April 16, 2001

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Communications Division, Third Floor
Office of the Comptroller of the Currency
250 E. Street, SW
Washington, DC 20219

Re: Leverage and Risk-Based Capital Guidelines: Nonfinancial Equity Investments; FDIC RIN 3064–AC47; FRB Docket No. R–1097; OCC Docket No. 01-03; 66 Federal Register 10212; February 14, 2001

Dear Ladies and Gentlemen:

The Federal Deposit Insurance Corporation ("FDIC"), the Board of Governors of the Federal Reserve System ("FRB") and the Office of the Comptroller of the Currency ("OCC") (collectively referred to as the "Agencies") have proposed to amend the risk-based capital guidelines to impose special minimum regulatory capital requirements on equity investments in nonfinancial companies. The proposal replaces a prior proposal issued by the FRB applicable only to bank holding companies. The proposed rule is one of the Gramm-Leach-Bliley Act ("GLBA") implementing regulations and could affect many commercial banks, savings banks and bank holding companies. The American Bankers Association ("ABA") brings together all categories of banking institutions 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 associations, trust companies, and savings banks – makes ABA the largest banking trade association in the country.

Background

The initial proposal by the FRB to impose special capital requirements on nonfinancial equity investments would have required a 50 percent deduction from Tier 1 capital of the total carrying value of these investments and would have defined those investments to include not only investments made under the newly authorized merchant banking powers but also investments under previously authorized and exercised investment authorities: Section 24 of the FDI Act, Regulation K, Sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act and statutes allowing investments in Small Business Investment Companies ("SBICs"). ABA strongly opposed the adoption of this proposal,[1] arguing primarily that the proposed 50 percent deduction was clearly excessive, that any merchant banking capital charge should not apply to investments previously made under existing investment authority, and that the better alternative would be the use of a supervisory approach that would consider the individual bank's or BHC's internal controls, systems and models.

Proposal

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

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

Second tier: if equity investments in nonfinancial companies make up 15 percent or more but less than 25 percent of an organization's Tier 1 capital, a 12 percent Tier 1 capital charge would be assessed against the amount of such investments exceeding the 15 percent threshold (except, as noted below, those made through SBICs).

Third tier: if equity investments in nonfinancial companies exceed 25 percent of an organization's Tier 1 capital, then a 25 percent Tier 1 capital charge would be assessed against the amount of equity investments in nonfinancial companies exceeding 25 percent of Tier 1 capital (except, as noted below, those made through SBICs).

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

Equity investments made through SBICs (except as noted below);

Non-controlling equity investments made under sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act;

Portfolio equity investments made under Regulation K; and

Most equity investments by state banks under section 24 of the Federal Deposit Insurance Act.

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

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

The Proposed Special Capital Charge

ABA is pleased that the Agencies have significantly reduced the 50 percent blanket capital charge originally sought to be imposed on all equity investment activities by the FRB. While ABA still maintains that the optimum method for dealing with nonfinancial equity investments would be to adopt a supervisory approach, as we originally advocated in our testimony to the Congress and in ABA's comments to the FRB,[2] nonetheless we recognize that a special capital charge ranging from 8 to 25 percent of Tier 1 capital is a significant improvement over "the one size fits all" 50 percent capital charge originally proposed. The proposed sliding scale approach addresses, in large part, many of ABA's concerns by assessing capital according to the increasing level of nonfinancial equity investments made by a banking organization.

However, ABA remains concerned that any special capital charge assessed against FHCs engaged in merchant banking activities will further exacerbate the inequities between FHCs and non-FHCs engaged in such activities. We believe that the legislative history of the merchant banking provisions of GLBA indicates that Congress intended that those investment banking firms affiliated with securities firms and insurance companies that opt to become FHCs should be permitted to continue to engage in merchant banking activities in substantially the same manner as had always been permitted.[3] Conversely, Congress also intended that bank and financial holding companies should not be placed at a competitive disadvantage relative to investment banking firms not affiliated with any depository institution, but rather they should be allowed to engage in merchant banking activities to the same extent as those other firms.[4]

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

Capital Treatment of Equity Investments Pursuant to Pre-GLBA Activities

The Agencies state that the new capital proposal establishes a marginal capital structure that is different and generally lower than the original proposal, that no special capital charge would be imposed on investments made through an SBIC within certain thresholds, and that SBICs hold a very large portion of the investments made prior to March 13, 2000, by banking organizations. In light of these changes, the Agencies request comment on whether it is necessary or appropriate to grandfather the individual investments made prior to March 13, 2000. ABA believes that it is appropriate and necessary to so grandfather these investments.

First, ABA continues to oppose any assessment of a special capital charge on non-merchant banking equity investments made pursuant to pre-GLBA investment activities. These investments have been permissible for banking organizations for many years preceding GLBA. The banking industry has a long history of engaging in such equity investment activities through SBICs,[5] under Regulation K,[6] 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.[7] To date, those activities have produced strong returns with minimal losses and have taken place over a relatively long period of time, involving both up and down markets. There is simply no evidence that additional capital is warranted for equity investments made pursuant to investment activities authorized for banking organizations prior to passage of the Gramm-Leach-Bliley Act. At the very least, ABA believes that investments through SBICs should be totally excluded from both the activity-level calculation and special capital charge.[8] ABA believes that all investments made pursuant to these pre-GLBA activities should not be subject to the special capital charge.

However, should the Agencies go forward with their proposal to assess capital against nonfinancial equity investments made pursuant to activities authorized for banking organizations prior to passage of GLBA, ABA would strongly encourage the Agencies to grandfather all equity investments made prior to March 13, 2000, the date that the FRB first proposed a special capital charge. Without such a determination, many of the investments made previously will be rendered uneconomic – not because of any change in inherent worth but solely because of an unanticipated change in regulatory treatment that results in greater unexpected cost.

ABA notes that the Agencies presently propose to exclude from the special capital charge any investment in a nonfinancial company held by a state bank in accordance with the grandfather provisions of Section 24(f) of the FDI Act. The provisions of Section 24(f) were specifically enacted by Congress in recognition of long standing authority for certain state banks, particularly in New England, to engage in such equity investments. ABA supports that exclusion.

Finally, the Agencies also request comment on the alternative of allowing banking organizations to phase in over a period of time (such as 3 years) the proposed capital standards with regard to investments made prior to March 13, 2000. ABA believes that a complete grandfather of these investments avoids the burdens associated with implementing a phase-in of the special capital charge. As the proposal notes, these investments involve only modest amounts at most banking organizations and will be liquidated over time. Modest investments liquidating over time would tend to argue against a phase-in of capital charges and in favor of a complete grandfather.[9]

Effect of Proposed Basel New Capital Accord

The Agencies are currently requesting comments from banking organizations on the Basel Committee on Banking Supervision's proposed New Capital Accord. ABA notes that the Agencies nonetheless do not reference the proposed New Capital Accord's suggested treatment for significant investments in commercial entities, although the new proposal moves closer to the proposed treatment of commercial investments under the proposed Accord. Nonetheless, the proposed treatment of nonfinancial equity investments still appears to differ considerably from the treatment outlined in the proposed New Capital Accord.

According to the The New Basel Capital Accord, posted at the Bank for International Settlements' website for the Committee on Banking Supervision:

"E. SIGNIFICANT INVESTMENTS IN COMMERCIAL ENTITIES

16. Significant minority and majority investments in commercial entities which exceed certain materiality levels will be deducted from banks' capital. Materiality levels will be determined by national accounting and/or regulatory practices. Materiality levels of 15% of the bank's capital for individual significant investments in commercial entities and 60% of the bank's capital for the aggregate of such investments, or stricter levels, will be applied.

17. Investments in significant minority- and majority-owned and controlled commercial entities below the materiality levels noted above will be risk weighted at no lower than 100% for banks using the standardised approach. An equivalent treatment will apply for banks using an IRB approach based on methodology the Committee is developing for equities.

F. DEDUCTION OF INVESTMENTS IN DECONSOLIDATED ENTITIES

18. Deduction of investments in deconsolidated entities will be 50% from Tier 1 and 50% from Tier 2." (Pp. 3-4.)

ABA assumes that as the Agencies finalize any revision of their capital adequacy standards in accordance with final Basel New Capital Accord, the Agencies will review their final rule on the special capital charge on nonfinancial equity investments in light of the New Capital Accord.

Conclusion

The American Bankers Association appreciates the opportunity to comment on this proposal on capital treatment of nonfinancial equity investments. While ABA believes that the Agencies have made considerable improvements in the proposal, ABA urges that the Agencies adopt a supervisory approach to capital adequacy instead of the proposed regulation. If the Agencies proceed with adopting the proposal, ABA recommends that all nonfinancial equity investments made pursuant to activities authorized for banks and bank holding companies prior to GLBA be exempt from the special capital charge. Barring that, all nonfinancial equity investments made pursuant to activities authorized for banks and bank holding companies prior to GLBA before March 13, 2000, should be completely grandfathered under their current capital treatment. Further, SBIC investments not be counted toward the investment percentage triggers as proposed. If there are any questions about these comments, please call the undersigned.

Sincerely,
Paul A. Smith

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[1] Letter dated May 22, 2000, filed with the Federal Reserve Board and Treasury in re Docket Nos. R-1065 and R-1067.

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

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

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

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

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

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