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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

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

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

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

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

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

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

The OCC's primary objective in the development of regulatory capital rules for merchant banking activities was to protect the existing capital and regulatory infrastructure surrounding SBICs, which reflect the long-standing Congressional preference for these entities. Many commenters did not believe that the original Federal Reserve Board March 2000 Capital Proposal was consistent with that objective. That proposal would have assessed, at the holding company level, a 50% Tier 1 capital charge on the carrying value of private equity investments in non-financial companies held directly or indirectly by a holding company, and would have applied these capital charges to a variety of existing investment authorities for bank and bank holding companies beyond the new GLBA merchant banking authority.

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

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

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

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

I would be pleased to respond to any questions.