of the SBIC's business plan and extensive due diligence on the proposed management team before licensing new SBIC entities.

3. SBICs are subject to many regulations specifically intended to manage risk. The regulations establish internal control requirements, portfolio diversification standards, SBA-approved valuation methods, and mandatory financial covenants. SBICs generally are not permitted to exercise control over companies in which they invest, which by itself may justify a lesser capital charge, as suggested in the preamble to the Federal Reserve's proposed rule.

For the reasons outlined in this letter, I believe the Federal Reserve should reconsider the inclusion of SBICs in its proposed rule.

I have enclosed two tables that detail the performance of bank-owned SBICs since the mid-1970's. One shows the weighted realized rate of return on invested capital for all types of SBICs from 1977, and the other shows the net income by SBIC type from 1976. Although banks make significant contributions to independent SBICs, our information is not available in such a way that we are able to delineate the performance of independent SBICs that have bank funding.

If I may be of any further assistance, please call me. Thank you for your support of the SBIC program.

Sincerely,

Aida Alvarez
Administrator

Table 25

Weighted Realized Rate of Return on Invested Capital
for SBIC Program Licensees
Fiscal Years 1977 to 1999

Fiscal Year	Bank Owned Regular SBICs	Debenture Regular SBICs	Participating Security Regular SBICs	All Regular SBICs	All SSBICs	All SBIC Program Licensees
1977	1.10	(1.31)	--	(0.30)	(10.78)	(1.07)
1978	(1.73)	5.06	--	2.27	(7.53)	1.47
1979	12.66	5.17	--	8.24	(2.54)	7.33
1980	12.53	9.42	--	10.70	(7.29)	9.10
1981	16.89	7.48	--	11.36	2.85	10.49
1982	26.86	10.19	--	17.73	(1.49)	15.77
1983	13.43	8.71	--	11.10	(1.12)	9.87
1984	16.56	10.50	--	13.76	(0.27)	12.36
1985	11.31	4.23	--	8.24	(0.65)	7.40
1986	10.28	1.71	--	6.99	2.29	6.55
1987	12.01	17.75	--	13.93	13.21	13.86
1988	14.82	8.11	--	12.89	5.79	12.28
1989	8.42	8.00	--	8.32	7.96	8.28
1990	14.77	6.39	--	12.95	3.23	12.19
1991	5.31	(4.38)	--	3.54	(1.38)	3.18
1992	11.89	1.50	--	10.46	4.34	10.04
1993	17.01	14.09	--	16.66	0.58	15.70
1994	16.03	0.63	--	14.32	4.37	13.80
1995	8.55	5.34	(14.70)	7.96	4.59	7.80
1996	14.51	11.58	(6.70)	13.58	10.99	13.46
1997	19.78	10.00	7.32	18.05	8.63	17.62
1998	21.33	10.34	7.34	19.33	5.55	18.86
1999	10.90	4.62	23.99	11.31	9.16	11.26

Realized Rate of Return on Invested Capital was calculated by dividing "Net Income" by the average of the beginning and ending balances of "Paid-in Capital Stock & Surplus" plus "Partners' Permanent Capital Contributed" plus "Undistributed Realized Earnings".

Table 26

SBIC Program Licensees
Total Net Income
Fiscal Years 1976 to 1999

Fiscal Year	Bank Owned Regular SBICs	Debenture Type Regular SBICs	Participating Security Regular SBICs	All Regular SBICs	All Specialized SBICs	All SBIC Program Licensees
1976	-4,995,796	-2,571,779	--	$-7,567,575	-1,992,334	$-9,559,909
1977	1,814,436	-2,263,132	--	$-448,696	-3,381,124	$-3,829,820
1978	-2,832,925	11,854,194	--	$9,021,269	-2,666,901	$6,354,368
1979	21,914,714	12,907,234	--	$34,821,948	-965,567	$33,856,381
1980	24,684,677	26,713,634	--	$51,398,311	-3,418,567	$47,979,744
1981	39,980,397	25,189,563	--	$65,169,960	1,858,184	$67,028,114
1982	89,437,736	41,070,451	--	$130,508,187	-1,244,676	$129,263,511
1983	60,350,196	38,157,399	--	$98,507,595	-1,110,636	$97,396,959
1984	87,385,808	47,791,535	--	$135,177,343	-289,424	$134,887,919
1985	72,654,759	20,829,187	--	$93,483,946	-774,284	$92,709,662
1986	82,975,808	8,603,996	--	$91,579,804	3,109,103	$94,688,907
1987	118,203,355	87,234,694	--	$205,438,049	19,874,664	$225,312,713
1988	180,844,309	39,751,326	--	$220,595,635	9,454,304	$230,049,939
1989	123,244,948	39,433,729	--	$162,678,677	14,077,530	$176,756,207
1990	251,791,064	30,280,151	--	$282,071,215	5,991,563	$288,062,788
1991	104,391,121	-19,264,793	--	$85,126,328	-2,556,389	$82,569,939
1992	260,526,759	5,291,855	0	$265,818,614	7,979,386	$273,798,000
1993	432,137,765	49,197,204	0	$481,334,969	1,075,421	$482,410,390
1994	475,775,074	2,352,770	0	$478,127,844	8,070,874	$486,198,718
1995	289,014,722	19,331,114	-6,895,480	$301,450,356	8,449,741	$309,900,097
1996	556,476,256	50,322,099	-8,961,227	$597,837,128	22,247,594	$620,084,722
1997	763,761,345	49,269,620	18,594,974	$831,625,939	18,131,071	$849,757,010
1998	1,004,565,290	64,439,378	29,667,681	$1,098,672,349	11,335,188	$1,110,007,537
1999	611,703,587	31,980,311	131,545,337	$775,229,235	15,699,837	$790,929,072
Total	$5,645,805,405	$677,901,740	$163,951,285	$6,487,658,430	$128,954,558	$6,616,612,988

Office of Advocacy
U.S. Small Business Administration
Washington, DC 20416

May 22, 2000

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th St. & Constitution Ave., N. W.
Washington, D. C. 20551

Re: Regulation Y; Docket No. 4-1067 (Bank Holding Companies and Change in Bank Control): 65 Fed. Reg. 16460 (March 28, 2000)

Dear Ms. Johnson:

This letter contains comments on the proposed capital rule published in the Federal Register on March 28, 2000 to implement the merchant banking provisions of the recently enacted Gramm-Leach-Bliley Act.[1]

By way of background, the Office of Advocacy of the U. S. Small Business Administration (SBA), was established by Congress 24 years ago pursuant to P. L. No. 94-305 to represent the interests of small business before federal agencies and Congress. It is an independent agency headed by a presidentially appointed Senate confirmed Chief Counsel. One of the duties of the Office is to "....study the ability of financial markets and institutions to meet small business credit needs...." (15 U.S.C.S. 634b(5)) and "....determine financial resource availability...." (15 U.S.C.S. 634b(6)).

In addition, the Chief Counsel of Advocacy is required by section 612 (a) of the Regulatory Flexibility Act (RFA) to monitor agency compliance with the RFA. The Chief Counsel is also authorized to appear as *amicus curiae* in any action brought in court to review a rule. In such proceedings, the Chief Counsel may present views with respect to compliance with the RFA, the adequacy of the rulemaking record with respect to small entities, and the effect of the rule on small entities. It is pursuant to this authority that the Chief Counsel is submitting comments on the proposed capital rule.

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[1] Pub. L. 106-102, 113 Stat. 1338 (1999)

The Proposed Rule – In Brief

The rule being proposed by the Federal Reserve Board (Board) would increase the percentage of equity capital that bank holding companies (BHCs) which qualify as financial holding companies (FHCs) must maintain to support merchant banking investments. The proposal would increase the charge against regulatory capital from 8%, the present target risk-weighted capital ratio for top-tier BHCs, to 50%. The Gramm-Leach-Bliley Act has expanded the kind of merchant banking investments BHCs and FHCs can make. Because of this expanded investment opportunity, the Board is proposing this increase on the basis that it is necessary in order to minimize risk. This proposal would apply to investments by BHCs in Small Business Investment Companies (SBICS), which make investments in small growth companies – investments that differ from traditional venture capital investments in that they are broadly diversified in terms of size, industry and location and are constrained by law to minimize risk.

Because of Advocacy's statutory mandate to represent the interests of small business before Federal agencies, these comments are limited to the impact of the proposal on the level of bank holding company capital that will be available for investment in Small Business Investment Companies (SBICs) and to issues of the Board's non-compliance with the RFA.

Background – SBIC Program

Purpose. The SBIC program was established by Congress to expand the amount of equity capital available to small business. Under the Small Business Investment Act of 1958[2], Congress specifically authorized banks to invest in and control SBICs as an exception to laws restricting private equity investing by banks, thus ensuring increased capital availability to small business.

Risk Controls. To guard against inappropriate and risky investments and thus mitigate against losses to investors, *significant safeguards were adopted and exist today*.

- Banks may invest no more than 5 percent of their capital and surplus in an SBIC.
- SBICs are also subject to many congressionally mandated regulations specifically intended to manage risk. The regulations require * licensing procedures to ensure management competence, * internal controls, * portfolio diversification standards, * valuation requirements, and * compliance with certain financial covenants.

Thus, risk to bank investors is minimized. A study by the Federal Reserve Board confirmed this. It found that investments by banking organizations in SBICs are *not an untested activity for which special measures to avoid risk must be taken.*[3]

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[2] 15 U.S.C. Sec. 661 *et seq*

[3] *The Economics of the Private Equity Market,* George W.Fenn, Nelli Liang, and Stephen Prowse (Board of Governors of the Federal Reserve, 1995)

Success Patterns. Over the past 20 years, the bank-owned SBICs have never had a loss year. On average, the group has experienced a weighted realized return on equity of 14.2 percent. SBA management is not aware of any failures of bank-owned SBICs in the past 10 years.

Program Trends – Positive Results. The SBIC program has become an increasingly important source of equity capital for the nation's small growth businesses. Currently there are 101 bank-owned SBICs with $5.3 *billion* of capital. In FY 99, these bank-owned SBICs accounted for *68 percent* ($2.9 billion) of the program's total investment in small businesses.

Over and above bank-owned SBIC capital are the investments by banks as minority investors in independent SBICs. In a 2.5 year period ending February 2000, banks invested $418 million in 25 of the 62 new non-bank SBICs that received licenses. This investment amounted to 24 percent of the $1.76 billion total private capital raised by the new non-bank owned SBICs during that time. In many instances, the bank's participation was critical in helping an SBIC raise the minimum capital required for licensing.

In summation then, commercial banks represent the largest source of the SBIC program's private funding, both through wholly owned SBIC subsidiaries and through minority investments in independent SBICs. The investments have proved to be profitable and sound and are attractive to banks.

Community Reinvestment Act (CRA) – SBIC Impact. Allowing minority investments in SBICs helps banks, particularly community banks, satisfy investment requirements under the CRA. Such investments advance the purposes of CRA – namely to have banks invest in growth companies at a local level, thus expanding capital available to small growth firms.

The Issues

Heretofore, banks have been allowed to invest in SBICs subject to a charge against Tier I regulatory capital of 8%. The Board's justification for increasing the charge to 50% is "...to prevent the development within banking organizations of excessive risk from merchant banking and other investment activities."

- What will be the impact of the increase in the charge against regulatory capital on the amount of investment capital available to advance the public policy objectives of the Small Business Investment Company program?
- How does this comport with objectives of the Gramm-Leach-Bliley Act, namely to allow expansion of bank holding company investments into diversified activities, including equity investments in small business?
- How will it help small banks meet the investment objectives of the Community Reinvestment Act (CRA)?

These are questions that the Board should answer and make the answers available to the public for comment before adopting any proposal that significantly changes the charge banks must take against Tier I regulatory capital for investing in SBICs.

Initial Regulatory Flexibility Analysis Required by RFA
The proposed rule states:

> "In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603 (a)), the Board must publish an initial flexibility analysis....

The Board is correct that an initial regulatory flexibility analysis (IRFA) is required. However, the section dealing with the RFA merely says:

"...The proposed capital amendments generally would not apply to financial or bank holding companies with consolidated assets of less than $150 million and, thus, are not likely to have a significant economic impact on a substantial number of small entities (i.e. holding companies with less than $100 million in assets). The Board believes the proposed amendments to its capital guidelines are necessary and appropriate to ensure that bank holding companies maintain capital commensurate with the level of risks associated with their activities and that the investment activities of bank holding companies do not pose an undue risk to the safety and soundness of affiliated insured depository institutions."

Nowhere is there any reference to section 603(b) or (c) of the RFA, which detail what an initial regulatory flexibility analysis (IRFA) must contain, namely (to mention only those provisions applicable here):

- a description of and, where feasible, an estimate of the number of small entities to which the proposed rule will apply;
- a description of any significant alternatives that minimize the impact on small entities; or
- exemptions from coverage of the rule or any part thereof for small entities.

What is presented as an "analysis" is deficient. No data is provided on the number of entities affected and no analysis is provided of the impact of the capital charge rule on operating costs and availability of funds for expanded diversified investment. Without an analysis of the impact, it is not surprising that there is no description of ***alternatives that minimize the impact*** nor any discussion of exemptions. For example, there is no discussion of investments in SBICs, which are well documented as low risk, versus new merchant banking investments which the Board is viewing as potentially high risk. The statements in this "analysis" are at best only conclusions. They provide no exposition of the data and information relied on by the Board to arrive at its conclusions. To be in compliance with the RFA, the data and information that justify the conclusions must be delineated in detail so that the public can make informed comments on the Board's rationale for the rule and the provisions of the rule.

Is This a Certification Rather Than an Initial Regulatory Flexibility Analysis?
If this is an effort to certify that the rule will not have a significant economic impact on a substantial number of small entities, the "certification" is also deficient and not in compliance with the RFA. Any certification must be accompanied by a "factual basis" for the certification and not merely conclusions.[4] Here again the Board's notice only provides a conclusion, namely that "The proposed capital amendments generally would not apply to financial or bank holding companies with consolidated assets of less than $150 million..." No basis is provided for this conclusion that would allow interested parties to draw an informed assessment as to its accuracy.[5]

What follows is a more detailed discussion of the issues that should have been addressed in the Board's initial regulatory flexibility analysis.

Rationale for the Regulatory Proposal

Regulatory Authority
In the *Background* paragraph of the notice of the proposed rulemaking, the Board cites Section 103 (a) of the GLB Act[6] which amends the Bank Holding Company Act[7] to authorize financial holding companies to acquire equity investments in nonfinancial companies (aka merchant banking investments).

In proposing this regulation, it is not clear from the notice if the Board is relying on the regulatory authority cited in the proposed rule as authorization for the rule or if the Board is relying on other authority to establish the increased charge to regulatory capital. The referenced citation grants the Board and the Secretary of the Treasury authority to issues regulations, "including limitations on transactions...," but the thrust of this authority is to enforce the permissible activities of the law "...to assure compliance with the purposes and prevent evasions of this Act..."[8] It is not clear that a rule increasing the capital charge assures compliance or prevents evasions of the law. Nor is it clear that the rule is imposing "limitations on transactions." By increasing the cost of investments, thereby limiting the amount of funds available for investment in merchant banking activities, it is limiting investment options but not by direct limitations on transactions.

Regulatory Justification – The Problem The Rule Is Addressing
Before going further, it is important to note that, when adopting the GLB Act, Congress made no changes to the enabling legislation underlying the SBIC program or to the risk management constraints under which the SBIC program operates.[9] Despite this, the Board's proposal treats *new* merchant banking investments and merchant banking investments in SBICs equally, without drawing any distinction between 1) *known risk*

[4] 5 U. S. C. sec. 605 (b)
[5] Agency certifications and regulatory flexibility analyses are judicially reviewable pursuant to 5 U.S.C. sec. 611. Also see *North Carolina Fisheries, Ass'n, Inc. v. Daley,* 27 F. Supp. 2d 650 (E.D. Va. 1998) and *Southern Offshore Fishing Ass'n v. Daley,* 55 F.Supp. 2d 1336 (M.D. Fla. 1999)
[6] Pub. L. 106-102, 113 Stat. 1338 (1999))
[7] 12 U.S.C. 1843(k)(4)(H)
[8] 12 U.S.C. 1843(k)(7)(A)
[9] 13 CFR part 107

that is already constrained (i.e. investments in SBICs) and 2) *new risk – new merchant banking investments by banks*, knowledge of which is mostly speculative and for which new constraints may be needed along the lines of longstanding regulations applicable to SBICs.

The Federal Reserve and the Treasury interviewed both securities firms and bank holding companies to examine the types of merchant banking investments made under current authority in order to determine what, if anything, was needed to regulate/oversee expanded bank investments. Securities firms, which function as venture capital entities, invest in high risk ventures in the expectation of significant returns on their investments. By contrast, bank experience with merchant banking equity investments thus far has largely been limited to government licensed and government-regulated Small Business Investment Companies which are constrained to minimize risk.

Presumably, the Board has data from these interviews that would shed light on the level of risk experienced by the entities that own SBICs or have investments with SBICs. Unfortunately, this specific information was not shared with the public. The relevance in the context of this rule is that any rules issued under the Gramm-Leach-Bliley Act need to be in balance with other public policy objectives established by Congress for the banking industry and for equity markets. Without this detailed information, the public has no way of knowing whether the Board considered the impact of the rule on ensuring that capital would remain available for small businesses or that investments would remain feasible in the communities where the banks are located. These are the objectives of the SBIC program and the Community Reinvestment Act. It is reasonable to question the Board's rationale for the rule since it is not clear that such an increase in capital requirements strikes a balance with these other laws.

The issue that should have been explicitly addressed is what is the level of risk associated with investments in SBICs that justifies increasing the charge from 8% to 50% and what will this do to the level of funds available for investment in such activities? The Board did not provide any data to answer this question, despite its extensive experience in regulating the banking industry. Once again it merely drew a conclusion without providing specific justification, to wit: "Importantly, the risks associated with these investment activities do not vary according to the authority used to conduct the activity. Thus, similar investment activities should be given the same capital treatment regardless of the source of the legal authority to make the investment."

The Board went on to say: "Moreover, current regulatory capital treatment, which applies an 8% minimum capital charge to these investments, was developed at a time when the investment activities of banking organizations were relatively small. In recent years, some bank holding companies have greatly expanded the level of their investment activities." In the context of this rule, the statement is puzzling since merchant banking activities have heretofore been limited largely to investments in SBICs and these investments are limited to 5% of capital. Other investments involve guaranteed municipal and government bonds. *Where is the evidence of increased risk stemming from well regulated merchant banking investments in SBICs? Should not the Board be*

focussing its attention on new merchant banking investments rather than on well-regulated investments?

Impact Assessment

The Board reviewed a sampling of the call reports of bank holding companies that have significant investment activities. From this review, the Board concluded "...with virtually no exception, bank holding companies would remain well capitalized on a consolidated basis even after applying the proposed capital charge to all of the investments...nearly all of these companies would be able to increase significantly their level of investment activity and continue to be well capitalized...For these reasons, the capital proposal is not expected to have a significant effect on the level of investment..."

There is something missing in the logic here. How can increasing the charge from 8% to 50% *not* affect the level of available capital for investment? Banks owning SBICs and investing in SBICs will now have to set aside more capital to support their investments. This will draw down capital they might have for other merchant banking activities. If the Board is saying that Banks have so much cash now they will have ample funds to invest, is the Board also saying that it needs to dry up some of that cash? What happens to investments in small business --- which was an issue of major concern to the Congress when deliberating Gramm-Leach-Bliley Act? Is controlling cash availability the only way to control risk – it may be the traditional way but is it the only way given the objectives of the Act?

Alternatives

The foregoing leads to the question as to what alternatives the Board considered when devising the rule. In fairness, the Board has asked for comments on a number of issues, too lengthy, however, to enumerate here. Using the regulatory process to obtain information is of course the purpose of "notice and comment" under the Administrative Procedures Act[10] and we believe the questions were appropriate.

However, the issue of concern here is compliance with the Regulatory Flexibility Act. The RFA requires a regulatory agency to identify and discuss *alternatives* that would minimize impact and provide justification for the proposal. This is intended to generate informed comments before an agency selects a final rule.

In this case, no alternatives are presented. There is no factual discussion of why the increase in the charge was pegged at 50%. There is no discussion of any variations that the Board considered but rejected. There is no inkling that the Board considered any exemptions.

One logical exemption that should have been considered - not necessarily adopted – but at least considered and *discussed openly in the IRFA* - would be an exemption for investments in SBICs, which are already highly constrained to minimize risk. Or, a different increase for investments in SBICs. Another option would be to exempt SBICs for a specific time period, reserving the option to impose increased charges at a later date.

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[10] 5 U.S.C. Sec. 553

The Board has the data – the information on bank investments – on which to draw inferences as to risk and to capitalization that would argue "for" and "against" alternatives. Instead the Board shifts the burden for suggesting and justifying alternatives to the public – *which does not have relevant data nor the formula the Board uses for determining high or low or reasonable risk.*

The lack of any discussion of specific alternatives deprives the public *and the Board* of the opportunity for a full debate on alternatives, as to what is workable, what is fair, what balances public policy objectives.

Is this a *Significant* Rule? Does the Rule Impose Costs of $100 Million or More?

The Board, as an independent agency, is not subject to Executive Order 12866, which establishes analytical procedures for such rules. Nor does the proposed increase probably fall within the definition of an "unfunded mandate." But as a member of the governance of the United States the Board needs to share with the public information it has as the expert agency as to the impact of this regulation. The following mathematical exercise may be crude, and arguably imprecise, but it does provide some graphics as to the impact of this rule.

At the present time, 101 bank-owned SBICs have $5.3 billion in capital, all from bank investments. If the average charge is 8%, then the banks have in reserve somewhere in the vicinity of $424 million to support its investments. Admittedly, it may well be more.

If the charge is increased to 50%, then the banks which own SBICs will have to set aside an additional $2.226 *billion* to support their current investments. And this is just the impact on bank-owned SBICs. Thus, if the Board were subject to EO 12866 or if this were an unfunded mandate, the Board would have to go through a far more stringent analysis and impact assessment than what is included in the notice of the proposed rule.

In the context of the entire banking system affected by this proposed rule, the amount of capital that banks would have to find to support existing investments in SBICs may well be regarded as small. But it is not clear how imposition of this additional burden of $2.268 billion is consistent with Congress' express concern that the reforms of the Gramm-Leach-Bliley Act not harm investments in small business.

CONCLUSION

The Board is responsible for ensuring the security and integrity of the banking system and investors in the system. We take no issue with the appropriateness of its efforts to preserve the integrity of the system as it will begin to operate under the Gramm-Leach-Bliley Act. We do, however, take issue with the Board's failure to comply with the Regulatory Flexibility Act which must be treated as a congressional mandate equal in importance to the Gramm-Leach-Bliley Act and other laws dealing with financial markets. The public policy objectives of these laws must be brought into balance and the balance reflected in rules proposed. The Gramm-Leach-Bliley Act empowers the Board

and the Department of the Treasury to implement the law; the Regulatory Flexibility Act establishes an analytical framework that must be followed by the regulatory agencies responsible for implementing this new and important congressional mandate. The Board has failed to comply with the RFA and is depriving itself of informed debate on important issues. That is the purpose of the RFA.

In closing, we believe it important to remind the Board of research that has been done on the credit crunch of 1989-1992. That research showed that 1) the primary adverse impact of the credit crunch was experienced by small business and 2) a major contributing factor to the credit shortage was the increase in capital requirements established to meet the Basal agreement. A more recent study by Diane Hancock and James Wilcox: *The "Credit Crunch" and the Availability of Credit to Small Business*[11] arrived at the same conclusion. The changes in capital requirements tightened credit availability and the lack of credit, particularly for small firms, pushed many firms into bankruptcy, exacerbating the economic adjustments that were occurring in the economy. While economic conditions now may not be the same as in 1989-1992, the issue is still relevant since reducing the amount of available equity capital, it is also reducing the amount of capital available for credit.

Respectfully submitted by:

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[11] Journal of Banking and Finance, Vol. 22 (6-8) pp. 983-1014

Statement of Representative Maxine Waters
House Banking and Financial Services Committee
Subcommittee on Capital Markets and GSEs
Hearing on Capital Markets and the New Economy
June 6, 2000

Merchant banking – a term that refers to institutional financing where the financing company acquires equity in privately held nonfinancial companies, or public companies going private – represents a significant source of investment funds for US capital markets. Merchant banking can take a variety of forms including venture capital funds and Small Business Investment Companies.

According to a November 1999 Congressional Research Service report, merchant banking, also referred to as private equity investing, "raised a record-setting $85.3 billion in 1998, the fifth consecutive record fund raising year." The recently issued rules on merchant banking activities of Financial Holding Companies is cause for discussion.

Pursuant to the Gramm Leach Bliley Act, Financial Holding Companies were given authority to conduct merchant banking activities. The Act authorizes the

Federal Reserve Board and the Secretary of the Treasury to issue regulations implementing this merchant banking authority. Under this regulatory authority, the Board and the Treasury issued two rules on merchant banking activities of Financial Holding Companies: an interim rule and a proposed final rule, both of which were subject to a comment period expiring on May 22, 2000.

Although Governor Laurence Meyer of the Federal Reserve System argues in his written testimony that "the rules would allow merchant banking to continue to develop along the lines already evident in the industry and in the manner intended by Congress," the rules were met with much criticism.

John P. Whaley of the American Bankers Association Securities Association describes the rules as "draconian" and states that the proposed rules "rebuild many of the barriers among financial services firms that Congress sought to eliminate through passage" of the Gramm Leach Bliley Act.

Of particular concern, however, is the effect the rules will have on the development of small businesses. Many small businesses are locked out of traditional financing sources. Venture capital funds and Small Business Investment Companies (SBICs) are important tools to

bridge the "capital gap" faced by small businesses. According to the National Association of Small Business Investment Companies (NASBIC), Small Business Investment Companies (SBICs) "represent a major source of critical venture capital for thousands of US small businesses. In FY1999 SBICs invested $4.2 billion in US small businesses."

The National Association of Small Business Investment Companies (NASBIC) and others have argued that the proposed capital requirements – which would require bank holding companies to maintain in equity at least 50 cents of capital for every dollar a bank holding company invests in merchant banking-type investments – will adversely affect the available funding for small businesses.

The effects of these proposals is of great concern to me and others who advocate on behalf of small businesses. I look forward to this discussion and hope that we find a way to protect our small businesses while improving our capital markets.

TREASURY UNDER SECRETARY GARY GENSLER
HOUSE BANKING SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES

Mr. Chairman, Ranking Member Kanjorski, Members of the Subcommittee, thank you for the opportunity to appear here today to discuss private equity investing and merchant banking, and their role in the capital markets.

The enactment of financial modernization legislation was intended to stimulate greater competition and innovation in the financial services industry. The Administration and Treasury strongly supported the enactment of financial modernization legislation and worked hard to produce a balanced bill that serves the interests of consumers, companies, and the economy. As part of that legislation, banks are allowed to engage in merchant banking activities, both as intermediaries and as investors, to enable them to better compete with other institutions that are active in these markets. At the same time, however, Congress intended to limit the mixing of banking and commerce and to ensure that merchant banking activities are conducted in a safe and sound manner.

The new merchant banking authority provided under the financial modernization legislation significantly expands the ability of bank affiliates to invest in the private equity market. We and the Federal Reserve Board are in the midst of a rule-writing process implementing the merchant banking provisions of the financial modernization legislation. As part of this process, we are consulting broadly to ensure that those rules fully carry out Congress's intent to grant financial holding companies this important new authority and to preserve the safety and soundness of our financial system, the strongest and most vibrant in the world.

I would like to discuss four areas in my remarks today:

- First, the nature of merchant banking and private equity investments and their role in our capital markets.

- Second, the current role of financial institutions in merchant banking and the private equity market.

- Third, the approach taken in last year's financial modernization legislation in authorizing participation by financial holding companies in the private equity market.

- Finally, how the Federal Reserve and the Treasury Department have proposed to use their rule-writing authority to implement this legislation.

Merchant Banking and Private Equity Investment

The most important thing to understand about investments in the private equity market, or as it is often called, merchant banking, is that these investments are generally higher risk, longer term, illiquid investments. To help you better understand this market, let me begin by describing the history and size of the private equity market, the nature of the investments and the risks they pose, and the vehicle through which most of these investments take place, the private equity partnership.

History and Size of Private Equity Investing

Private equity investing has been a feature of the capital markets for centuries. Private equity investments generally are understood to include transactions undertaken by professional investors in unregistered shares of private or public companies. The organized private equity market represented over $400 billion in assets under management as of year-end 1999. Until the 1950s, private equity investing was largely the domain of wealthy individuals. Families like the Whitneys and Rockefellers made significant venture capital investments in the post-war period. Institutions started to become involved in this type of investing in the 1960s and 70s, through direct investments, limited partnerships, and Small Business Investment Companies ("SBICs").

After a series of tax and pension law changes in the late 1970s, limited partnerships became the predominant vehicle for collective investment in private equities, leading to dramatic growth in this market. Although information on this market is limited, the available data indicate that the organized private equity market has grown from under $5 billion of private assets under management in 1980 to over $400 billion in 1999, a more than 80-fold increase over twenty years. This growth has paralleled a long period of strong growth in the public equity market. During this time, the public equity market has grown from approximately $1.5 trillion in 1980 to over $17 trillion in 1999, an approximately 12-fold increase.

During the period from 1980 to 1999, the composition of the private equity market shifted significantly. In 1980, approximately two-thirds of private equity investments were in the form of venture capital, that is, investments in start-up or early stage companies. By 1999, venture capital investments had fallen to one-third of the private equity market. From 1980 to 1999, non-venture capital investments grew almost 150-fold and now constitute two-thirds of the private equity market. While leveraged buy-outs represent the bulk of non-venture capital investments, such investments also include privately held, middle-market companies and companies in financial distress.

Nature of the Investments

Private equity generally is the most expensive form of finance available. Equity investing, by its nature, represents the highest-risk part of the capital structure, because it has the lowest priority of claim on the cash flow of a company. Private equity investing adds further risk elements. First, these investments are illiquid, as they cannot be readily bought or sold the way registered shares of a publicly held company can be. Second, the investments generally are made in higher risk companies, such as start-ups, leveraged buy-outs, or similar investments. Third, the investments are typically held for the intermediate to longer term in the expectation of higher returns for higher risk.

Private equity investors demand high rates of return to compensate for the risks associated with these investments. For venture capital investments, there are significant risks that a product or strategic plan of a start-up company may prove unworkable. For a leveraged buy-out of an existing firm, there are significant risks associated with the high levels of debt a company takes on in connection with such a buy-out.

Private equity investments generally are longer-term investments. They are generally held from three to seven years, and may be held longer. These investments tend to be illiquid, in part because the securities generally are not registered or the companies are not public. The ownership stakes held by private equity investors also tend to be quite large, further contributing to the illiquidity of the investments. Investors often will have controlling or majority stakes in companies.

Private equity investments are made with a goal of eventual resale. An investor's exit strategy may consist of selling a stake in a company through a merger or acquisition or taking the company public. The ability of investors to successfully exit an investment and realize any appreciation in value depends in large part on how receptive markets are to such a sale. Thus, one of the most important opportunities and risks of private equity investing relates to the performance of the equity and merger markets.

We are currently in the midst of the longest economic expansion in our history. In addition, the U.S. capital markets have had a long period of strong performance. Experience over the last decade, therefore, can provide only partial guidance as to the riskiness of private equity investments in the future. We should be careful not to let today's confidence lead to complacency as to the general risks associated with these investments in the future.

Private Equity Partnerships

Let me briefly describe the vehicle by which most of these investments take place. The best estimates are that approximately 80 percent of private equity is invested through limited partnerships. These partnerships generally have a professional asset manager acting as the general partner. The general partners most frequently are independent private firms that are not affiliated with either commercial or investment banking organizations. The investors are generally public or private pension plans, endowments, foundations, corporations, and wealthy individuals.

For many of these investors, the funds placed with private equity partnerships represent a portion of their funds that they dedicate to higher risk assets. Other high risk investments sometimes include investments in real estate or hedge funds. Indeed, the partnerships that invest in the private equity market are set up in much the same way as hedge funds. An important difference between private equity partnerships and hedge funds, however, is that private equity partnerships generally do not use leverage within the partnership. The portfolio companies themselves, however, often do have leverage.

Role of Financial Institutions in the Private Equity Market

Let me now turn to the role of financial institutions in the private equity market. While private equity investment takes place largely outside of financial services firms, commercial and investment banks play a number of roles in this market, as agents, intermediaries, and investors.

As agents or underwriters, financial services firms provide services to investors, companies, and asset managers. In particular, they raise funds for portfolio companies and partnerships and advise on mergers and acquisitions. They also act as intermediaries, managing private equity partnerships and investments for others. Investment banks, in particular, are active in each of these areas. In these roles, financial services firms generally are more insulated from risk than they are when acting as investors.

Commercial and investment banks also are investors in the private equity market. Investment in private equity by commercial and investment banks has grown during the last ten years. While precise figures are not available, the best estimates are that these investments currently represent roughly 20 percent of the organized private equity market. Investment banks have invested in private equities since the 1970s, generally as a complement to their management of private equity partnerships. Some of the earliest venture capital partnerships, such as the Sprout Group, were formed by investment banks.

Prior to enactment of the financial modernization legislation, commercial banks and their affiliates had limited authority to invest in equities through Edge Act corporations, under the Bank Holding Company Act, and through SBICs. These investments accounted for just under ten percent of the total investments in the private equity market. This activity has been concentrated in a few large banks, with the top ten commercial banks accounting for an estimated 90 percent of the total private equity investments held by commercial banking organizations.

Currently about $5.3 billion, or approximately 14 percent, of the private equity investments held by commercial banks are invested through SBICs. While this is only a small portion of commercial bank investment in private equity overall, commercial banks represent 60 percent of the total private investment in SBICs.

Financial Modernization

In removing many of the restrictions of the Glass-Steagall Act to allow broader affiliations

of financial services firms, last year's financial modernization legislation sought to provide increased competition and innovation in financial services. The legislation permits financial services firms to participate more broadly in merchant banking activities. This will enable commercial and investment banks to affiliate while allowing investment banks to retain their private equity investments. We fully support this "two-way street" approach. In addition, the legislation allows financial services firms to take advantage of the complementary nature of private equity investing with many of their existing activities.

Nonetheless, the legislation does not allow for unrestricted merchant banking activities. When the President laid out his four key principles for achieving an acceptable financial modernization bill, one was to ensure that the legislation did not permit inappropriate mixing of banking and commerce. We had learned important lessons from the experience of other countries, and we did not want to repeat their experience in our country. In particular, we had seen the risk of permitting combinations of companies that allocate capital with those that compete for capital. After much debate, Congress concluded that we should be cautious about allowing banking and commerce to mix through the affiliation of financial and commercial organizations.

The United States has the most efficient capital markets in the world. The allocation of capital and risk in our markets is not burdened by corporate affiliations or relationships between financial and commercial enterprises. Other countries, both in Europe and in Asia, allow their banks to have direct, long-standing, ownership interests in commercial firms. None of these countries, however, has capital markets as efficient and as well-developed as ours. None has a capital market that contributes so successfully to its economy as ours does.

Accordingly, the financial modernization legislation included prudent steps to prevent the mixing of banking and commerce. As Representative Kanjorski stated, "[a]s a result, we will prevent the development of the cozy relationships between financial firms and commercial companies that helped lead to the disruption of the Japanese banking system earlier this decade."

Congress followed two key principles in authorizing financial holding companies to engage in newly authorized merchant banking activities - first, to maintain an appropriate separation between banking and commerce, and second, to ensure that merchant banking activities are conducted in a safe and sound manner. To achieve these objectives, the Act permits financial services companies to engage in the newly authorized activities only if the following conditions are met:

- To become a financial holding company, and thus conduct merchant banking activities, an organization must be well-managed and well-capitalized.

- The financial services holding company must have either a securities affiliate or an insurance underwriter and a registered investment adviser that advises an insurance company to ensure there is some level of capital markets expertise and controls within the organization.

- The activity must be part of a "bona fide" underwriting or merchant or investment banking activity, including investments engaged in for the purpose of appreciation and ultimate resale.

- The investments must be held only for a period of time that enables their sale or disposition on a reasonable basis consistent with the financial viability of the investment activities.

- The company must not manage or operate the portfolio companies on a day-to-day basis except as may be necessary or required to obtain a reasonable return on investment upon resale.

In addition, the Act restricts cross-marketing between a depository institution and its holding company's portfolio investments. It also provides that a portfolio company is presumed to be an affiliate under section 23A of the Federal Reserve Act if a holding company holds 15 percent or more of its capital.

Implementing Rules

Finally, Congress provided joint rule-writing authority to the Treasury and the Federal Reserve Board to ensure that merchant banking activities would be conducted in a safe and sound manner and would preserve an appropriate separation between banking and commerce. As Chairman Leach and Senator Sarbanes each said in separate statements during floor debate on the conference report, "under the [rulemaking] authority, the Federal Reserve and the Treasury may define relevant terms and impose such limitations as they deem appropriate to ensure that this new [merchant banking] authority does not . . . undermine the safety and soundness of depository institutions or the Act's general prohibitions on the mixing of banking and commerce."

We are currently in the midst of the rule-making process. Two rules have been published for comment. The first is an interim rule and request for comments published jointly by Treasury and the Federal Reserve implementing the merchant banking provisions of the legislation. The interim rule addresses issues such as permissible investments, risk management, holding periods and other issues. The second is a proposed rule published for comment by the Federal Reserve that would establish capital requirements at the bank holding company level for equity investments.

The comment period on each of the requests for comment recently closed. We are currently reviewing and analyzing the comments received. We plan to discuss the issues raised by commenters both with the Federal Reserve and with the other bank regulatory agencies. It is therefore premature to make any predictions as to how we will resolve any of the issues addressed in the comments.

In developing these rules, Treasury and the Federal Reserve not only relied on institutional knowledge of the financial markets, but also conducted research and broad surveys of market participants. Interviews with some of the larger financial firms engaged in merchant banking highlighted current industry practices, including holding periods, involvement in the management of portfolio companies, and monitoring and risk management systems.

The firms we interviewed clearly recognized that private equity investments often are riskier, less liquid and more volatile than other types of investments. These investments also often involve

investment in leveraged companies. Consequently, these investments require greater capital support and careful monitoring and risk management. This was consistent with what I had seen in my 18 years on Wall Street. The interim rule is meant to be consistent with industry practices in making, monitoring and managing the risks associated with merchant banking investments.

Interim Rule

The interim rule includes six main provisions:

- Holding periods for merchant banking investments. The rule generally permits a ten year holding period for direct investments and a fifteen year period for investments held through private equity funds. A longer holding period may be approved by the Board on a case-by-case basis. The maximum holding periods permitted under the interim rule are longer than current industry practice. Further, the longer periods permitted for investments held through private equity funds are intended to recognize the added market discipline that such funds bring to bear on merchant banking activities.

- Restricts routine management of portfolio companies. The interim rule implements the provisions of the financial modernization legislation that generally prohibit a financial holding company from operating a portfolio company on a day-to-day basis. The rule also describes the circumstances under which routine management is permissible and includes certain safe harbors. First, the interim rule allows a financial holding company to appoint directors without limitation, including directors that are employees of the holding company. Holding company employees who are directors can exercise all powers as directors. Second, the holding company may select the senior officers of the company. Third, through particular covenants, the holding company may require the portfolio company to obtain the approval of the holding company for certain actions outside of the ordinary course of business, such as significant changes in the business plan, redemptions of stock, or sales of significant assets.

- Establishes recordkeeping and reporting requirements. The interim rule includes recordkeeping and reporting requirements that are designed to ensure that both the financial holding company and the Board can adequately monitor the exposure of the firm and its compliance with applicable limitations.

- Restricts cross-marketing by an affiliated bank. The rule implements the restrictions of the legislation on the ability of depository institutions to cross-market with a portfolio company held by a financial holding company affiliated with the depository institutions.

- Presumption of control under section 23A. The interim rule adopts the presumption of control provided in the legislation for the purpose of applying the limits of section 23A of the Federal Reserve Act to transactions between portfolio companies and an affiliated depository institution. A financial holding company is presumed to control a portfolio company if it has an interest of 15 percent or more of its equity capital.

- Establishes transitional caps on investments. As an interim measure, the rule establishes caps on the amount of merchant banking investments that a financial holding company may make under the new merchant banking authority. Under the first cap, a financial holding company's merchant banking investments may not exceed the lesser of 30 percent of the company's Tier 1 capital or $6 billion. The second cap, which applies only to investments that have not been made through a private equity fund, limits merchant banking investments to the lesser of 20 percent of the holding company's Tier 1 capital or $4 billion. The caps may be exceeded with the approval of the Board.

It is important to note that the interim rule applies only to activities conducted under the new merchant banking authority and does not apply to investments made under previously existing authority. It does not apply to or in any way limit the ability of banking organizations to continue to use other investment authority that predates the financial modernization legislation.

Capital rule

In addition to the rule that Treasury and the Federal Reserve have jointly issued on the new merchant banking activities, the Federal Reserve has proposed, with our participation and support, a rule governing the regulatory capital treatment of equity investments in non-financial firms.

The Board's capital proposal would place a 50 percent capital requirement at the holding company level for such investments throughout a bank holding company. The capital requirement, as proposed, would apply not only to newly authorized merchant banking investments, but also to certain specified investments made under previously existing investment authorities, including equity investments made by banking organizations through SBICs and Edge Act corporations. I would like to note here that these capital requirements would not apply to investments through SBICs made by organizations that are not affiliated with a depository institution.

Given the risks of merchant banking investments, no one would suggest that it is appropriate for an institution to borrow $24 of debt, add one dollar of equity, and invest $25 in a private equity investment. This, however, is what is permitted by existing regulatory capital rules. The 50 percent regulatory capital requirement proposed by the Federal Reserve would allow financial holding companies to modestly leverage one dollar of equity with one dollar of borrowing to invest two dollars in private equity investments. The proposed requirement is half of the customary 100 percent equity capital that is raised by private equity partnerships managed by non-financial services institutions. The 50 percent requirement also is within the range of economic capital often held by financial services firms to support private equity investment.

We and the Federal Reserve have received significant comments with respect to the proposed capital requirements. Commenters have raised concerns as to the appropriate level of the capital requirement and the scope of its application with respect to investments under pre-existing authority. While Governor Meyer will discuss these issues further, I know that both the Federal Reserve and the Treasury will be considering all these comments carefully prior to publication of final rules.

Conclusion

At the present time, we continue to review the comments received on the rules and will carefully consider the important issues raised by the commenters. As we move forward, Treasury and the Federal Reserve will work closely to ensure that the new merchant banking authority is used in a way that preserves the safety and soundness of our financial institutions and the strength of our capital markets.

Thank you. I will be happy to answer your questions.

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Statement of

Laurence H. Meyer

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises

Committee on Banking and Financial Services

House of Representatives

June 7, 2000

Mr. Chairman and other members of the Subcommittee on Capital Markets, I appreciate the opportunity to explain the rules recently proposed by the Federal Reserve Board and the Department of the Treasury to allow financial holding companies to engage in merchant banking activities under the Gramm-Leach-Bliley (GLB) Act. I want to stress that part of what I'm about to discuss is only a proposal, and the rest is a rule that has been adopted only on an interim basis. The Board and the Treasury have requested comment from the public on both parts, and both are subject to review and modification in light of those comments. Our experience has been that public comments are generally very helpful, and we value the insight and information they provide from practitioners, analysts, other policy makers and informed members of the public. The public comment period ended on May 22, and the Board and the Treasury are analyzing those comments now.

As I'm sure you can appreciate, because we are in this evaluation phase I do not know what final rules will be adopted. The staff is in the process of reviewing and analyzing the comments, and both Treasury officials and members of the Board are reserving judgment until we see both a summary of the full comments and the staff's analysis. At that time, the Board will review the proposal and the interim rule in light of the comments, and both are subject to revision. In addition, the Federal Financial Institution Examination Council (FFIEC) will be discussing bank capital requirements on equity investments, a discussion that will, of course, be considered in the Board's final decision on holding company capital requirements on these assets. With these caveats in mind, the Board nonetheless believes it would be useful not only to describe what the

Board and the Treasury proposed, but also to summarize the information and analysis we reviewed in developing our proposals.

Our initial proposal was based on a considerable amount of information and experience regarding the current equity investment activities of securities firms and large banking organizations. It would allow merchant banking to continue to develop along the lines already evident in the industry and in the manner intended by the Congress. At the same time, the rule and proposal attempt to address the boundaries between merchant banking and the mixing of banking and commerce. And most important, the rule seeks responsibly to come to grips with the very real safety and soundness risks to an insured depository institution affiliate of both a financial holding company that engages in merchant banking and a bank holding company that invests in equities using existing authorities.

I. Summary of the Interim Rule and Capital Proposal

Let me first briefly explain what the Board and the Treasury have proposed. For the sake of brevity, I will sacrifice some detail. The notice published by the Board and the Treasury in the *Federal Register* explains the proposal in great detail.[1]

The GLB Act allows financial holding companies—which are bank holding companies whose depository institutions meet specified capital, management, and, for insured institutions, CRA requirements—to acquire shares, assets or ownership interests in any type of nonfinancial company. Merchant banking authority represents a broad exception to the central prohibition in the Bank Holding Company Act against the ownership of interests in nonfinancial firms. Moreover, this new merchant banking

[1] 65 *Federal Register* 16,460, 16,480 (March 28, 2000).

authority is in addition to—and does not replace—the authority that bank holding companies have under other provisions of the Bank Holding Company Act to engage in equity investment activities.

The merchant banking authority included in the GLB Act helped ensure a so-called "two-way street" for securities firms that wish to affiliate with a bank without being required to divest traditional business lines. Prior to the GLB Act, securities firms could not affiliate with a bank without terminating their merchant banking activities.

The GLB Act specifically authorizes the Board and the Secretary of the Treasury to issue regulations implementing this new authority, including limitations that we jointly deem appropriate to protect depository institutions. The interim rule and capital proposal are the result cf extensive discussions between Board and Treasury officials.

Prior to making our proposal, staff reviewed existing research and the staffs of the two agencies jointly conducted interviews at a number of major securities firms and bank holding companies in order to gather information on how the merchant banking business is conducted. We also called on our experience in supervising the more restricted investment authorities exercised by both member banks and bank holding companies, including authority to make investments through small business investment companies, authority to make investments overseas, and holding company authority to make investments in up to 5 percent of the voting shares and up to 25 percent of the total equity of any company. Our proposal incorporates many of the best practices employed by merchant banking professionals and banking organizations and, we believe, would allow securities firms to become financial holding companies while continuing to conduct their merchant banking activities.

The proposal is in two parts. The first is an interim rule that contains the framework for defining and conducting merchant banking activities. The second is the capital proposal.

A. Interim Rule

The interim rule is designed to implement the provisions of the GLB Act that were enacted in order to prevent merchant banking activities from being no different than a mixture of banking and commerce. It also supports the important objective of encouraging the safe and sound exercise of this new merchant banking authority. The interim rule:

* provides guidance on the GLB Act's requirement that merchant banking investments be held only for a period 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.

* implements the GLB Act's restrictions on the routine management or operation of a portfolio company by a financial holding company. The interim rule contains a number of safe harbors and examples of routine management and explains the types of special circumstances in which routine management is permissible.

* establishes recordkeeping and reporting requirements designed to enhance the ability of the financial holding company and the Board to monitor the risks and exposures of merchant banking investments and compliance by the financial holding company with the Act's limitations on holding periods and routine management. These recordkeeping and reporting requirements are general in design and largely could be met by the types of records and reports ordinarily kept by companies engaged in merchant banking activities.

* implements the restrictions in the GLB Act on the ability of a depository institution controlled by a financial holding company to cross-market its products or services with a portfolio company it holds under its merchant banking authority.

* adopts the presumption established by the GLB Act for applying the limits contained in section 23A of the Federal Reserve Act on transactions between a depository institution and its affiliates to transactions between a depository

institution and a portfolio company controlled by the same financial holding company.

As a transition measure, the interim rule also establishes two caps on the amount of merchant banking investments that a financial holding company may hold. The caps are high and apply only to investments made under the new merchant banking authority. The first is that the total amount of a financial holding company's merchant banking investments may not exceed the lesser of 30 percent of the financial holding company's Tier 1 capital or $6 billion. The second cap applies to merchant banking investments other than investments made by the financial holding company in private equity funds, and is the lesser of 20 percent of Tier 1 capital or $4 billion.

These caps do not apply to or limit in any way the investments made by a financial holding company under its other authorities, such as through small business investment companies. Moreover, these caps are really thresholds. The rule provides that a financial holding company may exceed these amounts with approval from the Board.

This approach allows the Board to monitor the risk management systems and exposure of financial holding companies that devote a significant amount of resources to merchant banking. We view the caps as a safe and sound way to allow merchant banking activities to begin and fully expect to revisit the need for caps as we review the interim rule and the capital proposal.

B. Capital Proposal

Perhaps the most important, but also most controversial, aspect of the proposal is the appropriate capital treatment of equity investments for regulatory purposes. This part

has been proposed for comment, but unlike the portion I just described, has not been adopted.

Our capital proposal would require bank holding companies to maintain in equity form at least 50 cents of capital for every dollar the consolidated bank holding company invests in merchant banking-type investments. Under existing capital rules, a bank holding company could hold only 4 cents of its own equity capital—that is borrow 96 cents—for every dollar invested in equity securities.

The proposed capital treatment would apply at the holding company level on a consolidated basis to the carrying value of investments made using the new merchant banking authority as well as to investments made in nonfinancial companies using other merchant banking-like investment authority.

It is to this issue of the capital charge, our reasons for proposing it and its implications that I now turn.

II. Safety and Soundness

While safety and soundness sensitivities are reflected in several components of the proposed regulation, an important aspect of the proposal to address potential safety and soundness concerns is the new capital requirement. The Board's concern about the safety and soundness of banking organizations, of course, has to be balanced against other goals of the GLB Act and we sought to do so. Nonetheless, this aspect of the proposal elicited the most comment and criticism. I believe, however, there can be little doubt about either the importance of safety and soundness or the Board's authority and responsibility in this area. We note that, in its consideration of the financial modernization legislation, Congress considered the appropriateness of capital standards at

the holding company level and did not limit the Board's authority to develop appropriate capital requirements for bank holding and financial holding companies.

A. Participation in the Equity Market by Banking Organizations

Prior to the enactment of the GLB Act, banking organizations were permitted to invest in equities to a limited extent. For example, the Small Business Investment Act of 1958 permits banks, and the Bank Holding Company Act permits their holding companies, to invest in certain *small* companies through their ownership of Small Business Investment Companies (SBICs). Banking organizations also have been authorized to match competition abroad by investing in *foreign* companies through their Edge Act affiliates and subsidiaries, and, under the Bank Holding Company Act of 1956, bank holding companies can invest in up to 5 percent of the voting shares (and up to 25 percent of the total equity) of *any* company. All of these authorizations, however, have involved limits in one form or another: on size or location of the individual portfolio companies, on the proportion of each portfolio company acquired, or on aggregate holdings.

The bulk of activity using these authorities has involved private equity investments. The private equity market is one in which transactions occur largely in unregistered shares in private and public companies. The market has grown quite rapidly in recent years and in 1999 is estimated to have had at least $400 billion outstanding. The *venture capital* component, the equity financing of new firms, had outstandings of at least $125 billion. It focuses on seed capital for the creation of new companies or equity needed for the continuation or growth of small firms. The *non-venture private equity* sector, the equity financing of middle-market firms and leveraged buyouts, is

considerably larger, with outstandings of about $275 billion. The contribution of a broad and deep private equity market to economic growth is considerable and its existence is critical to our nation's continued economic vibrancy.

Holding of Equities by Banking Organizations. Banking organizations play a modest but not insignificant role in the private equities market. Most banking organizations in fact do not make use of their existing authorities and, thus, do not participate in either the public or the private equities market. This may reflect the lack of expertise required to participate in such finance at most banking organizations, more traditional banking strategies, or the restrictions and limits placed on their participation prior to the passage of the GLB Act.

Most of the equity participation by banking organizations is concentrated in a small number of large banking organizations, whose activities are focused on the private equity market and, in some cases, whose holdings account for a significant proportion of their capital and earnings. In keeping with the small number of banking organization participants, their share of the market is small—about 9 percent to 10 percent of the private equities outstanding. Despite their limited market share, the ten U.S. banking organizations with the largest commitment to equity investments have about doubled their holdings in the last five or so years with aggregate investments currently exceeding $30 billion at carrying values. These holdings account for an estimated 90 percent of holdings by all banking organizations of private equities in nonfinancial firms. Seven of the ten largest holders each held equities with carrying values in excess of $1 billion at the end of 1999; two held more than $8 billion. Carrying values at the largest holders were equal to 10 percent to 35 percent of their Tier 1 capital and both realized and

unrealized gains on these holdings accounted for a growing share of their earnings. Clearly at some large banking organizations, holdings of stock—mainly private equities—already were large and rising before merchant banking was authorized by the GLB Act. As supervisors, equity investment by banking organizations had clearly gotten our attention well before last November.

Larger banking organizations generally employ all of the various legal authorities available to them in making equity investments. In making investments in private equity funds and direct investments, banking organizations generally use Bank Holding Company Act authorities and several institutions have made substantial international equity investments through their Edge Act affiliates. SBICs are also used substantially by larger banking organizations and by some regional and smaller institutions. There are roughly 100 SBICs affiliated with about 60 banking organizations. Although they account for only a third of all SBICs, they represent more than 60 percent of SBIC investments, about $5.25 billion out of a total of $8.75 billion. All SBICs—bank-related and others—account for about 7 percent of the venture capital market and about 2 percent of the total private equity market.

The large banking organizations active in private equity investments have considerable experience and diversified portfolios. They have, by and large, been successful—with some reporting annual rates of return in excess of 25 percent to 35 percent in recent years. For the most part, they also have been conservative in recognizing gains on their investments, discounting market valuations on traded equities to reflect liquidation realities and often recognizing increases in value on non-traded equities only by actual sales or other events. No large *aggregate* losses have been

reported on the equity holdings of these banking organizations in recent years. Of course, the last several years have also seen the longest economic expansion and largest and longest bull market in our history. Even in such an environment, however, the unusual returns have been dominated by a small number of great successes, the so-called "home runs" of the private equity business.

The attraction of banking organizations to the high returns and growing buoyancy in stock prices—especially for IPOs (initial public offerings)—has matched the growth in the entire private equity market. More private equity financing, especially venture capital financing, was accomplished in the past three years than in the previous thirty. In the fourth quarter of last year and the first quarter of 2000 almost as much venture capital was invested as in total over the previous four quarters ending in September.

Risk and Equity Holdings. Even with rising valuations, private equity is still the most expensive form of finance available. Investors in private equity securities demand high expected returns, ranging from 15 percent to 25 percent for mature firms seeking expansion capital to 60 percent to 80 percent for early stage ventures. The high hurdle rates for venture capital finance reflect the fact that the loss rates on individual deals are so high. A review of venture capital investments over the last four decades suggests that a fourth to a third of the deals resulted in absolute losses, which is why we do not see 60 percent to 80 percent returns on venture capital portfolios. The high risks that such loss rates imply are both the cause of the high issuer cost and the flip side of high average returns on a portfolio of venture capital equities. In both cases they represent risk compensation.

High returns on aggregate venture capital investments rely on those "home runs" I referred to earlier to offset the "strikeouts", if I may use an analogy. Generally, about 20 percent of investments have been "home runs" with extraordinary returns that offset the losses and mediocre returns of other investments. Evidence from 1,000 private equity partnerships developed by the firm Venture Economics suggests that over the entire period since 1969 investors received an average return of about a 20 percent annual rate, but that these returns were boosted by the explosive IPO market in the late 1990s, facilitating exit from a record number of investments by the partnerships. As with individual investments, "home runs" offset a substantial portion of "strikeouts". Median returns have averaged closer to 10 percent, and roughly one-fifth of the individual venture capital partnerships have resulted in capital losses.

Returns to such partnerships have varied widely over the years. Investors in more than 200 venture capital partnerships formed in the early 1980s, when the market was expanding rapidly, have received only about a 5 percent to 8 percent annual return on these investments. Nearly a quarter of these partnerships resulted in losses to investors. In a survey, large long-term institutional private equity investors reported that they generally expect a long-run rate of return on *private* equities of at least 15 percent, as compared to 11 percent to 12 percent for *public* equities, but some report that they expect the standard deviation of returns to be about *twice* as high—32 versus 16 percent. A "standard deviation" is a common statistical measure of variation, and measures of variation are used by economists as indicators of the degree of risk in an investment.

Any return (or losses) that banking organizations capture per dollar of portfolio equities held are multiplied significantly relative to their own investment in this part of

their business—both absolutely and relative to independent firms. That is, of course, the result of the higher degree of leverage at banking organizations. Independent venture capital operations are generally unable to leverage their holdings to any significant degree.

Banking Organization Capital and Risk Absorption. As in all businesses, the primary role of the capital of an organization is to absorb risk, i.e. loss. Without equity capital, businesses would not be able to borrow funds to finance any assets, let alone risky assets, because losses would then fall on the creditors who do not participate in the successes—the profits—of the firm. Insured depository institutions and bank holding companies, however, are required to hold as little as 4 cents of equity for every dollar of *risk* assets, although the average amount of equity actually held by all banks is about 9-1/2 percent of risk assets. The largest U.S. banks and bank holding companies have an equity-to-risk-asset ratio (Tier 1 ratio) of 7 percent to 9 percent. If assets contract in value by these amounts, the entity is insolvent; indeed, Congress requires the agencies to begin steps to close a bank when it becomes "critically under-capitalized", as defined by the Congress, which is when the tangible equity capital to total asset ratio of the bank falls to 2 percent.

A dollar contraction in asset values produces a dollar contraction in equity capital. Clearly, banking organizations have very little tolerance for risk—i.e. loss—because they hold such modest equity. Small declines in asset values would eliminate large proportions of their small equity base.

The risk of equity investments with modest equity capital backing is even greater when one considers that, under generally accepted accounting principles, a firm engaged

in equity investment is permitted to count as income a substantial portion of the increase in the value of its equity investments, even if the firm has not realized this profit by selling the securities. This increase in value—even though unrealized and subject to decline—is then permitted to count as capital for the firm and can be used to support growth of the firm. In effect, under our current capital rules, a banking organization could leverage these paper gains 25 times.

From an economic point of view, banks have been able to operate with a high degree of leverage because their creditors, depositors and others are comforted by the safety net—government guarantees of certain deposit liabilities and access to the discount window and payments and settlement systems—as well as by supervision and regulation, which is intended to ensure the safe and sound operation of the bank. In the late 1980s and early 1990s a large number of banks did in fact become insolvent because of credit losses, but historically a level of leverage that would be unacceptable in most other financial businesses has proved to be viable for banking organizations with *traditional* banking assets.

Risk and Capital. Commenters do not generally disagree with the observation that venture capital equity assets are riskier than the average banking organization asset. Nor have they generally disagreed with one of the very few, apparently immutable, laws of finance that, in the long run, the higher the nominal rate of return the greater the inherent risk of the asset. By greater risk, I mean the greater the variability of returns, and thus the larger probability of loss, for a portfolio of such assets. The thrust of the evidence the Board reviewed in developing its capital proposal, which I have described above, suggested that private equity investments carry risks that greatly exceed those of average

banking organization assets. Moreover, the Board was concerned that the level of this higher risk has become increasingly inconsistent with the minimum requirements of the current Basel capital Accord, particularly as the amount of such investments has risen sharply in an environment of substantially rising equity valuations. Our review of the merchant banking authority brought this general issue to the fore for equity assets purchased under *all* authorities, not just the new merchant banking authority.

As part of our review, supervisors and economists from both the Federal Reserve and the Treasury, with whom we share rule-making authority on merchant banking, met with banking organizations and securities firms active in the private equity business to review best practices. These interviews indicated that *both* sets of firms allocated very high levels of internal or economic capital to their private equity business—between 25 and 100 percent, with the median above 50 percent. That is to say, the practitioners' own experience and the resultant policy they followed internally was to assume that the risks were such that they should presume they might lose all or a significant share of their investment and should prepare for that eventuality. That practice seemed consistent with the evidence we reviewed, particularly given the current valuations placed on equities relative to historical norms.

That practice was also consistent with the experience of those firms that provide the dominant volume of the private equity market investment. At least 75 percent of the private equity funding is provided by independent firms that manage limited partnerships, raising funds from pension funds, endowments, foundations, corporations, and wealthy individuals. Their equity holdings are essentially balanced dollar-for-dollar with the owner/investor's own *equity* investment, with virtually no debt financing.

We also looked at the practice of other government agencies. The Small Business Administration limits the *subsidized* borrowing of non-bank SBICs from it to three times equity. In addition, the Securities and Exchange's net capital rule for securities broker-dealers generally requires the firm to deduct from its regulatory capital 100 percent of the carrying value of the firm's private equity investments, a rule that induces these firms to shift their holdings to non-regulated affiliates.

In view of their similarity, the Board did not distinguish in its proposal the risk of a venture capital investment made under the new merchant banking authority from that made under other authorities. By and large, the nature of most major banking organizations' existing equity investments are similar to those made by non-bank venture capitalists and are similar to those likely to be made under merchant banking powers. The high average returns to these investments—by suggesting their riskiness (recall the iron law that high return *means* high risk)—also suggested we seek comment on the need for a higher commitment of equity capital for all portfolio equity assets at banking organizations.

Consequently, we proposed a 50 percent capital requirement on portfolio equity investments held under any authority at any location in a bank holding company. This proposal is subject to review in light of public comments.

B. Comments about the Capital Proposal

Indeed, as mentioned at the outset, the Board is now reviewing and evaluating the comments on its proposals. My colleagues and I have not seen all of the comments or heard the staff's evaluation of them. We are not committed to any conclusion or decision at this time. Nonetheless, the objectives of the Subcommittee, as I understand them,

would not be met if I did not try to highlight the major issues as they seem to be unfolding. Please keep in mind the caveats I just noted as I try to do so.

Rating Agencies. Each of the two major rating agencies—Standard & Poor's and Moody's—has issued reports discussing banking organizations' private equity activities since the Board published its capital proposal. Standard & Poor's concluded that the proposed 50 percent equity support appeared to be about right "if the bank's portfolio is mature and diversified; less diversified portfolios could need up to 100 percent." It also noted that the heavy regulatory claim on capital for banking organizations active in private equity markets would have "no rating implications" "because Standard & Poor's ha[s] historically allocated this level of capital" to the equity investment activities of banking organizations.

Moody's noted that venture capital activities are "capital-intensive" and that it believed "that it is prudent for venture capital activities to be funded with a high equity component...If the bank is taking on significant fixed income obligations to fund an equity investment, we have further concerns." It concluded that "Moody's sees the recent Treasury and Fed proposal requiring U.S. banks to set aside capital equal to 50 percent of a bank's venture capital investments...as being supportive of bank ratings."

Economic vs. Regulatory Capital. In reviewing the capital proposal, the Board will have to consider a critical comment raised regarding the distinction between regulatory and economic capital. All parties generally agree, as I have noted, private equity is a risky asset. There is, as I also noted, substantial evidence that, in general, both the firms engaged in private equity investing and the rating agencies internally or analytically allocate at least as much capital to such assets as the Board has proposed.

That is, the economic capital applied to these assets for internal risk and other purposes already exceeds the regulatory capital by a wide margin, a margin that is not exceeded by our proposal.

However, commenters have argued that there would be considerably less difficulty with the proposed *regulatory* capital treatment for equities if the authorities permitted a *regulatory* capital treatment for the *rest* of a banking organization's assets that was consistent with the "real" or *economic* risk on those assets. This argument rests on the assumption that the *regulatory* capital on a significant volume of banking organization assets exceeds their *economic* charge and that, therefore, the *sum* of a higher *regulatory* capital on equities and the existing *regulatory* capital on all other assets would exceed the total *economic* capital on all the assets. The commenters that have raised this issue have argued the Federal Reserve has engaged in "cherry picking"—picking out the risky assets for higher capital charge without providing relief for the lower risk assets. They have urged the Board to wait until there is broader reform in the Basel Accord that would presumably address these concerns. The reforms underway in the Accord are, in fact, seeking to make bank regulatory capital charges more risk-sensitive and consistent with the "true" underlying economic risk at individual institutions. The U.S. banking agencies are aggressively promoting these efforts in discussions with other G-10 countries at Basel.

I remind you again that the Board has not discussed this particular comment yet, although similar issues have been raised in other discussions of capital more broadly. It may be better, as some commenters suggest, to deal with *all* the capital issues at one time. However, we face a practical problem. Private equity holdings are large and

growing rapidly now, and the restraints on further growth are being relaxed. Meanwhile, practical reform of the Basel Accord is at least three years in the future.

As the Subcommittee knows, policy-making requires trade-offs and we are going to have to balance the facts and considerations I have just noted. In doing so, however, we must also consider another variable in our deliberations, namely the undermining of the *regulatory* capital structure through so-called capital arbitrage.

Essentially, the regulatory capital framework now groups or "buckets" all banking assets into four risk categories for determining their capital charge—with most falling in the full-weight category that gets the 4 percent minimum Tier 1 charge mentioned earlier. Banking organizations in recent years, however, have developed methods to move off their balance sheets those assets whose *economic* risk—as determined by the market—implies an economic capital charge that is less than the regulatory capital requirement. That is, they have avoided a one-size-fits-all average regulatory capital requirement whenever that charge is above the market's risk evaluation on a specific set of assets, retaining those assets whose economic capital is equal to or higher than the regulatory requirement.

The Federal Reserve and the other banking agencies have not sought to block these transactions. Rather we have all recognized the market reality that the current regulatory capital requirements imply that banking organizations have two choices. The first is to simply stop extending certain low-risk credit because the regulatory capital requirement is too high. The second choice is to extend such credits coupled with market transactions that, by equilibrating the amount of capital required with that consistent with the real economic risk, permit the credit extension to be both safe and profitable. We

have, in short, permitted capital arbitrage whenever the banking organization can meet the market test.

Capital arbitrage means, however, that the resultant *regulatory* capital ratios for some banking organizations are biased upward. That is, the average retained assets are, on average, more risky and thus the same capital ratio as before does not represent the same degree of capital strength. Put differently, banking organizations engaging in capital arbitrage have already removed from their balance sheets a large number of those assets whose economic capital charge is less than their regulatory capital requirement. These banking organizations, that is to say, have already engaged in a form of cherry picking to *lower* their capital charges and thus have fewer low-risk on-balance sheet assets subject to full capital charge. It is difficult to estimate the capital "savings" made by these institutions from capital arbitrage and compare it to the potential "cost" of higher regulatory capital on equities. The measured value of the latter may exceed the former. Nonetheless, capital arbitrage is surely one of the variables we will consider in the final decision making process.

A related issue in interpreting distinctions between economic and regulatory capital is banking organizations' desire for *excess* regulatory capital. It appears clear that banking organizations want to hold a level of capital above the regulatory minimums, in part to assure they can retain the imprimatur of being classified as "well-capitalized" in the event of losses; and in part to receive higher ratings from the rating agencies and a lower cost of funds from the market. Thus, commenters were not assuaged by the observation that even after the imposition of the proposed capital charge on equities, all the banking organizations with significant equity holdings that are now "well-capitalized"

on a regulatory basis would remain so, and would have the ability to acquire additional equities and still remain "well-capitalized". Their focus and concern is the reduction in the margin by which they would be "well-capitalized".

Congressional Intent. Several commenters have argued that the Board's proposals are inconsistent with several stated congressional objectives: (1) facilitating small business venture capital equity finance, especially through SBICs; (2) permitting securities firms to become financial holding companies (the "two-way street"); and (3) the desire to avoid imposing bank-like regulation on the nonbanking activities of financial holding companies ("Fed-lite").

As noted earlier, the Small Business Investment and the Bank Holding Company acts permit banks and bank holding companies to invest in and operate SBICs with the special objective of easing access to venture capital by smaller firms. Some commenters have argued that higher capital requirements may blunt this effort. The Board must evaluate the potential impact of its capital proposal on the financing of small businesses through SBICs. An important question is whether a higher *regulatory* capital charge would, in fact, significantly reduce the commitment of banking organizations to SBIC finance. Banks tell us they already have an *internal* capital hurdle at least as high as the proposed regulatory charge, and in applying the charge we understand they make no distinction about the authority under which, or where in the organization, the shares are held. Moreover, a reduction in their investments—if it did occur—might not be a significant factor in total venture capital finance for small businesses, since banking organization-related SBICs account for only about 6 percent of all venture capital finance. Nonetheless, the comments require that we review the SBIC issue again.

Any observer of the negotiations leading to enactment of the GLB Act is aware of the importance placed on both the "two-way street" and "Fed lite". Some commenters argued that the proposed capital charge will make it difficult for securities firms to become financial holding companies by requiring that, as soon as they acquire a bank, they meet higher regulatory capital requirements on the equity investments already held by the firm. In developing the proposal, however, we tried to carefully evaluate this issue, including whether the internal capital charges securities firms told our staff they used represent a calculation of the risks associated with equity investment activities or are just used for internal management decision-making purposes but not for risk management. We will review this issue again in light of the comments.

An area where commenters have suggested that we may not have been consistent with our commitment to "Fed-lite" is the quantitative limit or cap on aggregate holdings of equities by banking organizations. Our thinking, admittedly similar to our historical stance, is to be cautious in new activities until we have become more comfortable with how banking organizations manage their positions. We followed such an approach with section 20 affiliates. Recall that merchant banking activities have been authorized to begin while the capital rule is simply proposed. Thus, financial holding companies—two-thirds of which are below $1 billion in consolidated assets—could begin to acquire potentially large amounts of risky assets before being required to hold an appropriate amount of additional capital to support these investments. Moreover, we chose a cap that we felt was unlikely to bind on any present participant any time soon and that, in any event, we could relieve on a case-by-case basis if appropriate. Our objective in the

proposal was to err on the side of caution, particularly for new participants, and to consider eliminating the cap in connection with the development of a final capital rule.

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The commenters raised important questions and the Board will carefully evaluate them and modify its proposal and interim rule where necessary and in the public interest.

TESTIMONY OF
MARC E. LACKRITZ
PRESIDENT

SECURITIES INDUSTRY ASSOCIATION

BEFORE
THE SUBCOMMITTEE ON CAPITAL MARKETS
OF THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON CAPITAL MARKETS AND THE NEW ECONOMY

June 7, 2000

Chairman Baker and Members of the Subcommittee, I am Marc Lackritz, President of the Securities Industry Association ("SIA"). I appreciate the opportunity to appear before you today to present SIA's views on the merchant banking rules issued by the Federal Reserve Board ("Fed") and Treasury Department ("Treasury").

SIA commends Chairman Baker and the Subcommittee for holding these important hearings. SIA has great respect for the Fed and Treasury and their dedicated staffs, but these rules have serious ill effects that could not have been intended. We are optimistic that these hearings will serve to encourage the agencies to develop and adopt merchant banking rules that do not have such adverse consequences; that foster rather than hinder the flow of capital to small and mid-sized companies; and that permit full, fair and effective competition in the capital markets by all of the participants in an integrated financial services industry. SIA looks forward to working with the Members of the Subcommittee, their staff, and the Fed and Treasury to achieve these results.

SIA brings together the shared interests of more than 740 securities firms, investment banks, broker-dealers and mutual fund companies 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. SIA believes that its membership and focus enable it to offer the Subcommittee a unique perspective: SIA would like to give the Subcommittee the securities industry's view of the merchant banking rules.

The securities industry believes that these rules -- and, in particular, the 50-percent capital charge on merchant banking investments, the total cap on merchant banking activity and the maximum holding period for venture capital investments -- will have a significantly adverse effect on the ability of securities firms within financial holding companies ("FHCs") to make merchant banking and other permissible investments on the same scale and to the same extent as securities firms that are not part of a FHC family. Because merchant banking is such an important part of the business of many securities firms, the existence of these rules will deter many firms from partnering with banks and becoming FHCs.

I. General Concerns with the Fed's and Treasury's Merchant Banking Rules

One of the most historic and important aspects of the Gramm-Leach-Bliley Act ("GLB Act") was the establishment of a "two-way street" in the financial services industry. That "two-way street" was designed to enable securities firms and banks to affiliate freely with each other and to ensure that securities firms, once they become partners with banks, are not artificially restricted in their activities.

To advance this "two-way street," and in recognition of the essential role that merchant banking plays in modern finance, Congress expressly authorized securities firms affiliated with FHCs to engage fully in the business of merchant banking. In fact, Congress emphasized that securities firms that affiliate with FHCs are to be permitted to continue their merchant banking activities in substantially the same manner as at present. Congress also placed specific statutory restrictions on the merchant banking activities of securities firms that affiliate with FHCs to safeguard against the potential risks that poorly run merchant banking programs could pose to those FHCs.

SIA believes that the Fed's and Treasury's merchant banking rules impose restrictions and limitations on merchant banking activities that go well beyond what Congress authorized in the GLB Act and that destroy the "two-way street" that is at the very core of the Act. For example, the 50-percent capital charge and the aggregate investment limit on merchant banking investments are artificial restrictions that are nowhere found in the GLB Act. These restrictions, which are not consistent with industry practice, were never contemplated by Congress in its extensive deliberations on the merchant banking powers of FHCs. Other aspects of the rules -- such as the rigid maximum holding period on merchant banking investments -- are plainly at

odds with the more flexible approach that Congress specifically directed the Fed and Treasury to take.

These limits on merchant banking activities are entirely foreign to securities firms that are unaffiliated with banks. Consequently, these limits place securities firms that are part of FHC families at a competitive disadvantage by artificially restricting their merchant banking investments and by making it prohibitively more expensive for them to provide venture capital to entrepreneurs and growing companies. For this reason, many securities firms will be discouraged, and some effectively barred, from acquiring banks and becoming FHCs. This outcome is plainly at odds with what Congress intended when it authorized full merchant banking powers for securities firms affiliated with FHCs. In short, rather than opening the "two-way street," the merchant banking rules recreate the very sorts of roadblocks to an efficient and integrated financial services industry that the Members of this Subcommittee and others in Congress worked so hard to eliminate with the repeal of Glass-Steagall and the enactment of the GLB Act.

In fairness, the Fed and Treasury may not have comprehended the ill effects of their rulemaking. The preamble to the merchant banking rules indicates that, based on informal interviews with securities and banking firms, the Fed and Treasury thought that their rules largely formalized existing industry practice. Unfortunately, this is far from the case. Let me be clear on this point: the merchant banking rules are simply ***not*** in accord with prevailing securities industry practice.

SIA's experience is that merchant banking practices are far more diverse than the Fed and Treasury have recognized and that, as a consequence, the rules do not accurately reflect those varied and prudent practices. To cite but one example, the Fed has proposed a uniform 50-percent capital charge on all merchant banking investments because it believes that securities firms and others typically maintain higher internal capital positions to support their merchant banking activities. SIA's experience is that while some securities firms do indeed maintain higher capital levels for merchant banking positions, those levels vary significantly from firm to firm and, even within the same firm, from investment to investment depending on an array of factors. Thus, the securities industry's practices do not support or justify the application of a single 50-percent capital charge on all venture capital positions.

The Fed and Treasury also indicated in the rulemaking that they believe that the restrictions they have placed on merchant banking activities are warranted due to the risks posed by this business. The agencies neglect, however, the successful record of the financial services industry participating in the merchant banking business. In fact, it was Chairman Greenspan who noted in a speech only a few weeks ago that banking organizations (including those securities firms that are affiliated with bank holding companies) have engaged in merchant banking and other investment activities for several decades, through both bull and bear equity markets, without significant problems. This successful record was achieved precisely because firms have developed extensive internal controls and management information systems for making, managing and monitoring their venture capital investments. Such established, prudent and time-tested policies and systems should not be disturbed by new rules that inflict arbitrary limits on the amount firms may invest, on how long firms may hold their investments and how these investments may be counted against regulatory capital.

SIA recognizes that the Fed and Treasury have legitimate concerns about the potential conduct of merchant banking activities by some FHCs and that the agencies therefore bear a responsibility to foster the development of merchant banking practices by subsidiaries of FHCs that do not threaten the safety and soundness of financial institutions. Yet, the instant rules -- which treat all FHCs alike regardless of their expertise and experience with venture capital and merchant banking investments -- will have the perverse effect of actually increasing, rather than reducing, the risks of merchant banking activities. To explain, the capital charge and other aspects of the Fed's and Treasury's rules raise significantly the cost of making merchant banking investments; those increased costs, in turn, will pressure securities firms affiliated with FHCs to make riskier investments in search of potentially greater rates of return necessary to offset the new capital charge and other costs associated with these rules. In addition, by applying the capital charge and other restrictions across-the-board to all investments made by an institution, securities firms do not gain incentives to manage or monitor more carefully their portfolio investments -- no matter how conservative or risky an investment is, firms will be required to set aside the same capital charge.

SIA believes that the Fed's and Treasury's safety and soundness concerns can be better addressed through the Fed's ample supervisory authority over FHCs and with rules that specifically implement the statutory limits that Congress crafted in the GLB Act and that are,

thus, far less intrusive and restrictive than what has been set forth in the current rulemaking. Such a course would allow the Fed to differentiate poorly managed firms from others and to focus their supervisory authority on those poorly managed firms; would encourage and reward institutions that develop sound internal merchant banking practices; and, perhaps most importantly, would be consistent (in a way that the current rulemaking is not) with the authority vested by Congress with the Fed and Treasury to adopt rules that promote the creation of a true "two-way street" in the financial services industry.

SIA has submitted a detailed comment letter to the Fed and Treasury urging them to reconsider various aspects of their merchant banking rules. A copy of that comment is attached to my testimony, and I will not repeat all of the points made in that letter here. Instead, I would like to touch on those parts of the merchant banking rules with which SIA has the greatest concerns.

II. The 50-Percent Capital Charge

For SIA, in several respects, the Fed's 50-percent capital charge is the most troublesome aspect of the merchant banking rulemaking. The capital charge increases by *eight-fold* the amount of capital required to be retained for merchant banking investments. To highlight this point, a simple example may be helpful. Let us say that a FHC with $500,000 of risk-based assets and a 6% Tier 1 capital ratio decides to make a merchant banking investment of $50,000. Under the current capital rules, that FHC would need to add $3,000 (6% of $50,000) of Tier 1 capital to maintain its current 6% Tier 1 capital level. Under the Fed's proposed rule, the FHC's risk-based assets would remain at $500,000 after its investment, but the FHC would need to deduct $25,000 (50% of its investment) from its Tier 1 capital. That means, in order for the FHC to maintain its 6% Tier 1 capital level, the $25,000 that was deducted would need to be replaced. This $25,000 replacement is over 8 times the $3,000 in additional capital required under the current rules.

In addition, the capital charge applies not only to new investments made pursuant to the GLB Act but also retroactively to pre-existing investments that have been made by bank holding companies under long-standing statutory authority. It is clear that the capital charge will increase the cost of merchant banking and other nonfinancial investments to securities firms that have partnered with banks and, thereby, disadvantage these institutions as compared to securities

firms that are unaffiliated with banks, which are not required to hold excess capital in the fashion mandated by the Fed.

One of the Fed's principal defenses of the capital charge is that some securities firms, as part of their internal risk modeling, apply high capital charges to their equity investment activities. First, as noted above, SIA's own experience indicates that a 50-percent capital deduction is by no means universally applied. Second, even if it is correct that some securities firms do maintain higher capital levels for equity investments as part of their internal models, those internal models also apply lower capital charges to other assets, which the firms regard as comparatively safe. The Fed's approach does not leave room for such common, necessary and wise adjustments. SIA respectfully submits that it is inappropriate for the Fed to extract a single part of an *internal securities* capital model and to inject it out of context in an entirely different arena -- to mandate a *bank regulatory* capital requirement.

The Fed erroneously believes that the capital charge is of no practical significance because FHCs and bank holding companies will remain well capitalized even after application of the capital deduction on merchant banking investments. Thankfully, most institutions may not fall from well-capitalized status by imposition of this rule, but objections to the capital deduction are not a mere academic exercise. Institutions typically need to maintain higher internal capital to preserve a cushion above their regulatory capital requirements. That cushion serves a variety of purposes, including providing protection from unanticipated events. A mandatory increase in the required regulatory capital for merchant banking does *not* eliminate the need for institutions to maintain a cushion above their regulatory minimums. Thus, the proposed capital charge will require FHCs and bank holding companies to increase their capital levels, which will distort their earnings, stock prices and possibly debt ratings, and will be detrimental to the ability of securities firms affiliated with such FHCs and bank holding companies to supply venture capital to small and mid-sized businesses.

Despite these real business and economic consequences, consideration of some form of extraordinary capital treatment for merchant banking investments (albeit, treatment that is less draconian than the proposed 50-percent charge) might have been warranted if the Fed perceived some industry-wide problem with respect to merchant banking activities. Yet, the rulemaking does not indicate that the Fed has found any such issues or problems, and SIA submits that there are none. Instead, the Fed applies the charge as a preemptive measure to safeguard against the

mere possibility of excessive risk by some institutions. SIA believes that it is wrong for the Fed to impose such a harsh charge on an entire industry without any evidence of inadequate practices or inappropriate internal controls, especially when the effect of this charge is to chill merchant banking investment activities, to undermine the statutory authority for FHCs to engage in merchant banking and to destroy the GLB Act's "two-way street."

The better approach to safeguard against the possibility of excessive risk is through the Fed's supervisory authority -- as umbrella regulator of FHCs. Specifically, the Fed could use flexible standards and rely on the very internal capital models that it cites in the rulemaking. Such an approach would require FHCs to maintain internal capital for equity investments but allow that capital level to vary according to such factors as the size and nature of the investments made; the size of the overall venture capital portfolio; and the extent of the securities firm's experience with merchant banking activities. Such a flexible approach would, indeed, be in line with industry practice (in a way that the Fed's 50-percent charge is decidedly not) and would address the Fed's safety and soundness concerns. Through the supervisory process, the Fed should monitor the internal capital models applied by individual institutions to ensure that the models appropriately account for the risks of the firm's merchant banking activities. If a FHC fails to develop and maintain an adequate internal capital model, then that institution may be subjected to an additional special capital charge.

III. Maximum Investment Cap

Securities firms also are gravely concerned about the aggregate investment limits or caps placed on the total merchant banking investments made by FHCs. Such caps -- which are nowhere to be found in the GLB Act -- are based on the lesser of a fixed dollar limit ($6 billion or $4 billion, after excluding private equity fund investments) or a set percentage of Tier I capital (30 percent of Tier I capital or 20 percent, after excluding private equity investments).

SIA finds several aspects of these caps to be highly objectionable. First, the Fed and Treasury provide no explanation in their rulemaking as to why they believe percentage or dollar limits set at these levels are appropriate. These limits appear to be entirely arbitrary and certainly do not reflect the securities industry's past practice in making merchant banking investments.

In addition, the $6 billion flat dollar cap unfairly penalizes securities firms with large investment banking operations -- even those companies that have plenty of Tier I capital to

support those venture capital programs. For example, under this dollar cap, a bank-affiliated securities firm with $60 billion in Tier I capital will hit the flat dollar limit at the same time as another firm that has less than half that amount in Tier I capital. SIA submits that the two institutions do not warrant the same regulatory treatment.

Furthermore, a percentage cap that is based on the carrying value of equity investments -- as is the case in the agencies' rule -- has the further perverse effect of penalizing firms with *successful* merchant banking programs. Another example illustrates the point: If two securities firms have invested the same amount of money in merchant banking, the firm with a strong merchant banking program, whose portfolio has shown significant gains, runs the danger of hitting the cap. The other firm, with a poor merchant-banking program that has achieved only losses, will not hit the cap and can continue making additional merchant banking investments. This is not a sensible result.

SIA also believes that the dollar limits are set at such a low level that securities firms with significant merchant banking operations will quickly reach -- or, in some cases, may have already passed -- the regulatory limits and, then, will be automatically precluded from further merchant banking investments if they become FHCs or prohibited from merging with other firms. Securities firms with significant merchant banking activities are not likely to take any chance of running into this type of barrier to their investment banking and venture capital business; rather, they may merely avoid affiliating with banks or becoming FHCs. In much the same fashion, a FHC with significant investment banking business may be prevented by the regulatory limits from acquiring a securities firm that also engages in significant venture capital activities. In this case, the caps would have significant antitrust consequences and would defeat the "two-way street."

IV. Maximum Holding Period

The maximum holding period on FHC merchant banking investments also has raised strong objections from the securities industry. The merchant banking rules generally permit FHCs to hold merchant banking investments for a period of up to 10 years. The Fed and Treasury allow a longer holding period only in extraordinary circumstances, with prior approval and subject to a 100-percent capital charge.

As an initial matter, SIA believes that the imposition of an across-the-board maximum holding period is inconsistent with both the plain meaning of the GLB Act and its unambiguous

legislative history. The GLB Act requires only that a merchant banking investment be held for no longer than such period of time as will allow the sale or disposition of the investment, consistent with its financial viability. What the GLB Act specifically avoids is placing a pre-set time limit on how long investments may be held. The legislative history makes it even clearer that Congress intended the holding period for an investment to be flexible and left within the discretion of the FHC. For example, the House-Senate Conference Committee explicitly noted that the decision to dispose of an investment should be made by a FHC -- and not its regulators -- on the basis of a variety of business and economic factors.

On this basis, SIA submits that the GLB Act was not intended to permit the Fed and Treasury to impose a pre-set limit on how long investments may be held. SIA also believes that there is no statutory basis for the requirement that the Fed approve applications to hold an investment beyond the 10-year limit. In fact, this "application" requirement is contrary to the entire approach in the GLB Act, which is designed to do away with applications and prior requests to the regulatory agencies to engage in permissible financial activities. Furthermore, the truly draconian capital charge of 100-percent that applies to investments held beyond the prescribed time limit is unjustifiably punitive and also should be eliminated. With all due respect to the agencies, SIA believes that there is no valid reason for such a charge to apply merely because a FHC could not dispose of a *bona fide* merchant banking investment within an arbitrarily determined amount of time.

SIA submits that the maximum holding period will have undesired safety and soundness effects. The holding period will pressure securities firms affiliated with FHCs to dispose of investments prematurely at a price below true value just to avoid the regulatory burdens and capital hits imposed by this rule. SIA's experience is that investments may be held for 10 years or more if there are circumstances that prevent their profitable sale or disposition. SIA believes that, when unusual circumstances require a FHC to hold an investment for more than 10 years, it is counterproductive and unsafe for the Fed and Treasury to impose rules that force a FHC to abandon that investment merely because some pre-set time period has been reached. Such an outcome is plainly not in the best interest of FHCs, their shareholders, the public, or the regulators.

V. Private Equity Funds

Finally, the Fed's and Treasury's rulemaking distinguishes between direct investments of FHCs and investments made through private equity funds. The rules impose fewer restrictions and limits on portfolio investments made through private equity fund vehicles. SIA supports, and believes quite appropriate, the decision to treat investments made through private equity funds differently from direct investments.

SIA believes, however, that the definition of private equity fund adopted by the Fed and Treasury is far too narrow and does not reflect the economic and business realities of how such funds are currently operated. Our experience indicates that most private equity funds will not meet the stringent definitions adopted by the agencies. For example, the agencies' definition restricts private equity funds to 12-year terms (with a maximum of three annual extensions thereafter). SIA's experience is that the tenure of private equity funds is often not limited to 12 years. In addition, the Fed and Treasury have stated that a qualifying private equity fund must be held by at least 10 investors that are unrelated to the FHC. Again, we believe that the 10-investor requirement does not reflect securities industry practice; indeed, SIA's experience is that private equity funds often have fewer than 10 investors.

SIA submits that the narrow definition of private equity fund and the various other restrictions imposed on such funds by the rules are not justified on legitimate safety and soundness grounds. In fact, the imposition by the Fed and Treasury of record keeping, reporting and other requirements on private equity funds will significantly affect the operations, cost and performance of these funds. The net result may well be to chill private investor interest in bank-affiliated private equity funds and, thereby, force securities firms affiliated with FHCs to make more direct investments. This is the exact opposite result from what the Fed and Treasury should hope to achieve because investments made through private equity vehicles inherently raise fewer regulatory concerns due to the presence of outside investors who impose significant market discipline on investments made through such funds.

VI. Conclusion

The securities industry believes that full merchant banking authority is one of the most important new powers in the GLB Act for securities firms affiliated with FHCs. SIA submits that the restrictive posture taken by the Fed and Treasury in their merchant banking rules undermines the authority granted by Congress to FHCs and endangers the financial services reform born of years of painstaking effort by the Members of this Subcommittee, others in

Congress, the Fed, the Treasury and industry participants. SIA hopes that these hearings will result in the Fed and Treasury taking a different tack -- one that relies more on the Fed's supervisory authority. SIA looks forward to working with Congress and the regulatory agencies to craft new merchant banking rules that advance the goals of financial services reform and safeguard safety and soundness to FHCs and their affiliated depository institutions.

Our comment letter to the Fed and Treasury, which is attached, provides more detail on the issues I have touched on, and also addresses other provisions in the rules that concern SIA. Chairman Baker and Members of the Subcommittee, SIA thanks you for holding these important hearings.

HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE –

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES
HONORABLE RICHARD H. BAKER, CHAIR

JUNE 7, 2000

CONGRESSIONAL TESTIMONY

BY

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Chairman Baker, Ranking Minority Member Kanjorski, committee members, thank you for allowing me, Harry C. Alford, President/CEO, National Black Chamber of Commerce, Inc. the opportunity to speak before you concerning the proposed rule changes R-1065 and R-1067 for Merchant Banking Capital Requirements.

The National Black Chamber of Commerce was incorporated in Washington, DC in May 1993. Today, we have established an infrastructure of 185 affiliated chapters located in 36 states and 6 nations. We have direct reach to 64,000+ business owners and are the largest Black business association in the world. Having completed the task of building a viable infrastructure, we are now focusing on key issues that affect entrepreneurs in our communities. All surveys and studies reveal that the key issue concerning small businesses, and Black-owned businesses are no exception, is Capital Access.

There is a great lack of capital access for small businesses and the need to increase the channels or opportunity pools is ever present. We need more capital! It is the lifeblood for business start up and business development. Any action or condition that lessens capital access is a threat to jobs, healthcare, education and even national security. Small business drives this economy and the "nutrient" of capital access is always the great variable in the success ratio of such entities.

On March 17, 2000, the Board of Governors of the Federal Reserve Bank and the Secretary of the Treasury issued joint regulations relating to the merchant banking provisions of the Gramm-Leach-Bliley Act. The proposed rule relating to the capital adequacy of Bank Holding Companies (BHC's) and Financial Holding Companies (FHC's), if enacted, would limit the overall amount of merchant banking activities BHC's and FHC's might engage in, including investments in Small Business Investment Companies (SBIC's). SBIC's were created by Congress to provide venture capital financing for small businesses. In addition to Congress, this administration has supported SBIC's as an instrument for job creation in low to moderate-income areas. These two rules could counter the intent of Congress and the vision of this administration by significantly slowing down the activity and amount of investment in such venture capital pools.

The proposed rule changes would unjustly require BHC's and FHC's to deduct 50% of the total carrying value of their merchant banking investments, including SBIC investments, from their Tier 1 regulatory capital for purposes of calculating both their "risk-weighted capital ratio" and their "leverage capital ratio". The net result of the proposed capital adequacy rules would be to increase the percentage of equity capital BHC's and FHC's must have to support SBIC investments from 8% to 50%. This would be a 525% increase in the equity capital charge BHC's have traditionally incurred when making investments in SBIC's. The proposed stringent capital requirement will work as a strong deterrent for FHC's and BHC's who might otherwise continue to invest in SBIC's.

Traditionally, regulators have used such requirements to deter bad practices such as predatory lending. Significantly raising the charge offs scares investors. Thus, we are

quite shocked at this practice now being applied to mainstream investment pools that fuel the development for small business and create jobs by the thousands. The 106th Congress will be recorded as the session that promoted small business investment and inner city renaissance. In the era of New Markets initiative, American Renewal Act and other new pieces of ingenuity, these proposed rule changes have the affect of being the "sole fly in the buttermilk". We strongly urged this committee and the 106th Congress to use its powers to squash this direct threat to the SBIC program.

In addition to the SBIC threat, the proposed rules would greatly decrease the opportunities that banking institutions may have in meeting their Community Reinvestment Act (CRA) obligations. The rules would take away a key tool to investment in low to moderate-income areas, which the SBIC program provides.

In conclusion, we feel these rules would undermine Congressional intent and cause great harm to our constituency. All who believe that capital access is important to business development and job creation should oppose them.

Thank you so much for your precious time.

NASBIC
America's Small Business Partners

Statement
of
Lee W. Mercer

National Association of
Small Business Investment Companies

Before The

United States House of Representatives

Committee on Banking and Financial Services
Subcommittee on Capital Markets, Securities
&
Government Sponsored Enterprises

June 7, 2000

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Chairman Baker, Mr. Kanjorski, and members of the committee:

My name is Lee Mercer. I am president of the National Association of Small Business Investment Companies (NASBIC). NASBIC is the nonprofit association that has represented the SBIC industry since Congress passed the Small Business Investment Act of 1958 establishing the SBIC program. NASBIC works with Congress to provide the information it needs to draft well-conceived SBIC legislation and with the Executive Branch (primarily SBA) to help develop reasonable operating regulations for SBICs. NASBIC also produces educational programs (e.g., the Venture Capital Institute) and publications designed to help SBIC managers and others in the venture capital industry gain the knowledge and skills required to invest successfully in small private businesses. Finally, NASBIC works with the news media and others to ensure that information published about the SBIC program is as complete and accurate as possible.

On behalf of the members of our association, I thank you for the opportunity to appear before you to present our views on the merchant banking capital requirement proposed by the Federal Reserve Board (the Board), in consultation with the Secretary of the Treasury (Treasury) in Dockets R-1065 & R-1067. We believe that the proposed capital requirement would have substantial adverse consequences for both bank-owned SBICs and those SBICs that have or are seeking banks as minority investors in their funds. We believe the Board and Treasury acted precipitously and against the weight of existing facts and congressional intent by stipulating that the proposed regulation should be applicable to bank investments in small business investment companies (SBICs). We believe that both the facts and congressional intent related to the SBIC program support the proposition that bank investments in SBICs should be exempt from the requirements of the proposed regulation.

SBICs represent a major source of critical venture capital for thousands of U.S. small businesses. In FY 1999 alone, SBICs invested $4.2 billion in U.S. small businesses. Importantly, 53% of that total was invested in companies in business for three years or less. The average number of employees in an SBIC-financed company was 158; the median number of employees was 27.

Bank-owned SBICs accounted for $2.9 billion (68%) of the $4.2 billion total. Currently, 101 bank-owned SBICs hold $5.3 billion in capital assets—61% of the total $8.73 billion in private capital invested in all SBICs. Additionally, banks are increasingly important investors in independent SBICs, having provided 25% of the $1.76 billion in private capital held by all independently managed SBICs licensed in the past 2.5 years.

The average investment for bank-owned SBICs in FY'99 was approximately $3.6 million; the more important median was approximately $1 million. For non-bank SBICs, the FY'99 average investment was approximately $660,000; the median was approximately $400,000. In the private equity industry as a whole, the average 1999 venture capital deal-size in was about $7 million and the median approximately $4 million.

The $4.2 billion in total SBIC investments was only about 10 percent of total venture capital investments. Of great importance, however, is the Small Business Administration (SBA) estimate that the total 3,096 SBIC transactions represented approximately 50% of the number of

venture capital transactions in the United States during that 12-month period. Bank-owned SBICs alone accounted for 798 (26%) of the 3,096 total investments made by SBICs in FY 1999. These statistics prove that SBICs—for which bank capital is such an integral part—are a critical source of venture capital for U.S. small businesses whose requirements have yet to reach the level that would attract the interest of non-SBIC venture capital funds. If thought of in terms of a pyramid, the SBIC program is the wide base—in terms of a great number of smaller-sized transactions—that supports thousands of small businesses that are started each year. Without that base, the number of small businesses that would be able to grow to the extent that they would merit the support of the balance of the U.S. private equity industry would be substantially reduced. That, in turn, would likely have a substantial negative impact on the U.S. economy.

Any regulation with the potential to impart a significant negative blow to the SBIC program as an important source of capital for U.S. business, job, and technology growth should not be imposed without a significant factual base to support it. That factual base has not been established in the proposed regulation. Specifically, we would like to draw your attention to the following points.

1. The following statement is made to justify making bank investments in SBICs subject to the capital charges of the proposed regulation: "Importantly, the risks associated with these investment activities do not vary according to the authority used to conduct the activity." What are the facts that would lead one to conclude that investing in an SBIC is such a risky endeavor that current rules relating to capital charges must be changed? None are presented. Only unsupported assumptions are advanced: (a) that all merchant banking activities are the same and carry the same substantial risk that must be addressed by an arbitrary approach that has never been imposed before; and (b) that the 50% capital allocation to merchant banking activities apparently used by some banks for internal modeling purposes is appropriate for all banks and all purposes. This is an inappropriate approach given that SBICs are subject to regular government examination. It is also an unfair assessment of all risks associated with bank SBIC investments. When banks invest as limited partners in independent SBICs, the diversification they achieve with respect to the investment substantially mitigates risk.

2. Given the substantial data on SBIC operations that is available from both banks and SBA, at a minimum the analysis should have provided tables indicating the results of bank SBICs over time—during both growth and recession cycles. In fact, SBA data indicates that since 1978, bank-owned SBICs have realized positive returns on invested capital in 21 of the 22 years for which data is available. The mean return for the period is 12.9%.

3. Given the number of bank-owned SBICs, the analysis should have explored the full range of internal accounting models used by banks for their SBIC investments. Such a survey would have captured the likely impact of the proposed regulation on present and future bank investment in SBICs—with banks listed by size. In that latter regard, merely assuming that the proposed regulation will have no impact based on a small "sampling of call reports of (large) bank holding companies engaged currently in significant investment activities" is insufficient. To seek to impose a significant arbitrary requirement in an area so important to

the national well being without broad factual analysis carries with it at least the same—if not greater—level of risk as that the proposed regulation seeks to address.

4. In addition to an analysis of bank-owned SBIC operational data, we believe that the analysis should also include a discussion of the laws and regulations governing SBIC operations. Congress and SBA have moved aggressively since 1992 to address safety and soundness issues related to SBIC operations. In addition, banks may not invest more than five percent of their capital and surplus in SBICs. There should be no finding that bank investments in SBICs pose substantial risks to banks—risks of the same level as merchant banking activities carried on under other authority—without an analysis of the current legal and regulatory requirements that have been imposed to address the same issue addressed by the proposed regulation. To do so indicates either a belief that existing SBIC laws and regulations have no impact on risk or that the only way to address risk in the SBIC program is through a 50% charge to capital. Neither proposition is supportable.

5. Banks currently receive presumptive Community Reinvestment Act (CRA) credit for investments in SBICs. The proposed regulation does not address this fact and the issues that are related to it. The proposed regulation would likely make it more difficult for banks to meet their CRA investment requirements. Would that impact be felt equally among large and small banks? Does the proposed regulation take into account congressional intent with respect to CRA? If not, why not? These are questions should have been addressed by the Board and Treasury.

6. Although the Board references its obligations under the Regulatory Flexibility Act (5 U.S.C. 603(a)), it provides no analysis of the impact that the proposed regulation will have on small businesses. Such an analysis is clearly warranted given available SBIC statistics.

7. Finally, although the Board indicates that its proposed regulation was promulgated following consultation with Treasury, there is no indication that the process included consultation with agencies that are generally involved with bank capital adequacy standards. These would include the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS). These agencies and the Board have typically used the Federal Financial Institutions Examinations Council (FFIEC) to address issues such as that addressed by the proposed regulation. The proposal should have included a discussion of the normal process and an explanation of why it was not used.

In conclusion, we believe that no adequate justification has been presented which would warrant application of the proposed regulation to bank investments in SBICs in accordance with authority granted under the Small Business Investment Act of 1958. Absent a complete and thorough review and discussion of historical operational results, the laws and regulations already in place to address risk, and congressional intent with respect to the SBIC program, bank investments in SBICs should be exempt from any final regulation that would change current regulations regarding capital required to support investments in SBICs. That is the essence of good government in general and of the requirements of the Regulatory Flexibility Act in particular.

Testimony of

John P. Whaley

On Behalf Of

The ABA Securities Association

and

The American Bankers Association

before the

Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises

of the

Committee on Banking and Financial Services

United States House of Representatives

June 7, 2000

Testimony of John P. Whaley

On Behalf of the ABA Securities Association

Before the
Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises

Committee on Banking and Financial Services
United States House of Representatives

June 7, 2000

Mr. Chairman and members of the subcommittee, my name is John P. Whaley. I am a partner of Norwest Equity Partners and Norwest Venture Partners, both of which are 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 in information technology related industries. Norwest Equity Partners makes equity investments in companies with traditional and emerging business models with a focus in media and telecommunication industries. Norwest Equity Partners also invests in management-led buyouts of more mature businesses. Together, these firms comprise the private equity investment business of Wells Fargo & Co., a $218 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

and investment banking activities. My testimony today also reflects the views of the ABA.[1]

Mr. Chairman, I commend you for holding this hearing to focus on capital markets developments after passage of the Gramm-Leach-Bliley Act ("Act"), particularly the merchant banking rules recently issued for comment by the Board of Governors of the Federal Reserve System ("Board") and the Department of the Treasury ("Treasury").[2] Many of ABASA's members regard the authority to engage in expanded merchant banking activities as the single most important feature of 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 you know, Mr. Chairman, one of the clearly stated purposes of the legislation was to create a two-way street among all financial services providers. Unfortunately, the proposed merchant banking rules undermine, in many important respects, Congressional intent. In fact, we believe that the proposed rules, in effect, rebuild many of the barriers among financial services firms that Congress sought to eliminate through passage of the Act. Accordingly, ABASA is strongly opposed to the proposed rules, as currently drafted.

In my statement today, I would like to highlight three issues:

- How the proposed rules undermine Congressional intent;

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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] Although the merchant banking proposals are actually two separate proposals, i.e., an interim merchant banking rule proposed by both the FRB and Treasury (Docket No. 1065) and a proposed capital rule issued by the FRB (Docket No. 1067), the proposals are strongly intertwined and, accordingly, for ease of reference, we refer to them generally as the proposed rule or as the proposal.

- The negative impact that will result if a 50% capital charge is placed on merchant banking activities; and

- The need to eliminate unnecessary and burdensome regulatory restrictions imposed on merchant banking activities conducted through private equity funds.

As we discuss in our comment letter to the Board and Treasury, a copy of which is appended to this statement, ABASA has many additional concerns and comments with respect to other aspects of the proposals. However, our opposition to the proposals is chiefly grounded upon the three issues outlined above.

The Proposals Undermine Congressional Intent.

New Section 4(k)(7) of the Bank Holding Company Act authorizes the Board and Treasury to issue regulations *implementing* the merchant banking authority granted to financial holding companies ("FHC") under new Section 4(k)(4)(H). It is our position that the proposed rules extend well beyond implementing the merchant banking provisions of the Act.

The Act conditions an FHC's ability to engage in merchant banking activities on:

1. the depository institution not holding the ownership interests acquired;

2. the ownership interests acquired being held for the purpose of appreciation and ultimate resale or disposition of the investment, and

3. the holding company not engaging in the routine management or operation of the company or entity, except as may be necessary to obtain a reasonable return on the investment upon disposition.

These three conditions were included in order to maintain the separation between banking and commerce.

Neither the capital charge nor the restrictions on private equity funds implement the statute's objective of ensuring that FHCs may engage in merchant banking activities but not in commerce. Rather these restrictions, in all likelihood, will unduly interfere with the ability of FHCs to engage in merchant banking – an activity specifically authorized as financial-in-nature by the Congress.

The legislative history describing Section 4(k)(4)(H) indicates that the Congress intended that those investment banking firms affiliated with securities firms and insurance companies that opt to become financial holding companies should be permitted to continue to engage in merchant banking activities in substantially the same manner as had always been permitted.[3] Conversely, Congress also intended that bank holding companies should not be placed at a competitive disadvantage to investment banking firms that are unaffiliated with any depository institution; but should be allowed to engage in merchant banking activities to the same extent as non-bank affiliated investment banking firms.[4]

Despite Congress' stated intentions, the regulatory restrictions imposed by the proposed rules, particularly the 50% capital charge against merchant banking activities and the aggregate investment limits,[5] will effectively guarantee that the two-way street is unattainable. Securities firms will opt not to become FHCs because the price, in terms of limits on current and future merchant banking activities, is too steep. Foreign banks will

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

[4] Id.

[5] The interim rule establishes two aggregate limits on merchant banking investments: an FHC is prohibited from making additional merchant banking investments if the aggregate carrying value to the FHC of all merchant banking investments exceeds either the lesser of 30 percent of the FHC's Tier I capital or $6 billion, or the lesser of 20 percent of the FHC's Tier I capital or $4 billion excluding investments made by the FHC in private equity funds.

conduct their merchant banking operations from offshore locales in order to avoid the draconian effects of the proposed rules. Bank and financial holding companies will be precluded from engaging in merchant banking activities on the same terms and conditions as their non-bank affiliated competitors.

The statutory provisions generally prohibiting FHCs from routinely managing portfolio investment firms and from holding these investments indefinitely more than adequately address the separation between banking and commerce, Mr. Chairman. It is ABASA's position that in issuing these proposals, the Board and Treasury have gone way beyond effectuating congressional intent, but rather undermine that intent.

Nor are these provisions necessary to protect the safety and soundness of depository institutions or to control risk as the Board and Treasury would seem to claim. Congress believed it more than adequately addressed any safety and soundness concerns by authorizing merchant banking activities to be conducted only through holding companies for the first five years. Additionally, in authorizing merchant banking activities, Congress recognized the essential role merchant banking plays in modern finance and determined that any risk associated with these activities was acceptable. After all, only firms with well-capitalized and well-managed banks can exercise these new activities. It is inappropriate for the Board and Treasury now to second-guess that determination and raise additional barriers to full entry into merchant banking.

Furthermore, no evidence exists that FHCs cannot control risks associated with merchant banking activities. The banking industry has a long history of engaging in merchant banking activities through small business investment company firms

("SBICs"),[6] through Regulation K firms,[7] and under the authority of sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act and Section 24 of the Federal Deposit Insurance Act.[8] 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.

Finally, merchant banking activities serve an important function in providing needed capital to corporations. While it is true that some of the target companies are "start-up," early stage firms, many others are not. For example, many banking organizations anticipate using the new merchant banking powers to facilitate the transfer of family-owned businesses from one generation to another or to take equity kickers as consideration for loans to established corporations. It is ABASA's strong belief that the proposed rules, if adopted, will have a very negative impact on the flow of capital to firmly established operating companies, as well as small and medium-sized start-up companies. Such a result is good neither for corporate America nor for the consumer.

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[6] 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 SBICs generally provide the largest proportion of financed dollars to small businesses. For 21 of the last 22 years, bank-owned SBICs have made a profit on their venture capital investments, averaging an annual rate of return of 13%.

[7] Many banking organizations engage in merchant banking activities abroad through a variety of vehicles. Limits on these activities include no more than 40 percent of the equity of a company, with no more than 20 percent of which consists of voting equity.

[8] Bank holding companies may make passive noncontrolling 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 merchant banking activities under Section 24 of the Federal Deposit Insurance Act.

<u>The Fifty- Percent Capital Charge Will Have a Strong Negative Impact on Merchant Banking Activities.</u>

The proposed rule amends the regulatory capital guidelines applicable to merchant banking activities conducted by both FHCs and bank holding companies ("BHCs"). Specifically, the proposal would impose a 50% capital charge (deducted from Tier I capital of the holding company) on all investments made by a holding company, directly or indirectly, in nonfinancial companies. This onerous capital treatment would not be limited to only the new expanded merchant banking authority granted to FHCs by the Gramm-Leach-Bliley Act, but rather would extend as well to all merchant banking investments made under existing authority, including equity investments authorized under the Small Business Investment Act.

First and foremost, ABASA is opposed to the 50% capital charge as it is excessive and bears no resemblance to the BIS-approved risk-based capital guidelines. Under those capital guidelines, a banking organization must hold a total of 10% or more in risk based capital in order to be considered well capitalized. To achieve that 10% risk based capital ratio, the organization must hold a minimum of 6% Tier I capital against every $100 million in investments, plus 4% or more in Tier II capital.[9] Thus, under current regulations, a holding company would have to maintain $6 million in Tier I capital for every $100 million in investments.

The proposal turns all this on its head by requiring the holding company to deduct from its Tier I capital $50 million for every $100 million in investments in order to maintain its same well-capitalized position. Thus, the proposal would require eight

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[9] Well-capitalized under the risk-based capital guidelines also requires a minimum leverage ratio of 5%.

times more capital for merchant banking activities than is currently required for existing merchant banking activities.

This sea change in regulatory capital requirements will not only have a significant negative impact on the ability of holding companies to engage in new merchant banking activities authorized under the Gramm-Leach-Bliley Act but also on the ability of holding companies to engage in those specific merchant banking activities authorized for banking organizations ***prior*** to passage of the Gramm-Leach-Bliley Act, including banking organizations' ability to make equity investments through an SBIC. No grandfather of equity investments previously made is contemplated by the proposal, leaving banking organizations in the untenable position of having to raise their overall capital requirements—quite significantly in some circumstances—without contributing even one additional dollar toward an equity investment.

It should be understood that, if allowed to stand, the 50% capital charge will render uneconomic many of the investments previously made through SBICs, Regulation K firms, or under authority of the Bank Holding Company Act or the FDIA. These investments will become uneconomic not because of any change in inherent worth but solely because of an unanticipated change in regulatory treatment.

Second, it is not completely accurate for the regulators to suggest that the 50% capital charge is drawn from the internal capital allocation models employed by those investment banking firms, both bank and non-bank affiliated, that are engaged in merchant banking activities. While it is true that investment banking firms internally allocate capital to merchant banking activities and that that allocation generally ranges between 25 and 100 percent of capital, it is equally true that these firms allocate

significantly lower amounts of capital to other activities than is currently required under the risk based capital rules. For example, 6% capital is required to be held against commercial loans, yet many firm models distinguish between blue chip borrowers and other less creditworthy firms and allocate less capital against the better credit.[10] Economic internal capital models and regulatory capital requirements are, however, aligned when all capital allocated under the internal models averages out to equal to or better than the 6% of Tier 1 capital requirement.

What, in fact, the Board has done is to "cherry pick" or select only the high capital allocations from internal capital allocation models and ignore all the lower capital allocations assigned under these same models. It is unfair for the regulators to suggest that they are following industry precedent set by internal models when they ignore all other capital allocations set by these very same models.

Third, the regulators are wrong to suggest that the proposed capital charges will have no meaningful impact on both FHCs and BHCs. In fact, the proposal will have a significant practical impact on holding companies. Specifically, holding companies will be forced to replace capital depleted as a result of the 50% capital charge in order to maintain opportunities to grow their business and to satisfy both regulatory and market demands and expectations for large capital cushions at the holding company level.

For all the above reasons, ABASA believes that the proposal to impose a "one-size-fits-all" 50% capital charge on all merchant banking investments is wrong-headed, not in accordance with Congressional intent and, in fact, counterproductive. Such a special capital charge is particularly inappropriate when applied to organizations that

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[10] Board staff has freely acknowledged that the current risk-based capital guidelines are inadequate: they overestimate the capital required for some assets and underestimate the capital required for others.

have experience managing the risks of such investments and have appropriate internal mechanisms, processes and controls to handle, and hold appropriate capital against, such risks. The Board as a supervisory matter has the tools to review the internal controls of such organizations to validate the fact that they appropriately manage the risks of such activities.

An across-the-board 50% capital deduction is unreasonable even for those organizations that do not yet have internal controls that pass the Board's supervisory muster. In those instances, if the Board sees the need for a standard regulatory capital requirement, something much more reasonable should be considered. First, special merchant banking capital requirements should only apply in those instances where an FHC's merchant banking investments constitute a significant portion of the FHC's portfolio, for example where the investments exceed 20% of Tier I capital. Then, they should be imposed at a more measured level than the 50% deduction and should blend with the current risk-based capital framework.

If any regulatory capital is adopted by the Board, in no case should it apply to equity investments that are permissible under the Bank Holding Company Act for all bank holding companies or their subsidiary institutions. SBIC investments, non-controlling investments, and investments under Regulation K have all been conducted prudently and profitably by BHCs for many years. There is simply no evidence that additional capital is warranted.

Finally, on a related matter, ABASA strongly objects to the interim rule's aggregate investment limits. The limits are neither supported by the plain language of the Act nor its legislative history. Erecting yet another barrier to an FHC's ability to engage

in merchant banking activities ignores congressional intent that FHCs be able to participate in this important activity to the same extent and on the same basis that non-bank affiliated firms engage in the same activities. Moreover, we note that fixed dollar limits as opposed to percentage limits make no sense in today's consolidating markets. Since we are led to believe that the aggregate investment limits are likely to be eliminated once the Board has addressed the capital rules applicable to merchant banking, we do not comment extensively on those limits here. Of course, we strongly support their elimination.

Unnecessary and burdensome regulatory restrictions should not be imposed on merchant banking activities conducted through private equity funds.

The proposal recognizes that merchant banking investments may be made directly in portfolio companies and through the use of pooled funds. The proposal further provides that investments made through a specially-defined type of pooled fund, "a private equity fund," in which an FHC, by definition,[11] may only be a minority investor (no more than 25 percent) should have fewer restrictions than those made directly.

This distinction is most appropriate, because equity fund investments inherently raise fewer regulatory concerns than do direct investments in portfolio companies. Proportionally less of the FHC's own capital is at risk. The majority participation 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 made to allow the FHC to engage in

[11] As more fully described in our attached comment letter, we also believe that the requirement to have at least 10 investors other than an FHC is both needlessly large and counterproductive.

prohibited commercial activities. Finally, the 25 percent limit establishes a strong presumption that the FHC's minority position will prevent it from exercising meaningful "control" over portfolio companies in which the fund invests. The equity fund investments reinforce the banking and commerce separation.

Having recognized these legitimate reasons for less restrictive treatment, the proposal imposes fewer restrictions on portfolio investments made by these specially-defined private equity funds – *but only in very limited circumstances.* For example, under the proposed aggregate investment limits, an FHC may hold a greater amount of investments in private equity funds than it may hold directly in portfolio companies.

In a number of other instances, however, the proposal needlessly imposes the same burdensome restrictions on portfolio investments made by a private equity fund as on portfolio investments made directly. That is, the proposal's restrictions apply to the FHC's investment in the private equity fund itself, *and* then "looks through" the equity fund to the portfolio investments made by the private equity fund and imposes many of the restrictions on the fund's investments.

It is to these "look through" provisions that ABASA strongly objects. We believe these restrictions will needlessly deter FHCs from investing in private equity funds and create a significant disincentive to the inclusion of FHC investors in many private equity funds.

Two extreme examples of these "look-through" restrictions are the proposed rule's "routine management" and holding period restrictions. When an FHC makes an investment in a private equity fund, no matter how small or passive, neither the FHC nor the fund may "routinely manage" a portfolio company in which the fund has made an

investment. Similarly, each of the fund's portfolio investments is subject to holding period limits.[12]

Moreover, where the FHC's investment in the private equity fund is deemed to be "controlling" – even though it may never exceed 25 percent of the fund's equity – additional "look-through" restrictions are imposed. Again, these restrictions, listed below, apply not just to the FHC's investment in the private equity fund, but also to the private equity fund's investments in portfolio companies:

- Cross-marketing restrictions between a bank and the fund's portfolio companies.
- Affiliate transaction restrictions between a bank and the fund's portfolio companies.
- Internal controls requirement regarding the fund's portfolio investments.
- Recordkeeping requirements regarding fund's portfolio investments.
- Reporting requirements regarding the fund's portfolio investments.

ABASA believes that *all* of the look-through restrictions are unnecessary, misguided, and counterproductive. Let me explain why.

We recognize that it is appropriate to impose the proposed rule's restrictions on an FHC's first-level investment in a private equity fund since that is itself a direct merchant banking investment. But we strongly oppose the restrictions "looking through" to the underlying portfolio investments made by the private equity fund. These "look through" restrictions are unnecessary to ensure that the FHC does not operate the underlying portfolio company. They are unnecessary *because of the limits that the proposed rule*

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[12] ABASA recognizes that the holding period for portfolio investments by private equity funds is longer than the holding period for direct merchant banking investments. ABASA believes, however, that *no* holding period limits should be placed on portfolio investments by private equity funds.

already imposes on the FHC's investment in that specially-defined private equity fund. Specifically, the fact that the FHC's interest in the private equity fund is limited to a minority participation of less than 25 percent means that unaffiliated, arms-length investors will hold the remaining 75 percent (at least). In addition, the fund is prohibited from becoming an operating company, must hold diversified investments, and must establish a plan for the resale of investments. And perhaps most importantly, the fund may not be formed or operated for the purpose of making investments that are inconsistent with the merchant banking statutory provision or for evading any of the proposed rule's limitations.

All of these limits ensure that a private equity fund may not be used as a vehicle for the FHC to *operate* a portfolio company as opposed to merely *investing* in it. As a result, investments made under such limits simply do not raise the same banking-commerce regulatory concerns as would an FHC's direct investment in a portfolio company.

As described above, in many instances the proposed rule expressly recognizes the force of this logic. Except with respect to the "routine management" and holding period restrictions, the proposed rule does *not* impose look-through restrictions on private equity fund investments where an FHC's investment in a private equity fund is not "controlling." But there is another significant concern here in that the "control" standard is established far too conservatively. The proposed rule's 25 percent cap and various related limits for the specially-defined private equity fund could themselves have been established as the "control" threshold. Any FHC investment meeting these restrictions could have been

deemed a "non-controlling" investment in the private equity fund, with none of the proposed rule's restrictions looking through to the fund's portfolio investments.

However, instead of this straightforward, common sense result, the proposed rule imposes a cumbersome distinction between "passive" investments below the 25 percent limit that are *not* controlling, and "non-passive" investments below the 25 percent limit that *are* controlling. Using "passivity" as the touchstone will import into the merchant banking context the complex precedent that the Federal Reserve has used in very different contexts, *e.g.,* for purposes of determining whether a company's investment in a bank should make it a regulated bank holding company. Such precedent is needlessly restrictive in the very different circumstance of a merchant banking investment made through a private equity fund.

In short, ABASA believes that the very limitations that apply in the proposed rule's definition of "private equity fund" ensure that the FHC will not be able to use an investment in such a fund to operate a portfolio company in violation of the continued separation of banking and commercial activities. In truth, the proposed definitional restrictions impose sufficient distance between the FHC and actual "control" of a portfolio company. The resulting separation makes unnecessary ***all*** of the proposed rule's "look-through restrictions" on portfolio companies held by specially defined private equity funds in which an FHC invests.

Moreover, ABASA believes that the statute provides clear legal authority to establish the control threshold in this manner. The merchant banking provision does apply to an FHC that uses the merchant banking authority to directly or "indirectly" acquire ownership of the shares of a portfolio company. But as the proposed rule

expressly recognizes, "[w]here *control* exists [of a private equity fund by an FHC], the financial holding company is deemed by the BHC Act to indirectly own the shares of the portfolio company held by the private equity fund."[13] The corollary is also true: where an FHC does *not* control a private equity fund, the FHC is *not* deemed to indirectly own the shares of the portfolio company. The issue is therefore the definition of "control."

Accordingly, ABASA urges that the control threshold be deemed to be the proposed rule's definitional limits on an FHC's investment in a private equity fund. The proposed rule's current distinction between "passive" and "nonpassive" investments in a private equity fund should be eliminated, and "look through" restrictions should not be applied to any portfolio company investment made by a specially defined private equity fund that by definition cannot be controlled by an FHC.

Indeed, ABASA believes that, even if an FHC's investment in a private equity fund were to exceed 25 percent, it should not trigger the look-through restrictions unless the FHC were also the general partner of the fund. Put another way, the type of "control" that warrants the look-through provisions does not exist unless the FHC is *both* a general partner *and* has a significant equity stake in the fund. ABASA urges that this change to the rule's proposed definition of "private equity fund" be adopted as well.

One final point. The proposed rule's cross-marketing restriction clearly applies between a bank and a portfolio company (under certain circumstances). It has been suggested that the restriction also applies between a bank and a private equity fund itself, so that an FHC might not be able to provide fund investment opportunities to a bank customer. Such a strained interpretation of the statute is fundamentally at odds with the purpose of the restriction, which was to separate banks from commercial activities, not to

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[13] 65 Fed.Reg. at 16468.

separate bank customers from financial investment opportunities. ABASA strongly opposes such a restrictive reading of the statute.

Conclusion

In conclusion, we are opposed to the proposed merchant banking rules and fervently hope that the Board and Treasury will limit their activities to effectuating Congressional intent and addressing the fundamental concerns raised by the many commentators. ABASA appreciates the opportunity to air its concerns regarding these proposals and their impact on merchant banking – an activity that is of fundamental importance to the financial services industry, corporate America and consumers.

ATTACHMENT

Beth L. Climo
Managing Director

May 15, 2000

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Ave., NW
Washington, DC 20551

Merchant Banking Regulation
Office of Financial Institution Policy
U.S. Department of the Treasury
1500 Pennsylvania Ave., NW, Room SC 37
Washington, DC 20220

RE: Merchant Banking Proposals, Docket Nos. R-1065 and R-1067, 65 Federal Register 16460, 16480 (March 28, 2000).

Dear Ms. Johnson and Sir or Madam:

The ABA Securities Association ("ABASA") appreciates the opportunity to comment on the interim rule jointly proposed by the Board of Governors of the Federal Reserve System ("Board") and the Department of the Treasury ("Treasury"), and the proposed rule published for comment by the Board. Both the interim and proposed rules address merchant banking activities, an important new authority granted to financial holding companies ("FHCs") by the Gramm-Leach-Bliley Act, Pub. L. No. 106-102 ("the Act" or "the statute").

ABASA is a separately-chartered subsidiary of the American Bankers Association ("ABA"), formed in 1995 to develop policy and provide representation for those holding companies involved in securities underwriting and dealing, proprietary mutual funds and derivatives activities. As the Board and Treasury know, ABASA has worked long and hard over the last five years to play a contributing role with respect to many of the securities and capital markets provisions of the Act.

I. SUMMARY

Many of ABASA's members regard the authority to engage in expanded merchant banking activities as the single most important feature of the Gramm-Leach-Bliley Act. One of the clearly-stated purposes of the legislation was to create a two-way street among all financial services providers. As a result, ABASA has a vested interest in ensuring that its members are

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able to engage in merchant banking activities to the full extent of both the letter and intent of the Act.

Unfortunately, the interim and proposed rules undermine, in many important respects, Congressional intent and, in effect, rebuild many of the barriers among financial services firms that Congress sought to eliminate. Further, the proposed rules are not necessary to protect the safety and soundness of the banking system or to control risk to depository institutions. Accordingly, ABASA strenuously objects to the proposed rules.

As discussed below, ABASA has numerous concerns and suggestions with respect to particular aspects of the proposed rules, but its opposition to the proposals centers on three of the regulatory restrictions. ABASA is particularly opposed to:

- **The fifty percent capital charge applicable to all merchant banking activities;**
- **The aggregate investment limits on all newly authorized merchant banking activities; and**
- **The unnecessary and burdensome regulatory restrictions imposed on merchant banking activities conducted through private equity funds.**

II. GENERAL COMMENTS

A. THE PROPOSED REGULATORY RESTRICTIONS UNDERMINE CONGRESSIONAL INTENT.

New Section 4(k)(7) of the Bank Holding Company Act authorizes the Board and Treasury to issue regulations *implementing* the merchant bank authority granted to affiliates of securities firms under new Section 4(k)(4)(H). By contrast, the regulatory restrictions referenced in the summary above extend well beyond implementing the merchant banking provisions of the Act.

As the Board and Treasury are aware, the Act conditions a financial holding company's ability to engage in merchant banking activities on (1) the depository institution not holding the ownership interests acquired, (2) the ownership interests acquired being held for the purpose of appreciation and ultimate resale or disposition of the investment, and (3) the holding company not engaging in the routine management or operation of the company or entity, except as may be necessary to obtain a reasonable return on the investment upon disposition. These three conditions were included in order to maintain the separation between banking and commerce.

ABASA submits that neither the capital charge, the aggregate investment limits nor the restrictions on private equity funds implement the statute's objective of ensuring that FHCs may engage in merchant banking activities but not engage in commerce. Rather, we believe that these restrictions, in all likelihood, will unduly interfere with the ability of financial holding

companies to engage in merchant banking – an activity specifically authorized as financial-in-nature by the Congress.

The legislative history describing Section 4(k)(4)(H) indicates that the Congress intended that those investment banking firms affiliated with securities firms and insurance companies that opt to become financial holding companies should be permitted to continue to engage in merchant banking activities in substantially the same manner as had always been permitted.[1] Conversely, Congress also intended that bank holding companies should not be placed at a competitive disadvantage to investment banking firms that are unaffiliated with any depository institution; but should be allowed to engage in merchant banking activities to the same extent as non-bank affiliated investment banking firms.[2]

Despite Congress' stated intentions, the regulatory restrictions imposed by the proposed rules will effectively guarantee that a two-way street is unattainable. Securities firms will opt not to become FHCs because the price, in terms of limits on current and future merchant banking activities, is too steep. Foreign banks will conduct their merchant banking operations from offshore locales in order to avoid the draconian effects of the proposed rules. Bank and financial holding companies will be precluded from engaging in merchant banking activities on the same terms and conditions as their non-bank affiliated competitors.

ABASA also reminds the regulators that never, in all the years that financial modernization legislation was under consideration by the Congress, had there ever been any discussions about attaching capital charges, aggregate investment limits or other similarly restrictive measures to the merchant banking authority. Indeed, we are confident that if anything like the onerous capital charge or aggregate investment limits suggested in the rules had been proposed at the legislative stage, the ABASA Board of Directors would have opposed, rather than supported, the legislation.

The statutory provisions generally prohibiting FHCs from routinely managing portfolio investment firms and from holding these investments indefinitely more than adequately address the separation between banking and commerce. In addition, Sections 23A and 23B restrictions on transactions between depository institutions and their affiliates and the Act's additional provisions restricting depository institutions and portfolio investment firms from cross-marketing[3] each others' products act as a further separation of banking from commerce. The Board and Treasury should do no more than effectuate Congressional intent.

B. THE ACT ADEQUATELY ADDRESSES SAFETY AND SOUNDNESS CONCERNS.

These regulatory restrictions are not necessary to protect the safety and soundness of depository institutions. The Congress has more than adequately addressed any safety and

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

[2] Id.

[3] See Section 4(n)(5) of the Bank Holding Company Act.

soundness concerns by prohibiting merchant banking activities from being conducted through a bank or bank subsidiary, for at least the first five years. Congress' approach is the only uniform, across-the-board manner in which safety and soundness reasonably can be addressed. All other concerns about safety and soundness can and should be addressed through the supervisory approach. Such an approach avoids a "one-size-fits-all" solution in favor of remedies tailor-made to the particular institution and concern sought to be addressed.

Moreover, additional regulatory restrictions adopted in the name of safety and soundness could have the unintended effect of actually increasing risk for some firms. For example, a firm without a long history of experience in merchant banking might choose to limit its merchant banking activities to more "run-of-the-mill" types of activities until sufficient expertise and comfort had been acquired. Examples of these types of activities include providing mezzanine financing or taking a small stake in a private equity fund. Many established firms provide mezzanine financing, which provides a lower return and associated lower risk. An onerous regulatory capital charge such as that contained in the instant proposal might encourage a firm to shift its investment activities away from mezzanine financing and other less risky investments toward traditional direct equity investments in order to achieve the higher returns necessary to justify the expense associated with a 50% capital charge. Similarly, the aggregate investment limitation might encourage firms to allocate limited investment capital to riskier investments in order to achieve the highest return on that limited resource.

C. RISK IS CONTROLLED THROUGH EXISTING STATUTORY REQUIREMENTS AND INTERNAL MANAGEMENT SYSTEMS.

Finally, the referenced regulatory restrictions are unnecessary to control risk. In authorizing merchant banking activities, Congress recognized the essential role merchant banking plays in modern finance[4] and determined that the risk associated with these activities was acceptable. After all, only firms with well-capitalized and well-managed banks could exercise these new activities. It is inappropriate for the Board and Treasury now to second-guess that determination and raise additional barriers to full entry into merchant banking.

No evidence exists that FHCs cannot control risks associated with merchant banking activities. The banking industry has a long history of engaging in merchant banking activities through small business investment company ("SBIC") firms, through Regulation K affiliates, and under the authority of sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act.[5] To date, those activities have produced strong returns with minimal losses and have taken place over a relatively long period of time, involving both expansionary and recessionary markets.

The Board and Treasury have not cited any instance in which a bank holding company was unable to manage the risks associated with merchant banking activities. More importantly, no evidence exists to suggest that FHCs exercising the new authority to engage in increased merchant banking activities will engage in activities that are any more risky. ABASA would

[4] House Rept. No. 106-74 at 122.

[5] 15 U.S.C. § 682; 12 CFR, Part 211; 12 U.S.C. §§ 1843(c)(6) and 1843(c)(7).

suggest that before adding onerous regulatory restrictions in the name of controlling risk, the Board and Treasury should make a supportable and substantial demonstration of the inadequacy of the industry's current risk management systems.

In fact, rather than control risk, the regulatory restrictions imposed by the proposal could exacerbate risks to financial holding companies. Risk management involves, in part, diversification of product offerings and income streams. Some ABASA members have previously provided the Board with data demonstrating the significant contributions limited merchant banking activities have made to bank holding company revenues.[6] The regulatory restrictions proposed for both existing and newly-authorized merchant banking activities will surely diminish the positive contribution these activities have made, and can make in the future, to the profitability of bank and financial holding companies.

Finally, merchant banking activities serve an important function in providing needed capital to corporations. While it is true that some of the target companies are "start-up," entrepreneurial firms, many others are not. For example, many banking organizations anticipate using the new merchant banking powers to facilitate the transfer of family-owned businesses from one generation to another. It is ABASA's strong belief that the proposed rules, if adopted, will have a very negative impact on the flow of capital to many of these small and medium-sized companies.

III. SPECIFIC COMMENTS

A. THE CAPITAL PROPOSAL.

The Board proposes to amend its regulatory capital guidelines for FHCs and bank holding companies ("BHCs") as to the treatment of certain investments in nonfinancial companies by imposing a 50 percent capital charge (deducted from Tier I capital of the BHC) on all investments made by a holding company, directly or indirectly, in nonfinancial companies. This treatment would extend to all investments made under new and existing merchant banking authority. ABASA strongly opposes this proposal. ABASA believes that there are other approaches, set out below, to the regulation of merchant banking by the Board that are superior to the draconian capital charge.

1. **The Proposed Capital Charge.**

A 50 percent capital charge on all merchant banking investments in nonfinancial companies is excessive. For example, under current capital guidelines if a well-capitalized BHC made an additional $100 million in nonfinancial company investments, it would need to add $6 million in Tier I capital to maintain its same well-capitalized position. Under the proposal, however, the holding company would have to deduct $50 million from its Tier I capital and

[6] We note that, generally speaking, over the last two to three years, the average size of portfolio investment activities relative to bank holding company capital has not significantly increased. Only as holding company capital increases has the absolute dollar amount of portfolio investing increased.

replace it to maintain its same well-capitalized position. The Board proposes to require more than eight times the capital for new merchant banking activities than is currently required. Even more striking is the fact that the proposal would take existing investments previously considered by the Board to be well-capitalized at 10 percent (those in SBICs, in subsidiaries of holding companies or made under the Board's Regulation K) and apply the new capital treatment to these investments as well. This has the incongruous effect of raising members' overall capital requirements – quite significantly in some instances – without the members even exercising any new merchant banking authority under the Act.

The Board has arrived at this excessive capital proposal perhaps through a misunderstanding of industry practice in internal allocation of economic capital. The Board states that it conducted reviews of banks' own internal allocations of capital and found that investments are supported by a capital allocation of 25 percent to 100 percent of the investment, depending upon the types of investment activity. Therefore the Board justifies a 50 percent capital charge as fair, and possibly even modest. But economic capital models are not used solely to manage risk. They are also used for management information and profitability measurement. ABASA believes that when the Board takes a single component of a bank's internal capital model (or risk adjusted return on capital "RAROC" model) and grafts it onto the Board's current risk-based capital guidelines, the Board makes a serious conceptual error that has resulted in a proposal requiring excessive capital.

Economic capital models have been developed by banks primarily to provide management with the tools to analyze the economic capital necessary to support each of their businesses (not their individual portfolio investments) and to determine the amount of capital required by the institution as a whole. The model assesses capital for two purposes: risk management and performance evaluation. For risk management, the goal is to determine how to optimize the bank's overall use of capital. This analysis includes an estimation of the risk of each business unit and the contribution of that unit's risk to the overall risk of the bank. The performance evaluation aspect measures the risk-adjusted rate of return of a particular activity and the economic profit of each business unit. The objective is to measure a business unit's contribution to shareholder value and to provide a way to budget capital and determine compensation of business unit personnel. Economic capital models are used now to evaluate product categories, customer segments and incentive compensation programs. All of these uses are qualitatively different from the purpose and measurement of regulatory capital. Assessing the risk associated with merchant banking (regulatory capital requirements) is a far different process than doing resource analysis to measure business performance and thus determine the economic capital to allocate to merchant banking (economic capital allocation).

Additionally, economic capital allocation models are fine-tuned by banks on a continuing basis, as many factors change and as the model itself is changed. Economic capital models permit adjustments and allocation among asset classes so long as the overall total capital satisfies regulatory capital requirements. By contrast, the Board's proposal precludes such fine tuning and by definition becomes inaccurate. The effect is evident in the current risk-based capital ("RBC") guidelines. Board staff have freely acknowledged in the recent past that the current risk-based capital guidelines are inadequate: they overestimate the capital required for some assets and underestimate the capital required for others. However, the process for amending the regulatory

capital guidelines is cumbersome and time-consuming. A regulatory capital model tends to be too inflexible for the dynamic risk it is crudely attempting to model. The Board's proposal perpetuates and exacerbates these problems instead of addressing them.

The Board's proposal severely unbalances the capital guidelines by making no adjustments for assets on which regulatory capital requirements are too high while selectively removing a category of assets for which the Board believes the regulatory capital requirements are too low and applying a completely different and much higher capital charge than would otherwise apply. This cherry-picking of capital components with no regard for the whole mix of assets subject to current risk-based capital requirements does not make for good regulatory policy. When looking at the holding company's capital requirement as a whole, the cherry-picking merely results in an excessive capital requirement for merchant banking and other investment activities.

The Board preemptively suggests in its discussion that the proposed capital charge will have no practical impact on financial holding companies, as they will remain well-capitalized. ABASA believes that the impact of these proposed changes will be much more significant than the Board suggests:

a) Bank holding companies maintain capital well in excess of well-capitalized levels in order to assure that any adverse regulatory consequences of a less than well-capitalized status do not occur due to sudden and unforeseen events. Examples might include unanticipated losses, changes in accounting rules, or sudden changes in regulatory interpretations or previous guidance. Companies take this approach in order to maintain opportunities to grow or add new activities even if there are some unanticipated losses or other short-term reductions in capital activities.

   This cushion will be seriously depleted by the Board's proposal. In order to maintain the operating room required to engage in a global financial services business, institutions will need to restrain growth or refuse new opportunities until they have restored the operating cushion to a level that they have so carefully sought to create. It is impossible to quantify these lost opportunities or the drag on operations that restoring that cushion will cause. But the difficulty in quantifying them prospectively does not diminish their significance. Until the cushion is restored, the holding company's ability to make new investments or even repurchase its own stock could be severely limited.

b) It is our members' experience that, until these capital cushions are replaced, the Board itself will discourage the companies from expanding their banking and nonbanking activities. The Board correctly states that the Act's well-capitalized requirements do not apply to holding companies but only to their depository institution subsidiaries. Nonetheless, the Board has a history of carefully monitoring BHC capital levels and requiring more capital in connection with any application for an acquisition. As evidence that the Board's concern with holding company capital is undiminished, we note that the Board carefully maintains its right to deny FHC status to a BHC even if all of its depository institutions are well-capitalized and well-managed.

c) ABASA believes that the Board overlooks, or seriously underestimates, the impact of its proposal in the market. The strength of the holding company's share price is crucial for expanding business lines and "growing the business." The market expects holding companies to maintain regulatory capital levels significantly above well-capitalized and it is that margin that the Board's proposal so drastically affects. As a consequence, the market will demand that holding companies further increase their capital levels. The Board's assertion that the capital charge will not have a practical impact on those firms seems patently unsupportable.

d) Finally, ABASA believes that the Board ignores the impact of its proposal on existing investments. By applying the new capital treatment to existing investments, the Board quite probably will render uneconomic some investments previously made through SBICs or Regulation K firms or under authority of Sections 4(c)(6) or 4(c)(7) of the BHCA. These investments would become uneconomic not because of any change in inherent worth but solely because of an unanticipated change in regulatory treatment. It is unclear whether these investments will be sold, liquidated or otherwise treated differently.

In sum, ABASA believes that the Board should not attempt to fashion an illogical hybrid by cherry-picking pieces from current risk-based capital guidelines on the one hand and a small part of banks' RAROC models on the other hand. The Board is proposing to use just one component of banks' internal models to raise capital requirements without any consonant reduction of capital pertaining to other assets that would be suggested by these same internal models. By using only one component of banks' internal models, the Board merely aggravates the imbalances of the current RBC system, yielding a piecemeal, arbitrarily-selective approach to RBC reform that will result only in exaggerating the problems of the present RBC system.

2. **Alternatives to the Board's Proposal.**

Current RBC guidelines are in the process of being revised, according to the consultative papers from the Bank of International Settlements' Bank Supervision Committee. In that context, banking supervisors, including the Board, appear to be moving towards a greater reliance on banks' internal models in place of the poorly graduated risk categories of the current guidelines.

Regulators have a precedent for such an approach in their 1997 adoption of market risk capital. Only banks that have trading activity in excess of 10 percent of assets, or $1 billion or more, are subject to the additional capital requirements. Banks subject to the market risk capital provisions must use their internal models to calculate their market risk, subject to a requirement for "backtesting" the models against the real world performance. Certain additional requirements, used as a risk control unit independent of the business trading units and reporting directly to management, also apply. Failures of the model are addressed by case-by-case requirements of additional capital in line with the significance of the error of the model.

ABASA recommends that the Board adopt a conceptually similar approach to the regulation of merchant banking. Fortunately, the Basel Capital Accord does not apply to bank holding companies or financial holding companies. Consequently, the Board is free to test new approaches to capital adequacy at the FHC level prior to applying any new approaches at the bank level, which may be an important source of experience in developing a new International Capital Adequacy Framework.

Accordingly, as with the market risk capital provisions, ABASA recommends that the Board adopt a *supervisory* approach to any special capital requirements for merchant banking activities. FHCs generally would be required to meet appropriate qualitative standards for managing merchant banking risk in order to qualify for the supervisory approach. In assessing whether 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 supervisor. As with the market risk approach, significant failures of the model could result in additional capital requirements for merchant banking investments, on a case-by-case basis.

For FHCs that do not qualify for the supervisory approach, a more standard "across-the-board" type of approach could be used, though one that is more reasonable than the proposed 50 percent capital deduction. For example, special merchant banking capital requirements would only apply where an FHC's merchant banking investments constituted a significant proportion of the FHC's portfolio, *e.g.,* where the investments exceed 20 percent of Tier I capital. Where special capital requirements would apply, they should be imposed at a more measured level than the 50 percent deduction and should blend with the current risk-based capital framework. ABASA believes this could be achieved with adjusted Basel risk weights of 200 percent, applied only to the incremental amount of investments that exceed the 20-percent-of-Tier I-capital threshold.

Whatever alternative might be chosen for FHCs that cannot use the supervisory approach, it should not impose *any* additional capital requirement on equity investments that are permissible under the Bank Holding Company Act for all bank holding companies or that are permissible for their subsidiary institutions. SBIC investments, non-controlling investments, and investments under Regulation K have all been conducted prudently and profitably by BHCs for many years. There is simply no evidence that additional capital is warranted.

If, however, the Board does choose to apply new, additional capital requirements on these investments, there must be a grandfather of the equity investments previously made under existing authorities, exempting them from retroactive capital increases. To retroactively increase requirements will completely alter the business analysis that suggested the investments were reasonable to begin with.

3. **Other Capital Issues.**

While ABASA opposes the Board's proposal to impose punitive capital requirements on traditional merchant banking investments, ABASA is also particularly concerned with that aspect of the proposal that treats debt as equity. Specifically, the Board proposes to apply the 50 percent capital charge to any debt instrument with equity features and *all other debt* if the BHC owns as little as 15 percent of the portfolio company's equity. The net effect of this treatment is to require that most loans be capitalized at 6 percent Tier I capital, while some will be subject to a 50 percent Tier I capital deduction.

ABASA objects strongly to treating debt as equity on the basis of a minor equity ownership. The proposal ignores the lower risk profile of a debt instrument that is associated with its priority in the capital structure. For merchant banking activities authorized under Regulation K, the Board only applied this treatment to subordinated debt, *i.e.* debt that has been contractually lowered in payment priority to an equity position. While different treatment of subordinated debt compared to senior debt may make sense, this proposed treatment of unsubordinated debt does not.

Additionally, we note that if the Board chose to evaluate the treatment of such debt by banks' internal capital models, it would find that the models rarely apply a 50 percent capital deduction to debt with equity features and are even less likely to apply it to senior loans to portfolio companies. In most cases, the credit analysis and the decision to make the loan would be conducted by an entirely different department within the FHC.

This treatment of debt as equity further exacerbates the competitive disparity between domestic FHCs and other investment banking firms and foreign banks. It also appears to have a disproportionate impact on smaller firms seeking capital. These firms are much more likely than large firms to have an existing credit relationship with the FHC or one of its depository institutions. The debt relationship will be damaged, or the likelihood of receiving an equity investment will be diminished. Either way, small businesses are likely to suffer a decrease in the availability of capital and/or a significant increase in their costs of debt, since banks are the major providers of small business lending.

While ABASA believes it is inappropriate to treat debt as equity, should the Board determine to go forward with its proposal, exceptions to the proposal need to be modified. For example, ABASA suggests that short-term working capital loans should all be exempt, whether collateralized or not. The Board provides an exception for loans at least 50 percent of which are participated out of the institution. Presumably the Board allows this exception because the purchase of the loan by another unaffiliated institution demonstrates the arm's-length nature and validity of the loan. Would not any purchase of a significant portion of the loan demonstrate the same thing?

B. AGGREGATE INVESTMENT LIMITS.

The interim rule establishes two aggregate limits on merchant banking investments. Specifically, the rule prevents an FHC from making additional merchant banking investments (including making additional capital contributions to a company held under the rule) if the aggregate carrying value to the FHC of all merchant banking investments exceeds:

- the lesser of 30 percent of the FHC's Tier 1 capital or $6 billion; or
- the lesser of 20 percent of the FHC's Tier 1 capital or $4 billion excluding investments made by the FHC in private equity funds.

An FHC may invest a greater amount only with prior approval from the Board.

ABASA strongly objects to the aggregate investment limits. The limits are neither supported by the plain language of the Act nor its legislative history. Erecting yet another barrier to an FHC's ability to engage in merchant banking activities ignores congressional intent that FHC's be able to participate in this important activity to the same extent and on the same basis that non-bank affiliated firms engage in the same activities.

Concerns about excess concentrations of capital for merchant banking activities without appropriate systems for monitoring and managing the associated risks, and concerns about failure to reserve sufficient capital against these activities, caused the Board and Treasury to propose aggregate investment limits. These types of concerns are not new to depository institutions or their regulators. Nor are these concerns limited to merchant banking activities. Banking regulators generally have addressed these issues through the supervisory process, not through the broad brush approach suggested here. No rationale has been offered to justify taking this new approach and, ABASA submits, none can be made. To the extent that these types of concerns exist, they should be addressed through the supervisory process.

Aggregate investment limits are an inappropriate regulatory tool for addressing concerns about excess concentrations, as they penalize those FHCs that have an established merchant banking business and can presumably more easily acquire new business that, under the proposed rule, would be subject to the aggregate investment limits. Yet these are the very firms – seasoned and mature – that we should want to engage in new merchant banking activities.

Moreover, we note that fixed dollar limits as opposed to percentage limits make no sense in today's consolidating markets. We understand, however, our concerns may be short-lived as the aggregate investment limits will be eliminated once the board has addressed capital rules applicable to merchant banking.

C. PRIVATE EQUITY FUNDS.

ABASA strongly objects to the unnecessary "look-through" restrictions placed on portfolio investments made by "private equity funds" in which an FHC makes a merchant banking investment. We believe these restrictions will needlessly deter FHCs from investing in

private equity funds, a result that we believe is fundamentally at odds with the interim rule's intent.

The rule expressly recognizes that investments made by a private equity fund in which an FHC is merely a minority investor (no more than 25 percent) should be subject to fewer regulatory restrictions than investments made directly by an FHC. The rule makes this distinction because such private equity fund investments inherently raise fewer regulatory concerns. Proportionally less of the FHC's own capital is at risk. The majority participation by unaffiliated investors imposes significant market discipline on investment decisions. Their participation also helps ensure that funds are invested for bona fide investment purposes, rather than being used as a means for an FHC to engage in prohibited commercial activities through the merchant banking authority. Finally, the 25 percent limit establishes a strong presumption that the FHC's minority position will prevent it from exercising meaningful "control" over portfolio companies in which the fund invests, further reinforcing the banking/commerce separation.

For all of these reasons, the interim rule expressly – and appropriately – imposes fewer restrictions on portfolio investments made by a private equity fund in which the FHC invests than on portfolio investments made directly by an FHC, *e.g.*, an FHC may hold a greater amount of investments in private equity funds than it may hold directly in portfolio companies.

In a number of other instances, however, the rule needlessly imposes the same burdensome restrictions on portfolio investments made by a private equity fund in which the FHC invests as it applies to portfolio investments made directly by the FHC – so-called "look through" restrictions. For example, when an FHC makes an investment in a private equity fund, no matter how small or passive, the rule's "routine management" and holding period restrictions apply not merely to the FHC's investment in the fund, but also "look through" to the portfolio investments made by the fund. That is, neither the FHC nor the fund may engage in any activity that would constitute "routine management or operation" of a portfolio company in which the fund has made an investment, and each of the fund's portfolio investments is subject to holding period limits.[7]

Similarly, where the FHC's investment in the private equity fund is deemed to be "non-passive" – even though it may never exceed 25 percent of the fund's equity – additional "look-through" restrictions are imposed. Again, these restrictions apply not just to the fund in which the FHC invests, but also to the portfolio company in which the fund invests:

1. The FHC's banks may not cross market the products and services of any portfolio company in which the fund has made an investment exceeding 5 percent of the company's equity (and such a company may not cross market the banks' products and services).

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[7] **ABASA recognizes that the holding period for portfolio investments by private equity funds is longer than the holding period for direct merchant banking investments. ABASA believes, however, that *no* limits should be placed on private equity fund investments.**

2. Restrictions under Sections 23A and 23B of the Federal Reserve Act presumptively apply to transactions between the FHC's banks and any portfolio company that is more than 15 percent owned by the fund.[8]

3. The rule's requirement for internal controls applies to the fund's portfolio investments.

4. The FHC must file reports regarding each of the fund's portfolio investments that is held for more than eight years.

ABASA recognizes that it is appropriate to impose restrictions on an FHC's first-level investment in a private equity fund, just as it is appropriate to impose restrictions on its direct merchant banking investment in a portfolio company. But ABASA also strongly believes that it is both unnecessary and inappropriate for any restrictions to extend beyond the qualified private equity fund in which the FHC invests to the portfolio companies in which the fund itself invests. As described above, and as the rule partly recognizes, investments made by a fund in which an FHC makes minority investments simply does not raise the same banking-commerce regulatory concerns as an FHC's direct investment in a portfolio company. The fact that the FHC's interest in the fund is limited to a minority participation of less than 25 percent, and the corollary that unaffiliated, arms-length investors will hold the remaining 75 percent (at least), ensures that the fund may not be used as a vehicle for the FHC to *operate* a portfolio company as opposed to merely *investing* in it.

Put starkly, an FHC may make a proportionally small investment (say, 6 percent) in a private equity fund that is clearly dominated and controlled by the other 94 percent of investors. In this circumstance, as ABASA understands the rule, both the FHC and the fund are prohibited from engaging in any action that would violate the rule's broad restrictions on the "routine management or operation" of a portfolio company in which the fund has made an investment – even if the fund's investment were both small and non-controlling. Given the clear distance of the FHC from the management or operation of such a portfolio investment, there appears to be little justification for extending the routine management restrictions to the FHC, and no justification for extending such restrictions to the fund itself. Similarly, in such circumstances, we see no reason that the rule's holding period restrictions, even though slightly longer for private equity fund investments, should apply at all to such investments.

The rule does recognize that certain of the "look through restrictions" (*i.e.*, the cross marketing, Sections 23A and 23B, and internal controls restrictions) should not apply where the FHC's investment in the private equity fund is "passive." ABASA believes that making this general type of distinction is clearly appropriate, but that the rule's "passivity" criterion for making the distinction is inappropriate. Using "passivity" as the touchstone will import into the merchant banking context the complex precedent that the Board has used in very different contexts, *e.g.*, for purposes of determining whether a company's investment in a bank should make it a regulated bank holding company. Such precedent is needlessly restrictive in the very different circumstance of a merchant banking investment made through a private equity fund.

[8] Indeed, this look-through restriction may apply even where there is no FHC "controlling" interest in the fund, *i.e.*, where the FHC sponsors and advises the fund.

Indeed, ABASA believes that the very limitations that apply in the rule's definition of "private equity fund" ensure that the FHC will not be able to use an investment in such a fund to operate a portfolio company in violation of the continued separation of banking and commercial activities. Specifically, the rule already requires that the FHC's investment in the fund, including related parties, may not exceed 25 percent of the fund's equity. In addition, the fund may not become an operating company, must hold diversified investments, and must establish a plan for the resale of investments. And perhaps most importantly, the fund may not be formed or operated for the purpose of making investments that are inconsistent with the merchant banking statutory provision or for evading any of the rule's limitations.

Taken together, ABASA believes that these definitional restrictions impose sufficient distance between the FHC and actual control of a portfolio company. The resulting separation makes unnecessary ***all*** of the rule's "look through restrictions" on portfolio companies held by qualifying private equity funds in which an FHC invests. Accordingly, ABASA urges the elimination of the rule's distinction between permissible "passive" and permissible "nonpassive" investments in a private equity fund, and elimination of the application of "look through" restrictions to any portfolio company investment made by a private equity fund.

Indeed, ABASA believes that, even if an FHC's investment in a private equity fund were to exceed 25 percent, it should not trigger the look-through restrictions unless the FHC were also the general partner of the fund. Put another way, the type of "control" that warrants the look-through provisions does not exist unless the FHC is *both* a general partner *and* has a significant equity stake in the fund. ABASA urges that this change to the rule's definition of "private equity fund" be adopted as well.

Finally, ABASA believes that one other aspect of the private equity fund provision ought to be modified. The rule currently requires a private equity fund to have at least 10 investors other than the FHC. We believe that this number is both needlessly large and counterproductive. First, contrary to the rule's commentary there are, in fact, examples of private equity funds that include fewer than 11 investors. Second, there should actually be fewer regulatory concerns where there are fewer investors. That is, where the clear majority of a fund's ownership is controlled by fewer investors, rather than being dispersed, it is *less* likely that an FHC's minority investment could be used to "control" a portfolio company in which the fund had made an investment. For that reason, ABASA believes that no restriction is required on the number of investors that comprise the majority investment in the fund.

D. PERMISSIBLE INVESTMENTS.

The interim rule specifies that allowable merchant banking investments must be made in any company "engaged in any activity not authorized pursuant to section 4 of the Bank Holding Company Act." That is, the company in which the FHC invests must be engaged in an activity that is not financial-in-nature or incidental to a financial activity or otherwise permissible for an FHC.

ABASA submits that it is incorrect to exclude from allowable merchant banking investments, investments in companies engaged in activities that are "financial-in-nature." We believe that as used in the statute, the reference to "any activity not authorized pursuant to this section" is meant to be descriptive rather than restrictive. The language merely differentiates the authority to engage in strategic investments from the authority to make merchant banking investments. If the acquisition is considered by an FHC to be merchant banking, it will be subject to all the limitations and conditions imposed by the Act. If instead, it is strategic, it will not be subject to these same limitations and conditions. The intent of the FHC at the time the acquisition is made should control, not the characterization of the investment as either financial-in-nature or merchant banking.

Also, from a practical point of view, it is unworkable. For example, an FHC makes a noncontrolling investment directly in a portfolio company and that company does not engage in any activities that are deemed to be financial-in-nature. Later, management of the portfolio company acquires a firm that is engaged in financial-in-nature activities. Under the interpretation posited by the interim rule, the FHC would be in violation of the merchant banking authority.

Similarly, FHCs may make noncontrolling investments in companies that are currently engaged primarily in activities that are financial-in-nature. The FHC cannot control whether that company branches beyond "financial-in-nature." If the FHC were forced to make this investment as "financial-in-nature" rather than as merchant banking, the FHC would have to divest within two years.

Finally, the definition of what is financial-in-nature is not fixed. Rather, as the Congress intended, it is a flexible, open-ended term that is meant to allow the regulators to take into account, among other things, changes in the marketplace and in the technology for delivery of financial services. An interpretation that views financial-in-nature and merchant banking activities as two separate and distinct businesses is sure to pose interpretive issues as the financial services industry evolves in the future.

E. PROHIBITION ON ROUTINE MANAGEMENT.

The Act prohibits FHCs from routinely managing or operating a portfolio company except as may be necessary or required to obtain a reasonable return on the resale or disposition of the investment. The interim rule clarifies that director interlocks at the portfolio company and certain types of agreements and covenants that affect only extraordinary corporate events would not, as a general matter, be considered routine management or operation.[9] The interim rule also

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[9] Routine management does not include:

- a FHC selecting any or all of the directors of a portfolio company if:
    - the portfolio company employs officers and employees responsible for the routine management and operation of the company, and
    - the FHC does not routinely mange or operate the portfolio company as described above.

provides that an FHC would be considered to be routinely managing or operating a portfolio company if the financial holding company establishes interlocks at the officer or employee level of the portfolio company or has certain other arrangements involving day-to-day management or participation in ordinary business decisions.[10] Finally, the rule sets forth those limited circumstances when it is permissible for an FHC to routinely manage or operate a portfolio company, requires documentation of these interventions, and limits the duration of the involvement.

ABASA believes that no definition of routine management and operation is necessary and that wherever possible the issue should be handled through the supervisory process. If, however, the Board and Treasury determine to go forward and define routine management and operation, ABASA suggests the following revisions:

1. An absolute bar on interlocks at the officer and employee level should be avoided. In addition, FHCs should have the flexibility to hire individuals below the top five executive level. For example, a portfolio company may need individuals with expertise in marketing or finance. It would not be unusual for the investment banking firm to both identify the need for such an individual and suggest a likely candidate for

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- covenants or other provisions regarding extraordinary events including:
  - the acquisition or control of significant assets of other companies;
  - significant changes to the business plan of the portfolio company;
  - the redemption, authorization or issuance of any shares of capital stock, and
  - the sale, merger, consolidation, spin-off, recapitalization, liquidation, dissolution, or sale or substantially all of the assets of the portfolio company or any of its significant subsidiaries.

[10] Routine management includes:

- Serving as or having responsibilities of an officer, employee or agent of the portfolio company and, at the same time, serving as director, officer, employee or agent of the financial holding company;
- supervising any officer or employee of the portfolio company and, at the same time, servings as a director, officer, employee or agent of the FHC;
- any covenant or other contractual arrangement between the FHC and the portfolio company that would restrict the portfolio company's ability to make routine business decisions, such as entering into transactions in the ordinary course of business or hiring employees below the rank of the five most senior officers, and
- participation in the day-to-day operations of the portfolio company or the management decisions made in the ordinary course of business of the portfolio company.

the position. That candidate may either be an employee of the FHC or someone with whom the FHC has experience. Unfortunately, the absolute bar on interlocks and prohibition on hiring executives below the top five would deny the portfolio company the ability to tap into the resources of its FHC investor.

2. References to agent should be eliminated. The interlock prohibition on officers and employees extends to agents of the FHC. ABASA recommends eliminating those references, as they seem to suggest that all agency relationships would be problematic. Of particular concern would be the hiring of a turnaround specialist who might be deemed to be an agent of an FHC due to some prior engagement.

3. The rule should reference the ability to select a general partner. The narrative portion of the release references the Board's existing interpretations that consider selection of a general partner to be the equivalent of selecting the board of directors. While ABASA is supportive of this position, it would be helpful if the interim rule clarified the permissibility of selecting a general partner.

4. Negative covenants should never be considered routine management. The interim rule identifies a set of covenants between an FHC and a portfolio company that generally would not be considered routine management. ABASA suggests that negative covenants, particularly financial covenants, should never be deemed to constitute routine management or operation of a company.

5. The exception is too narrow, does not comport with the Act, and should be broadened. The Act permits routine management where it is "necessary or required to obtain a reasonable return on investment upon resale or disposition." The interim rule, however, imposes a much more stringent standard. It permits routine management "only when necessary to address a material risk to the value or operation of the portfolio company, such as a significant operating loss or loss of senior management." In addition, the interim rule imposes a six-month time limitation on routine management, a time limitation that is nowhere mentioned in the Act. Anything over six months would require Board approval and the FHC to document each instance of its involvement in routinely managing or operating a portfolio company. The legislative language should be sufficient with bank regulators providing supervisory oversight.

F. <u>INVESTMENT HOLDING PERIOD</u>.

The interim rule provides that, in most cases, merchant banking investments may be held for a 10-year period. The rule allows a financial holding company to invest in qualifying private equity funds for the term of the fund, up to 15 years under certain circumstances.

Specific investment holding periods are contrary to the clear statutory language permitting an FHC to hold merchant banking investments for a sufficient period of time to "enable the disposition thereof on a reasonable basis consistent with the financial viability of investing for

appreciation and ultimate resale or disposition." This requirement, like the Act's other conditions, is intended to maintain the separation between banking and commerce.

ABASA urges that investment holding periods be handled, wherever possible, through the supervisory process rather than through specific rules. Any abuses associated with holding investments longer than permitted should be addressed not through burdensome and costly regulatory disincentives but through the supervisory process.

If, however, the Board and Treasury determine that holding periods are appropriate, we urge a uniform holding period of 15 years for all merchant banking investments, not just for private equity funds. It is our members' experience that direct portfolio company investments are sometimes held beyond 10 years. In addition, a uniform holding period for investments in portfolio companies and private equity funds will reduce some of the regulatory burdens associated with the interim rule.

Other burdens associated with the interim rule also should be reduced. For example, holding period measures should be performed across the portfolio, not on an individual investment basis. In addition, distributions from private equity funds and sales of investments to private equity funds in which an FHC has an interest appear to require tacking of holding periods, which is burdensome and costly. Again, attempts to circumvent the holding periods should be addressed through the supervisory process not through rules that require tracking dates of original acquisition of the investment.

Finally, many FHCs will be unable to comply with the requirement of giving one year's notice in order to hold the investment beyond the normal holding period. An FHC may very well intend to sell an investment within the requisite time period, but market conditions may prevent the transaction from going forward. Moreover, the ability to seek an extension on some notice shorter than a year is not likely to be abused by FHCs, considering the capital implications and other restrictions associated with getting such an extension.[11] Nor does the Board need one year to decide if an extension is appropriate.

G. CROSS-MARKETING.

The Act prohibits depository institutions controlled by an FHC from marketing or offering, directly or through any arrangement, any product or service of a company held under the proposed rule or allowing any product or service of the depository institution to be offered or marketed, directly or through any arrangement, by or through any company held under Section 4(k)(4)(H). In implementing this provision, the interim rule extends the prohibition well beyond what is required by the Act.

Specifically, various types of subsidiaries should not be subject to the cross-marketing prohibition. The prohibition does not extend to financial subsidiaries authorized under section

[11] An FHC that has held an investment beyond the applicable period must deduct 100 percent of the carrying value of its investment from the holding company's Tier 1 capital and may not include any of the unrealized gains on the investment in its Tier 2 capital for regulatory purposes.

5136A of the Revised Statutes or section 46 of the Federal Deposit Insurance Act. It should similarly not be extended to any other depository institution subsidiary authorized under specific statutory authority such as SBICs or Edge Act firms.

H. SECTIONS 23A AND 23B.

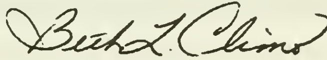
The interim rule implements provisions of the Act establishing a rebuttable presumption of control for purposes of the restrictions contained in Sections 23A and 23B of the Federal Reserve Act on transactions between a depository institution and a portfolio company in which the FHC owns or controls 15 percent or more of the equity capital of the company. The interim rule provides that the presumption may be rebutted with the agreement of the Board.

ABASA urges the Board to include in the rule two specific situations in which the presumption under Sections 23A and 23B should be considered to be rebutted. The first situation would provide that the presumption of control can be rebutted by demonstrating that an unaffiliated investor or two or more unaffiliated investors acting in concert hold, own or control, directly or indirectly, a greater amount of shares, assets or ownership interests in a portfolio company than does the FHC. The second situation would rebut the presumption of control if the FHC's ownership level in the portfolio company, private equity fund or other investment vehicle was less than 25%, the FHC had no more than one director on the board of the company or fund, and there was no other evidence or indicia of control on the part of the FHC.

IV. CONCLUSION

For all of the foregoing reasons, ABASA strongly urges the Board and Treasury to limit its activities to effectuating Congressional intent and addressing the fundamental concerns raised herein.

Sincerely yours,



Beth L. Climo

Testimony of Jeffrey Walker
Managing Partner, Chase Capital Partners
On behalf of
The Financial Services Roundtable
Before the
United States House of Representatives
Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises
Committee on Banking and Financial Services

June 7, 2000

My name is Jeffrey Walker. I am the Managing Partner of Chase Capital Partners, and I am a Member of the Executive Committee of The Chase Manhattan Corporation. I am pleased to have the opportunity today to speak on behalf of The Financial Services Roundtable on the merchant banking rules released by the Federal Reserve Board ("Board") and the Department of Treasury ("Treasury").

Chase Capital Partners, the primary equity investment arm for The Chase Manhattan Corporation, has a long-standing and successful history of making merchant banking investments. Chase Capital Partners has been involved in merchant banking activities for over sixteen years. In fact, it has closed over 1000 transactions since its inception. Several companies in which we have invested that may be familiar to you include Star Media, Geocities, Kinkos, 1-800 Flowers, Office Depot, American Tower, Harris Chemicals, Jet Blue Airways, Multex, Telecorp PCS and Triton Cellular. It is a global investment partnership with over $18 billion in assets under management, and has over 140 investment professionals in seven offices throughout the world.

Chase Capital Partners has maintained a successful relationship with the Chase Manhattan Corporation, its primary investor, by maintaining a diversified investment portfolio

that has generated an annual rate of return of over 40% on its realized investments. At the same time, Chase Capital Partners has consistently exhibited a strong risk management and reporting process and has received satisfactory results from its banking exams for its entire history.

Chairman Baker, thank you for holding this hearing today and for inviting The Financial Services Roundtable to participate. The Financial Services Roundtable is a national association whose membership is reserved for 100 companies selected from the nation's 150 largest integrated financial services firms. The member companies of the Roundtable engage in a wide range of financial activities, including banking, securities, insurance, and other financial service activities.

The Roundtable is pleased that the Subcommittee on Capital Markets continues its long tradition of promoting honest and open discussion on topical and important issues such as the one we are addressing today. The Roundtable expects that this hearing will help the Subcommittee evaluate the industry's concerns over the proposed capital charge and other restrictions contained in the merchant banking rules. The Roundtable further anticipates that this hearing will help address solutions for ensuring that banking organizations and securities firms have equal opportunities to engage in merchant banking activities under the Gramm-Leach-Bliley Act ("GLB Act").

Let me begin by stating that Congress authorized merchant banking investments under the GLB Act in recognition of the "essential role" that merchant banking plays in modern finance. The Roundtable strongly believes that the merchant banking rules threaten to restrict this important activity in ways that are plainly inconsistent with the clear intent of Congress. More importantly, the Roundtable believes that these rules will make it a great deal more expensive for FHCs to make merchant banking investments and, thereby, threaten to limit the availability of venture capital funds. Finally, the Roundtable believes that the rules are unnecessary given the long and highly successful history of bank holding companies and securities firms in making, managing, and monitoring venture capital investments in a prudent fashion. Any supervisory concerns of the Board and Treasury over merchant banking

investments can be dealt with most appropriately on a case-by-case basis through the traditional examination and supervisory process.

The Roundtable has submitted a comment letter to the Board and Treasury urging them to reconsider the proposed capital charge and other aspects of the merchant banking rules that disadvantage financial holding companies ("FHCs") in the conduct of merchant banking activities. As explained in full detail in the Roundtable's comment letter, a copy of which is attached to my testimony, the Roundtable has significant concerns about the following aspects of the merchant banking rules.

The Fifty Percent Capital Haircut

One of the most objectionable aspects of the merchant banking rules is the Board's proposal to impose a fifty percent capital haircut on merchant banking investments by FHCs under the GLB Act and equity investments by bank holding companies under other long-standing legal authorities. This extra capital charge increases the amount of capital that a holding company must carry against a covered investment by approximately *800 percent*. This is an *eight-fold increase* in the capital cost of making these types of investments.

The Roundtable strongly believes that this extraordinary capital charge undermines the very competition that Congress concluded was in the public interest when it passed the GLB Act. The capital charge will upset the "two-way street" that permits banking organizations to compete with securities firms and securities firms to own banks by making it more expensive for FHCs to make merchant banking investments. The capital charge also will disadvantage U.S. FHCs as compared to securities firms that are unaffiliated with banks and foreign banks that elect FHC status, neither of which will be subject to similar capital haircuts. This disparate treatment is inconsistent with the spirit of the GLB Act.

The Roundtable further believes that the arbitrarily high capital charge is not necessary. Banks and bank holding companies have engaged for decades in activities that the Board says

are identical in risk to merchant banking activities. They have done so without any threat to safety and soundness.

The Board's main justification for the capital charge is that some banking and securities firms apply internal risk models with a high capital assessment to equity investments. The Board's reliance on internal models in this case is inappropriate for two primary reasons. First, internal models usually apply a higher charge to some investments and a lower charge to investments judged as less risky. The Board's rules do not allow such adjustments. Thus, the Board is "cherry-picking" only the part of an internal model that applies a higher charge, while ignoring other parts of the model. Second, the industry's practices are divergent. The Roundtable surveyed many of its members and was itself surprised to learn that there is no common approach to addressing investment risk. Accordingly, the Roundtable does not believe institutions' internal capital models provide support for the application of a uniform 50% regulatory capital charge.

The Board assumes that objections to the capital charge are of no practical significance because FHCs will remain well capitalized even after the capital charge. This assumption is not correct. Institutions typically maintain a cushion above regulatory capital requirements. Such a cushion protects against unexpected events and ensures high ratings, among other things. A mandatory increase in capital will not reduce the need for an institution to maintain such a cushion.

Accordingly, the capital charge will have a real, concrete and significant impact on institutions. It will require institutions to raise additional capital for each equity investment. It will do so for no economic reason. This outcome is unwarranted given that circumstances have not changed and experience does not call for increased capital for merchant banking investments.

The Roundtable believes that an individualized approach to risk management is by far the most effective way of addressing the perceived risks of merchant banking. An individualized approach would not upset the careful balance that Congress sought to achieve in authorizing

merchant banking. The Board certainly has ample authority to limit merchant banking activities of particular institutions on a case-by-case basis.

If the Board, nonetheless, decides to impose specific capital rules on merchant banking activities, the Roundtable has suggested some alternatives. These alternatives, which are set out in detail in the Roundtable's comment letter, include excluding unrealized gains on merchant banking investments from an institution's calculation of its capital base or imposing a 200 percent risk weighting for investments made under the new merchant banking authority. Any of these proposed alternatives is an improvement over the Board's arbitrary capital charge.

The Maximum Investment Cap

Another objectionable feature of the merchant banking rules is the maximum investment cap on FHC merchant banking investments. The interim rule generally prohibits a FHC from making additional merchant banking investments if the aggregate value of all merchant banking investments exceeds the lower of $6 billion or 30 percent of the FHC's capital base.

As an initial matter, the GLB Act does not authorize these caps. Furthermore, the Roundtable strongly believes that any artificial investment cap on merchant banking will limit the ability of FHCs to compete in the market. A maximum cap will limit diversification and reduce market presence of FHCs. This will impair FHCs ability to compete for most major deals. In addition, a maximum cap also will punish those firms that invest wisely -- firms whose merchant banking portfolio's have shown significant gains will run the risk of hitting the caps; firms with poorly performing portfolios are less likely to hit the percentage caps.

The Roundtable is perplexed over why the Board and Treasury believe that a specific dollar cap, let alone one based on a fixed dollar amount, is appropriate. The dollar limits do not reflect the industry's past practice in investing in merchant banking. In fact, the dollar limits are so low that securities firms may reach the limits quickly and automatically be precluded from

further merchant banking investments. A one-size-fits-all approach to regulating merchant banking simply does not work.

The preamble to the interim rule suggests that the maximum cap is a temporary measure to be revisited as soon as the Board and Treasury adopt appropriate capital rules and gain experience in managing and supervising the risks of merchant banking. If the Board and Treasury are determined to impose a cap, the Roundtable urges them to include a specific "sunset" provision for the cap in the actual text of the rule. Ambiguity over the duration of the cap will have at least three negative consequences: first, it will impair the ability of FHCs to assess properly the viability of potential merchant banking investments; second, it will have a practical effect on the management of FHCs' merchant banking business (*e.g.*, decisions on staffing and recruiting); and, third, it will only add to the competitive advantage of securities and investment firms over FHCs and their affiliates in merchant banking.

<u>Coverage of More Than Merchant Banking</u>

The Roundtable further objects to the unwarranted, broad scope of the merchant banking rules, which encompass much more than merchant banking. In fact, the merchant banking rules are written so broadly that they cover existing equity investments made under long-standing legal authorities, including investments in small business investment companies ("SBICs") and loans to merchant banking clients.

Bank holding companies have made limited equity investments for more than 30 years without any additional capital charge. Moreover, the Board and Treasury have presented no evidence, and the Roundtable submits that there is none, to indicate that these investments have given rise to any safety and soundness risks or other concerns. The inclusion of these types of equity investments in the scope of the merchant banking rules is not necessary or appropriate.

The coverage of SBIC investments is particularly troubling. As you may well recall, small business was intended to be a principal beneficiary of the new merchant banking powers

for banking firms. The merchant banking rules, however, now require extraordinary capitalization for investments in SBICs. This treatment disregards the fact that SBICs are licensed, regulated and examined regularly by the Small Business Administration; have a limited partnership structure; and have consistently been regarded as conservative and profitable investments that do not pose a safety and soundness risk to banking organizations.

The Roundtable believes that the high capital cost of SBIC investments will cause a decline in such investments. This decline in SBIC investments may adversely affect essential financing for new and small companies and retard the creation of new jobs by such firms.

Retroactive Application of Merchant Banking Rules

Another troubling aspect of the merchant banking rules is that the proposed capital charge would apply retroactively to all equity investments made under long-standing authorities. The Roundtable strongly believes that this result is an unfair surprise, which penalizes bank holding companies that have made investments in reliance on current law.

Let us be clear about the consequences of this approach. Investments that have been held for many years in a safe and sound manner, without any suggestion of risk supporting additional capitalization, would now be subject to a significant capital hit. This hit applies even though there has been *no change* in the actual risk profile of the investment. For example, let us assume that a bank holding company holds the very same investments today as it held prior to the GLB Act. The bank holding company has no intention of engaging in any merchant banking activities under the GLB Act or electing FHC status for that matter. As a result of the merchant banking rules, this same bank holding company will have to retain extra capital to support its pre-existing investments. This result makes no sense.

In practice, the retroactive imposition of a capital charge on pre-existing investments will alter the economics of existing investments of bank holding companies. Investments that at one time were cost-effective and sound would suddenly become unprofitable. This result could

cause a fire sale of investments that have become too costly to retain. All of this will occur merely because the Board has changed the rules of the game. The nature of and risk posed by these investments, however, has not changed.

Other Provisions

The merchant banking rules contain several other provisions of concern to the Roundtable. To summarize a few, the merchant banking rules also impose (1) a maximum holding period on FHC investments, which is inconsistent with the plain meaning of the GLB Act; (2) limitations on managing a portfolio company, which are unduly restrictive in light of the language of the GLB Act; (3) recordkeeping and reporting requirements, which impose substantial and unnecessary burdens on FHCs and may require a FHC to disclose prematurely future divestiture plans; and (4) cross-marketing restrictions and restrictions on private equity funds, which are too broad. The Roundtable has addressed these and other troubling provisions in great detail in its comment letter.

Chairman Baker, in conclusion, the Roundtable appreciates the opportunity to provide our comments on this important topic of concern to banking organizations and securities firms, alike. Thank you again for this opportunity. I would be pleased to answer any questions that the Committee might have on this issue.

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