



CRS Report for Congress

Merchant Banking: Mixing Banking and Commerce Under the Gramm-Leach-Bliley Act

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Summary

A power Congress granted to banking (“financial holding”) companies in the Gramm-Leach-Bliley Act is merchant banking. It allows them to invest in nonfinancial businesses for a share of the profits. Other countries widely practice merchant banking. Its implementing agency, the Federal Reserve, has seen limited activity under its implementing regulation. Congress has paid attention to these investments because this application of the law, allowing merchant banking, has been controversial. The entire question of the separation of banking and commerce, of which merchant banking forms one part, has come under scrutiny in congressional hearings. This report will be updated as developments warrant.

Authorization

The Gramm-Leach-Bliley Act (GLBA)¹ eased affiliations among banks, securities firms, and insurance companies, under a holding company structure. GLBA repealed the Glass-Steagall Act,² which, originating in the aftermath of securities market troubles associated with banking practices, had separated the securities/investing business from the banking business since 1933. GLBA created financial holding companies (FHCs) to own (“hold”) banks and other financial enterprises. The Federal Reserve (Fed) regulates FHCs under the act. GLBA allows FHCs to make equity investments in nonfinancial companies conditional upon their controlling either (1) a securities company, or (2) an investment advisor to an insurance company inside the FHC.³

¹ P.L. 106-102, 113 Stat. 1338 — 1481, Nov. 12, 1999.

² Sections 20, 21, 26, and 32 of The Banking Act of 1933, P.L. 73-66, June 16, 1933.

³ 12 U.S.C. 1843(k).

What Is Merchant Banking?

Merchant banking mixes banking with commerce. The term comes from European practices, in which *bankers* financed foreign trade and other high risk ventures undertaken by *merchants* such as ship owners and importers for a share of the profits, rather than receiving interest returns from lending. Taking a stake in a venture made it merchant banking. Potentials for losses and conflicts of interest made it become generally illegal for commercial banks in America, via the 1933 Glass-Steagall Act. Other investors remained free to finance businesses through any combination of debt and equity. Congress restated limits on banking investments in the Bank Holding Company Act of 1956⁴, and its amendment in 1970.⁵

Whether to allow greater banker ties with operating nonfinancial firms, and if so, under what rules, were major issues in the congressional debate that produced GLBA in 1999. Congress recognized that some forms of ownership of commercial firms by banking organizations are the equivalent of providing direct financing to small businesses. Before GLBA, banking companies could use equity-investing authority only through Small Business Investment Companies (SBICs) and other limited powers. Bank holding companies could own noncontrolling interests in nonfinancial companies: not more than 5% to 10% of voting securities. GLBA allows FHCs into the high-risk, high-reward private equity market. Beyond our borders, 32 countries allow banks into that market, although five countries do not, and seven permit it only with restrictions.⁶

What Is the Private Equity Market?

The *public* equity (stock) market is generally the one in which anyone can buy or sell securities. Many requirements of “openness” in trading and reporting apply in the public market. By contrast, large-scale investors fund the restricted *private* equity market: pension funds, endowments, foundations, insurance companies, banks, and wealthy individuals. About a third of the private equity market is venture capital investment in startup and early-stage firms, with the rest leveraged buyouts (LBOs) and investments in existing mid-sized companies. LBOs are transactions in which private investors buy out a company using debt financing, which “leverages” capital they put into the deal. The organized private equity market is tiny compared with the public market.

Equity investing is the highest-risk part of a firm’s financing, because it has the lowest priority of claim on the cash flow of the company whose equity financiers purchase. Significant risks exist that products or strategic plans of start-up companies will prove unworkable. For LBOs, risks also come from high levels of debt that magnify profits and losses for owners. Private equity investments are not registered for public sale. The investments are necessarily in small to medium-sized businesses, rather than the larger blue chips of higher capitalization and greater predictability of earnings, consequently requiring greater anticipated returns to compensate for the risks.

⁴ P.L. 84-511, May 9, 1956.

⁵ P.L. 91-607, Dec. 31, 1970.

⁶ Institute of International Bankers, *Global Survey 2004*, p. 14, [<http://www.iib.org/gs2004.pdf>].

Investors generally hold private equity investments from three to seven years or longer. They may exit private equity by (1) selling a stake in a company, (2) arranging a merger or acquisition, or (3) arranging to take the company public. Returns on private equity are highly volatile and cyclical, reflecting changing conditions in the public equity and corporate mergers market. With the general economic and financial slowdown at the start of the century, activity in venture capital and similar investments softened.

New Opportunities for Merchant Banking

Many securities and insurance firms have long been involved in merchant banking. European financial firms have been making these deals for centuries. In America and abroad, securities companies created private equity funds (often as limited partnerships). This arrangement allows them to share the risks and rewards efficiently with other investors. GLBA granted American commercial bankers more opportunities for deal-making like those of their Wall Street and foreign counterparts.

Under GLBA, FHCs — but not banks or bank subsidiaries — can engage in merchant banking activities until 2004. Thereafter, a regulatory change could allow banks to own merchant banking subsidiaries, if the Office of the Comptroller of the Currency (OCC), which regulates national banks, and the Fed concur.

Many bankers have adopted the FHC structure, despite general expectation that only banking firms already active in the securities business would be interested. Even banking companies with no current merchant banking opportunities are converting to FHCs.

Regulatory constraints on bankers in the field are two: (1) capital requirements, restricting investments based on capital or dollar amounts, and (2) operational requirements, restricting management and sale of the investments. Bankers have felt that they must compete with investors not facing these constraints, thus, GLBA may not have provided them enough freedom to compete in the new field.

Capital Requirements

Capital requirements, a principal form of financial regulation, remain contentious. “Core” capital is what shareholders in a banking company have at stake in the business, which they stand to lose in case of failure. Obtaining core capital is more expensive than other means of raising money, so bankers seek to hold as little of it as possible. Minimum capital requirements protect against losses that might otherwise fall back onto the banks, federal deposit insurance, or the economy. If rules force bankers to operate with greater capital than they would otherwise choose, the rules in effect “tax” affected financial activity. Essentially, uses of funds (loans and investments) come to have a higher cost, should the sources of the funds be forced to contain a larger mix of capital. Net earnings then become lower although returns become less risky, with the extra capital.

In its original regulation, the Fed would have required FHCs to have core capital of 50 cents against every dollar of merchant banking investments. For bankers already holding private equities, the standard would have multiplied their requirement from the pre-GLBA 8% minimum general capital/asset ratio. The jump would have sharply reduced earnings on investments, including SBICs. The proposal would have directly

affected banks, as the OCC and the Federal Deposit Insurance Corporation needed to issue a consistent rule for banks' own investments, made under authority other than GLBA.

Bankers questioned whether capital requirements should be high, because some banks had done equity financing safely with less for years. Criticism also arose over competition, because nonbanking firms would not face these restraints. Many of the latter operate with low capital ratios and have great freedom to do deals. House and Senate Committee hearings in June 2000⁷ focused on redrawing the regulation in more banker-friendly ways.

The bank regulators proposed standards in January 2001 that set a three-tiered sliding capital deduction running from 8% to 25%. That rule would still have raised capital requirements from pre-GLBA amounts, yet was less costly than the earlier proposal. Investments in SBICs would not have to meet the new requirements unless they comprised more than 15% of the owning institution's capital. Regulators defended the revised proposal on three main grounds. First, roughly a quarter to a third of individual deals, and a fifth of portfolio investments overall, lose money. Second, financial risks increase as equity investments account for larger portions of financial firms' activities. Third, pre-GLBA capital values such as 8% were low precisely because bank equity investments were small at the time, and thus did not pose large-dollar amounts of risk.

Operational Requirements for Resale and Management Control

Under GLBA's wording, merchant banking investments must meet two operational requirements. (1) FHCs may hold individual investments only "for a period of time." (2) FHCs may not routinely manage or operate commercial firms except as necessary or required to obtain a reasonable return on the investments upon "sale or disposition."

The Fed set the "period" requirement in a final rule of January 2001⁸ at 10 years for direct investments, and 15 years for investments through private equity funds. Individual investments can receive exemptions, but owners must apply to the Fed before the expiration date. The Fed codified the law's prohibition against actively managing commercial firms, and required its approval for a FHC to seize managerial control of a company in which it has invested to protect its interests. It restricted merchant banking investments to 30% of FHC core capital, or 20% after excluding private equity funds. These percentage restrictions are not costly capital deductions, but are quantity restraints effectively limiting investments to small proportions of total assets. (Example: a FHC has 10% core capital supporting its entire holdings, \$10 per \$100 of total assets. It may invest perhaps 20% to 30% of the \$10 in merchant banking assets: \$2 to \$3.)

Industry commentators criticized the period requirement on two grounds. First, that the time frames were too short, encouraging "fire sales" as the limits approached. Second, that the Fed's extension of time for sale process is not appropriate, because normal bank

⁷ U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs. *Merchant Banking Regulations Pursuant to the Gramm-Leach-Bliley Act of 1999*, hearing, 106th Cong., 2nd sess., June 13, 2000 (Washington: GPO, 2001), 165 pp.

⁸ 12 C.F.R. 225.172.

regulatory processes better address timing problems. Regulators defended the periods because owners rarely hold such investments beyond five years, and finite holding periods allow FHCs to plan divestiture strategies. Industry views criticized the management prohibitions as interfering with normal business practices protecting investors. The Fed responded that restrictions reflect GLBA's limits on mixing banking and commerce.

Another hearing, before two subcommittees of the House Financial Services Committee, examined the redrawn merchant banking regulations on April 4, 2001. Concerns noted above over capital and operational restrictions resurfaced.⁹

Regulation as Issued

The Fed and other regulators issued the final rule on capital, effective April 1, 2002.¹⁰ It contains a sliding scale of capital charges for investments in nonfinancial firms. These deductions operate in the opposite direction of the 20/30% quantity limits. Their limit is the ratio of specified risky assets to supporting capital. **Table 1** shows its capital charges, which are essentially those proposed in January 2001.

Table 1. Capital Deduction for Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly (as a % of core capital)	Deduction from core capital (as a % of the adjusted carrying value of investment)
Less than 15%	8%
Next 10%	12%
Amount Over 25%	25%

Source: Rob Garver, "Pay to Play," *The American Banker*, Dec. 11, 2001, p. 4.

The significant exceptions to it are two: (1) Investments made before March 13, 2000, need not meet the new capital rule, although counted in the basket of all covered investments, and (2) SBIC investments become exempted if they amount to no more than 15% of core capital. Thus, long-standing investments are relieved, while new investments face higher requirements. The financial-form "tax" on covered investments is progressive, to discourage increasing risk-taking. The higher the capital set aside, the more expensive it becomes to fund the covered investments. (Example: an institution must raise capital, if it falls into the second tier of Table 1, of \$12 per \$100 of these

⁹ "Lawmakers Explore Opportunities to Soften Regulations Implementing Merchant Banking," *Daily Report for Executives*, Apr. 5, 2001, p. A-34.

¹⁰ U.S. Department of the Treasury; Federal Reserve System; Federal Deposit Insurance Corporation, "Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Nonfinancial Equity Investments; Final Rule," *Federal Register*, vol. 67, no. 17, Jan. 25, 2002, pp. 3783-3807.

investments, more than traditional bankers' capital of \$6/\$100 on assets generally and the \$6/\$100 regulatory capital requirement for securities broker/dealers).¹¹

Did It Work Out?

Prominent banking companies faced write downs in their private equity portfolios after in the burst-bubble year 2000, just after passage of GLBA. Equity investing cost seven large banking companies \$4.3 billion in 2001, and \$2.13 billion in 2002. Those few firms represent nearly 90% of the equity investments banking companies have made.¹² Newer data on activity of U.S.-based FHCs in this field, as reported to the Federal Reserve, appears in **Table 2**. According to these data, merchant banking has remained a small share of the private equity market,¹³ not to mention the national financial economy.

Table 2. Number and Merchant Banking Assets of Financial Holding Companies Reporting Merchant Banking Activities

Number of FHCs:	12/31/00	12/31/01	12/31/02	12/31/03	6/30/04
— Domestic	11	19	12	14	15
— Foreign	9	10	14	15	18
Assets Reported (\$ billion)	\$9.5	8.3	9.1	10.7	12.0

Source: Communication from the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System to William Jackson, Oct. 14, 2004.

Prospects

Private equity returns for all investors have since rebounded from negative territory, and have continued to exceed those of major stock market indexes over several years.¹⁴ The prospect of such excess returns may stimulate bankers' merchant banking, further mixing banking and commerce beyond its limited extent of recent years.

Congress may continue to explore connections between investments of banking companies, bank lending, and corporate governance. Future hearings may question whether public policy should allow bankers to make equity-type investments, including those in merchant banking, should Enron-like collapses involving the banking system recur.

¹¹ "FDIC Board Adopts Final Rule on Investments in Nonfinancial Firms," *Daily Report for Executives*, Dec. 11, 2001, p. A-1; and, Rob Garver, "Reaction to Capital Rule," *The American Banker*, Dec. 11, 2001, pp.1, 4.

¹² Barbara Rehm, "Banks Report Less Pain from '02 Equity Investments," *The American Banker Online*, Jan. 29, 2003.

¹³ Board of Governors of the Federal Reserve System, *Report to the Congress on Financial Holding Companies under the Gramm-Leach-Bliley Act*, Nov. 2003, p. 39.

¹⁴ According to the National Venture Capital Association [<http://www.nvca.org>].