For Release Upon Delivery
10:00 a.m., April 4, 2001

**TESTIMONY OF**

**JOHN D. HAWKE, JR.**

**COMPTROLLER OF THE CURRENCY**

**before the**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES**

**and the**

**SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT**

**of the**

**COMMITTEE ON FINANCIAL SERVICES**

**of the**

**U.S. HOUSE OF REPRESENTATIVES**

**April 4, 2001**

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

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

## Introduction

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**Small Business Investment Corporations**

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

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

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

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

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

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

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

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

**March 2000 Proposal**

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

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

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

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

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

**February 2001 Capital Proposal**

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

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

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

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

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

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

**Conclusion**

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

I would be pleased to respond to any questions.

## Summary of February 2001 Capital Proposal

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

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

**Table 1—Deduction for Non-financial Equity Investments**

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

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

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

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

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

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

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

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

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