U.S. DEPARTMENT OF THE TREASURY

REPORT TO THE CONGRESS ON THE IMPACT OF THE GRAMM-LEACH-BLILEY ACT ON CREDIT TO SMALL BUSINESSES AND FARMS

JANUARY 2005

Submitted to the Congress by the Secretary of the Treasury as required by Section 109 of the Gramm-Leach-Bliley Act.

Contents

Part I. Introduction and Executive Summary

Section A. Overview

As required by section 109 of the Gramm-Leach-Bliley Act (GLB Act or Act), this report (Report) analyzes the impact of the GLB Act on credit availability to small businesses[1] and farms. More specifically, section 109 of the GLB Act requires the Secretary of the Treasury (Secretary), in consultation with the Federal banking agencies,[2] to conduct a study of the extent to which credit is being provided to and for small businesses and farms as a result of the GLB Act and amendments made by the Act.[3]

The GLB Act[4] significantly altered the legal framework governing the permissible affiliations and activities of banking organizations in the United States. Enacted on November 12, 1999, it repealed the provisions of the Glass-Steagall Act[5] and the Bank Holding Company Act of 1956 (BHC Act)[6] that previously had constrained the ability of banking organizations, securities firms, and insurance companies to affiliate and compete with each other. In addition, the GLB Act amended provisions of the National Bank Act[7] and the Federal Deposit Insurance Act[8] to allow banks to have subsidiaries that engage in most financial activities. By removing these legal barriers, the GLB Act created a two-way street that permits banks, securities firms, and insurance companies to affiliate with each other through the financial holding company (FHC) and financial subsidiary structures when, or if, the organization believes such action is appropriate, such as for purposes of the organization's competitive strategy or with regard to market developments.

Specifically, the GLB Act permits FHCs and financial subsidiaries of banks to engage in any activity that has been determined to be financial in nature or incidental to a financial activity under the Act. The Act itself identifies several specific activities that are financial in nature and thus permissible for FHCs. These include the following: securities underwriting and dealing and insurance agency activities for both FHCs and financial subsidiaries, and insurance underwriting and merchant banking for FHCs.[9] In addition, the GLB Act authorizes the Federal Reserve Board (Board) and the Secretary to determine that additional activities are financial in nature or

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[1] According to a broad guideline used by the Small Business Administration and followed by the Federal Reserve for analysis of small business credit availability, a small business is a firm or enterprise with fewer than 500 employees. This definition encompasses more than 99 percent of all businesses in the United States. Board of Governors of the Federal Reserve System, *Report to the Congress on the Availability of Credit to Small Businesses* (Sept. 2002) at p. 19.
[2] Section 3(z) of the Federal Deposit Insurance Act defines "Federal banking agency" to mean the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation. 12 U.S.C § 1813(z).
[3] The complete text of section 109 is in Appendix A.
[4] Pub. L. No. 106-102, 113 Stat. 1338 (1999).
[5] 12 U.S.C §§ 78 and 377.
[6] 12 U.S.C. §§ 1841 *et seq.*
[7] 12 U.S.C. §§ 21 *et seq.*
[8] 12 U.S.C. §§ 1811 *et seq.*
[9] These activities are described in more detail in Appendix B. Section 122 of the GLB Act authorizes the Secretary of the Treasury and the Federal Reserve Board, after November 12, 2004, to remove jointly by rule the restriction on financial subsidiaries conducting merchant banking activities. 12 U.S.C. § 1843 note.

incidental to a financial activity and thus permissible for FHCs and financial subsidiaries, respectively. In making these determinations, the Board and the Secretary must consult with each other in the manner specified in the Act. The Act also permits an FHC to engage, to a limited extent, in a nonfinancial activity if the Board determines that the activity is complementary to a financial activity and does not pose a substantial risk to depository institutions or the financial system generally.

Given the GLB Act's potential impact on the structure of the financial services industry, there was concern raised by some about the impact of the legislation on the availability of credit to small businesses and farms. The availability of credit to small businesses and farms is important for the continued vitality of our nation's economy. As the Federal Reserve Board noted in its 2002 *Report to the Congress on the Availability of Credit to Small Businesses* (*FRB 2002 Report*): "small businesses – firms having fewer than 500 employees – contribute significantly to the strength and vigor of the U.S. economy. Together they employ more than one-half of private-sector workers and produce more than one-half of the private sector output. Large and successful companies often begin as smaller firms that prosper and grow. Likewise, most of the new firms that form and help the economy adapt to change start as small businesses."[10] Part of the concern regarding the availability of credit to small businesses and farms related to the perception that these firms might have greater difficulty gaining access to credit than would larger firms, perhaps because small business and farm lending may be considered riskier and information about such firms may be harder to obtain.

Section B. Report Focus

Section 109 does not prescribe for consideration any particular issues affecting credit availability to small businesses and farms. This Report focuses on three issues that are believed to be of greatest significance: provisions of the GLB Act permitting banking organizations to establish FHCs and financial subsidiaries and affiliate with companies engaged in securities, insurance and other financial in nature activities; the Act's impact on consolidation in the banking system and the extent to which significant consolidation might affect the flow of credit to small businesses and farms; and provisions of the GLB Act that expand access to Federal Home Loan Bank funding for certain institutions that make small business and farm loans.

In accordance with the requirements of section 109, Treasury staff consulted with each of the Federal banking agencies. One agency, the Federal Reserve, provided a formal written submission,[11] while the other Federal banking agencies provided verbal comments and background information. In addition, Treasury staff provided each of the Federal banking agencies an opportunity to comment on the draft final Report. The Treasury Department appreciates the valuable assistance provided by all of the Federal banking agencies in the preparation of this Report.

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[10] Board of Governors of the Federal Reserve System, *Report to the Congress on the Availability of Credit to Small Businesses* (Sept. 2002) at page 1.

[11] A copy of the Federal Reserve's submission is in Appendix C.

Section C. Summary of Findings

Our chief conclusion is that enactment of the GLB Act has had no measurable effect on the flow of credit to small businesses or farms. These are the principal findings:

- Impact of permissible affiliations. In November 2003 the Secretary and the Board submitted a Report to Congress on Financial Holding Companies under the Gramm-Leach-Bliley Act (2003 Report). The facts documented in the 2003 Report did not identify any significant effects of the GLB Act on flows of credit to small businesses.

- Impact of consolidation. While the U.S. banking system has undergone some consolidation over the past decade, the evidence, as described in the *2003 Report*, does not suggest that the GLB Act has changed the competitive structure of segments of the financial services industry directly affected by the Act. More importantly, research on the possible effects of bank consolidation on credit flows to small businesses suggests that financial consolidation activity has not tended to reduce the availability of credit to small business.

- Impact of Federal Home Loan Bank provisions**.** The GLB Act contained provisions that were designed to expand access to the Federal Home Loan Bank (FHLBank) System for smaller depository institutions. In particular, for smaller depository institutions, the GLB Act expanded the types of collateral that are eligible for advances to include loans to small businesses, small farms, and small agri-businesses, and membership requirements for smaller depository institutions were relaxed. While these provisions would be expected to have a positive impact on credit availability to small businesses and farms, there has been limited use of the Act's expanded collateral provision to date, and it has been difficult to measure the impact of the relaxed membership requirements.

Section D. Summary of Recommendation

This study provides no grounds for subsequent legislative or administrative actions.

Part II. Discussion and Analysis

Section A. Background on Credit Conditions for Small Businesses and Farms

As noted in the *FRB 2002 Report*, "small businesses obtain credit from a wide range of sources, including commercial banks, thrift institutions, finance companies, nonfinancial firms, and individuals such as a family member or friend. Of these sources, commercial banks are the leading providers, supplying credit lines, loans, and leases to slightly more than two-thirds of small firms that obtained a traditional form of credit from any source."[12] The firms that provide credit to farms are similar, except that a government sponsored enterprise – the Farm Credit System – also engages in the direct provision of credit to farms.

[12] *FRB 2002 Report* at p. 3.

On an aggregate basis, the small business and farm credit markets appear to have been healthy since the passage of the GLB Act. While there is no definitive data source on outstanding small business credit, data from the Federal Reserve's Flow of Funds indicates, as illustrated in Figure 1,[13] that debt of nonfinancial nonfarm noncorporate organizations (which is used here and in the *FRB 2002 Report* as a proxy for small businesses) continues to grow (albeit at a decreasing rate, likely influenced by recession conditions) each year since the enactment of the GLB Act. Figure 1 also illustrates that the growth rate of debt to these organizations exceeds the growth rate of debt to nonfinancial nonfarm organizations (which is used here and in the *FRB 2002 Report* as a proxy for large businesses). In terms of farm credit, Figure 1 illustrates growth of between 3 and 7 percent in outstanding farm debt in the years following the enactment of the GLB Act, which also exceeded the growth of debt to larger (nonfinancial nonfarm) businesses in recent years. Furthermore, as shown in Figure 2, the share of nonfinancial debt acquired by noncorporate businesses has grown since 1999, the share of debt acquired by farms has remained about constant, while the share of debt acquired by corporate businesses has fallen slightly.[14]

[13] Source (Figures 1 and 2): Board of Governors of the Federal Reserve System, Statistical Release Z.1, *Flow of Funds Accounts of the United States (*Sept. 16, 2004), Table L.2.

[14] The *FRB 2002 Report* (at p. 1) reports similar information regarding small business lending remaining healthy through 2002. "From 1997…to 2000, business financing flows to both large and small borrowers were strong; but in 2001 and the first quarter of 2002, they have moderated along with economic growth. Debt growth appears to have held up better at small firms than it did at large firms, and small businesses have not reported material differences in obtaining credit during the 2001-02 downturn. Indeed, despite a tightening of financial conditions in 2001 and the first three quarters of 2002, there is little evidence that creditworthy borrowers of any size have faced substantial credit supply constraints."

Figure 1

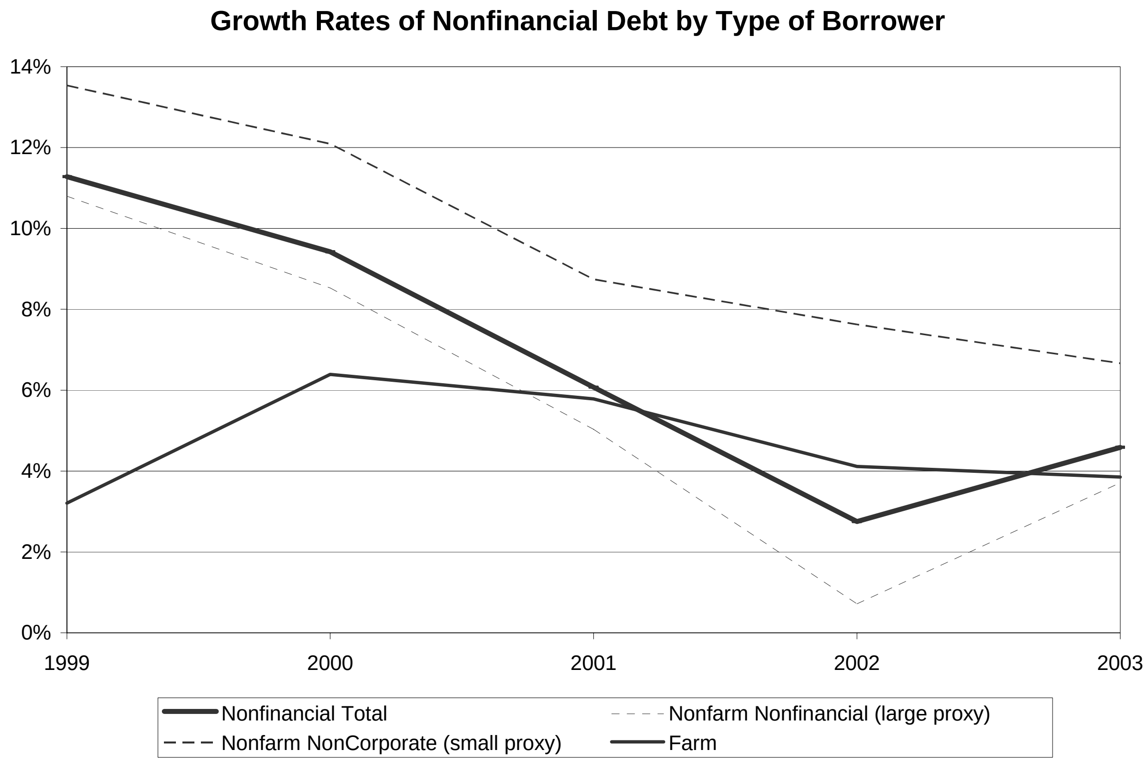
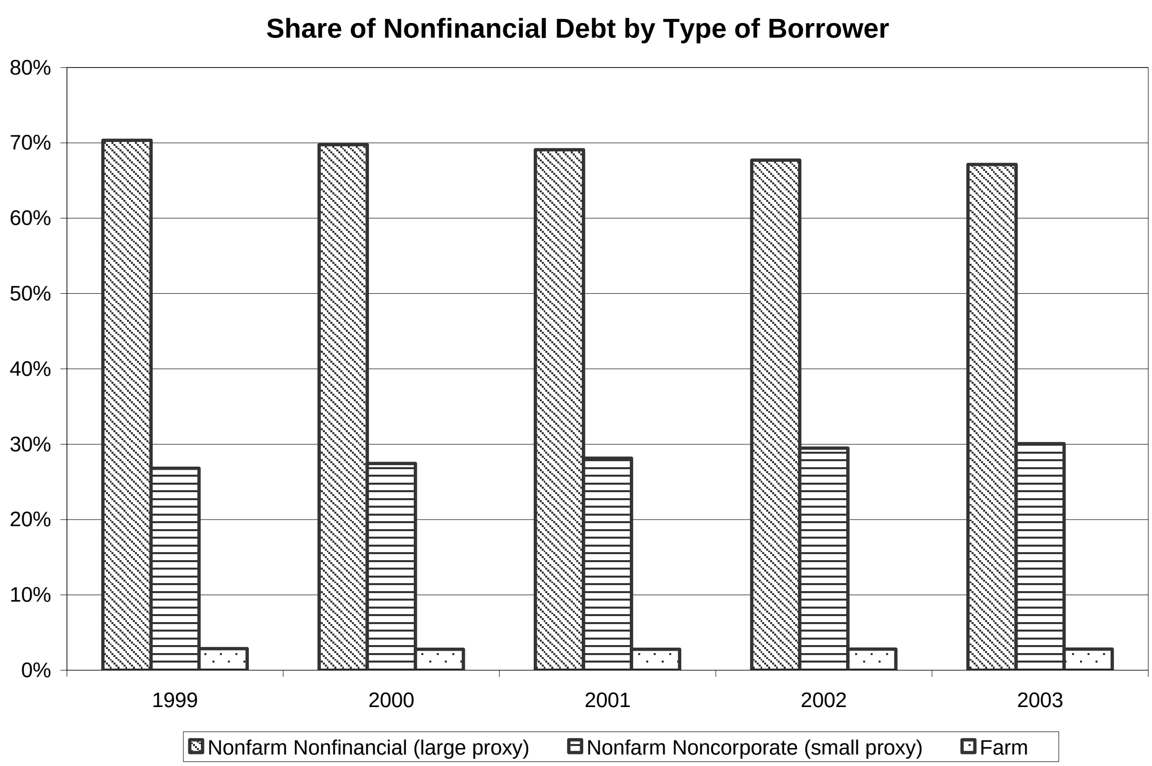


Figure 2



Given that commercial banks provide a significant amount of credit to small businesses, it also is useful to look at trends in segments of the commercial banking industry. Despite the general slowdown of the growth in small business debt over the period since the enactment of the GLB Act (as illustrated by Figure 1), it appears that small business lending activity of commercial banks has been fairly healthy. For example, the Office of the Comptroller of the Currency (OCC) provided the following information regarding positive trends in small business and farm lending by national banks:[15]

- National banks have expanded their loan portfolios to both small businesses and farms. The number of small loans outstanding to businesses increased 82 percent from June 30, 1999, to June 30, 2004, based on call report data. The total dollar volume of loans outstanding increased from $183 billion to $218 billion or 19 percent over this same timeframe. This broadly indicates that more loans were made available, but in smaller amounts.

- The greatest growth in the number of loans outstanding to small businesses was in the category of commercial and industrial loans below $100,000, which increased 109 percent from June 30, 1999, to June 30, 2004. The dollar volume increased by $8.4 billion or 25 percent. The next highest growth rate occurred in the nonfarm/non-residential loan category with outstanding amounts in the $250,000-$1 million range, where the number of loans and dollar volume increased by 35 percent and 42 percent respectively.

- The total dollar volume of loans outstanding to small farms has increased every year since 1999 except for the year 2001. The number of loans outstanding to small farms has been more sporadic. Loans outstanding to small farms increased from $14.6 billion in 1999 to $16.4 billion in 2004, an increase of 12 percent. Overall, the number of loans outstanding declined from 307,994 in 1999 to 303,792 in 2004, however, the average number of loans outstanding during this timeframe was 302,883.

Similarly, even though thrift institutions play a smaller role in commercial lending given their traditional focus on mortgage-related products,[16] the trends of small business and farm lending among thrift institutions also have been healthy since 1999. The Office of Thrift Supervision (OTS) reported to us that from 1999 through June 2004, total assets of thrift

[15] The data provided below by the OCC and the Office of Thrift Supervision are in terms of loan size and are a proxy for lending to small businesses and farms. To measure lending to small businesses and small farms, call report requirements specify that business loans with original amounts under $1,000,000 and farm loans with original amounts under $500,000 must be reported in each year as of June 30. In addition, the data reported in this presentation do not control for other factors (e.g., increases or decreases in the number of chartered entities), which may impact the comparison of the number of outstanding loans and outstanding loan volume over time.

[16] The Office of Thrift Supervision utilizes the Small Business Administration definition of small business. Thrifts must satisfy an Internal Revenue Service domestic and building loan test or maintain at least 65 percent of their assets in qualified thrift investments, which includes, among other things, mortgage and mortgage-related products. The *FRB 2002 Report* (at p. 5) also noted that "thrift institutions provide much less credit to small businesses than commercial banks do. The differences between the lending volumes of the two groups of institutions reflect both the disparity in overall size between the two groups and the lower proportion of small business lending conducted by the typical savings association." In 1996, the Economic Growth and Regulatory Paperwork Reduction Act increased thrift commercial lending authority from 10 percent to 20 percent of assets provided that any amount over 10 percent is made to small businesses. This statutory change gave thrifts limited additional flexibility to provide credit to small businesses.

institutions increased by 38 percent, while small business nonfarm commercial lending increased by 84 percent and total small business nonfarm lending (i.e., including mortgages) increased by 48 percent. Over that same time period, farm loans (secured by farms) increased by 48 percent and total farm loans (including unsecured loans) increased by 25 percent.

Section B. Impact of Permissible Affiliations

The *2003 Report* did not identify any significant effects of the GLB Act on flows of credit to small businesses or farms. Overall, the *2003 Report* indicated that the market response to the Act has been one of evolutionary, not radical change. Thus, while virtually all large bank holding companies, and a substantial number of smaller institutions, have become FHCs, as of the end of 2003 only 633 out of 6,415 U.S. banking organizations were FHCs.[17] Still, the major portion of banking assets are held by FHCs.[18]

The segment of the financial services industry that has seen the most significant changes has been securities underwriting and dealing, where banking organizations have expanded their activities.[19] Substantial growth also has occurred in insurance agency activities by banking organizations. Neither of these activities directly impacts small business or farm lending, and given the generally healthy conditions in the small business or farm credit market, it does not appear that the expansion of banking organizations into these areas has had a measurable impact.

This having been said, the GLB Act may have somewhat affected the incentive of banks to make *equity* investments in small businesses either directly or through Small Business Investment Companies (SBICs). While *credit availability* rather than *equity* investments is the focus of this Report, Federal Reserve Board staff (see Attachment C) noted the following in regard to investments in SBICs:

- On the plus side, the merchant banking provisions of the GLB Act allow for more investment in small businesses by providing FHCs with an alternative authority to make such investments.[20] Investments made under this authority are not subject to the limitations that

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[17] The *2003 Report* did not discuss the activities of financial subsidiaries of national and state banks. References in the *2003 Report* to banking organizations engaged in expanded activities pursuant to the GLB Act referred to FHCs conducting such activities under section 4(k) of the BHC Act.

[18] The *2003 Report* found that as of November 2003 FHCs represented a broad spectrum of banking organizations, including 49 of the 71 U.S.-based bank holding companies with assets of $10 billion or more and 473 U.S.-based bank holding companies with assets of less than $1 billion (as of November 2003). In the aggregate, FHCs represented 78 percent of the total assets of all bank holding companies. Several firms that were not affiliated with a commercial bank before passage of the GLB Act had acquired a bank and become an FHC under the Act. These firms include Charles Schwab & Co., MetLife, and Franklin Resources.

[19] The *2003 Report* contains more details at pp. 5-16.

[20] See 12 U.S.C. § 1843(k)(4)(H). Merchant banking is a form of equity financing through which an investor acquires an equity or other ownership position in another company, typically a nonpublic, less liquid company, for investment purposes. Prior to the GLB Act, bank holding companies had only limited authority to make equity investments in nonfinancial companies. The GLB Act significantly expanded this authority by permitting a qualifying FHC to acquire any amount – including up to 100 percent – of the equity securities or other ownership interests of a nonfinancial company as part of a bona fide underwriting, merchant banking, or investment banking activity. The Act places limits on the period of time that an FHC may hold a merchant banking investment and generally prohibits an FHC from routinely managing or operating a nonfinancial company held as a merchant

previously constrained bank holding companies investing either in SBICs or directly in small businesses.

- On the other hand, some decreased incentive for equity investments may have come from the capital rules that were established for merchant banking and similar equity investments.[21] These new rules, published by the Board, the Federal Deposit Insurance Corporation, and the OCC in January 2002, increased capital requirements on merchant banking and similar equity investments, but provided an exemption for SBICs to the extent that a banking organization's investment in SBICs does not exceed 15 percent of Tier 1 capital. However, banking organizations with SBIC investments in excess of 15 percent of Tier 1 capital face higher capital charges.

- The net effects, if any, of all of these actions are very unclear.[22] Moreover, the lack of data on merchant banking activities, the extreme difficulty of controlling for other relevant changes in the business environment, and the short period of time that has elapsed since the new capital rules went into effect would severely limit the usefulness of any study of this aspect of the GLB Act on small business finance.

Section C. Impact of Consolidation

The U.S. banking system has undergone significant consolidation in the past decade. A recent Federal Reserve staff study of mergers between 1994 and 2003 among banks, savings banks, savings and loan associations, and industrial banks found that the 3,517 mergers consummated during this 10-year period involved about $3.1 trillion in assets, $2.1 trillion in deposits, and 47,300 offices.[23] However, the substantial body of research on why banks merge has not identified the GLB Act as a causal factor.

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banking investment. In 2000 the Board and the Secretary jointly issued regulations implementing the Act's merchant banking authority and associated restrictions. See 65 *Federal Register* 16460 (March 28, 2000).

[21] See 67 *Federal Register* 3784 (Jan. 25, 2002).

[22] The Small Business Administration (SBA) also noted that the impact of these provisions on small businesses is difficult to determine. Even though since 2001 there has been a reduction of close to 20 percent in the number of bank-owned SBICs (from 91 to 74) and a complementary reduction in private capital managed by bank-owned SBICs (from around $6.1 billion to around $5.1 billion), banks may be choosing to make equity investments through alternative mechanisms rather than SBICs. Banks also may be choosing to be limited partners rather than owning and managing the fund. In general, data in the SBIC program is not sufficient to conclude what the overall impact on financing to small businesses has been.

[23] Federal Reserve Staff Study 176, *Bank Merger Activity in the United States, 1994-2003* (Steven J. Pilloff, May 2004). Roughly three-fourths of the deals involved the purchase of a commercial banking organization by another commercial banking organization, with the remainder involving a thrift institution as the acquirer, the target, or both. Most deals involved the acquisition of a small organization with operations in a fairly limited geographic area. In the aggregate, these small mergers tended to account for a relatively small share of the assets, deposits, and offices that were purchased. In contrast, the few acquisitions of very large banks accounted for a large share of the assets, deposits and offices acquired over the period, and they were disproportionately responsible for many of the changes to the banking industry caused by consolidation. Urban markets had disproportionately more mergers than rural markets, and mergers with targets in urban areas accounted for an even larger share of acquired deposits and offices.

More importantly, even though smaller banks tend to have relatively higher proportions of small business loans than larger banks,[24] the large body of research that has studied the possible effects of banking consolidation on credit flows to small businesses suggests that financial consolidation activity has not tended to reduce the availability of credit to small businesses. Following a merger, any decrease in small business loans by the newly consolidated bank is generally offset by an increase in small business lending by other existing banks and new banks that often are created in the wake of a major merger.[25] These issues were examined, and these conclusions were reached, most recently by Board staff in the *FRB 2002 Report*.[26] Notably the *FRB 2002 Report*, completed well after enactment of the GLB Act, did not identify the Act as having affected credit flows to small businesses. Specifically, the *FRB 2002 Report* found that --

> The evidence suggests that the thousands of small banks continue to account for a meaningful share of small business lending activity, measured by originations and holdings of business loans equal to or less than $1 million and equal to or less than $100,000, despite their declining numbers, a fall in their share of industry assets, and an increase in the share of small business lending activity attributable to the most active providers of credit and to all large banks. For example, in 2001 banks with assets of $250 million or less accounted for roughly 20 percent of activity for business loans of $1 million or less and almost 30 percent of activity for business loans of $100,000 or less.[27]

On the relationship between consolidation and small business credit, the *FRB 2002 Report* said --

> The results of studies that directly analyze the relationship between consolidation activity and the availability of credit to small businesses tend to suggest that merger and acquisition activity has not reduced credit availability to small businesses. Following a merger, any reduction in small business lending by the newly consolidated bank is generally offset by an increase in small business lending by other banks.[28]

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[24] On the relationship between bank size and small business credit, the *FRB 2002 Report* (at p. 38) reported that "the average banking organization with $1 billion or less in total assets held almost 20 percent of its portfolio as small business loans in June 2001. In contrast, organizations with assets between $1 billion and $10 billion held 13.6 percent of their assets as small business loans, and the largest organizations – those with assets greater than $10 billion – held less than 8 percent of their assets as such loans." An even stronger pattern was found for holdings of micro-loans (defined as business loans of $100,000 or less).

[25] Even though the bulk of academic research has not identified mergers/consolidation as impacting the availability of credit to small businesses, it is possible that some local market impacts may diverge from the national pattern, particularly those markets that are small, poor, isolated, losing population, or highly concentrated. Many such markets are rural and likely to be less dynamic and less attractive to bank entry in the wake of in-market bank consolidation. However, there is little existing research or data to identify these potential impacts. In addition, it is unclear how the provisions of the GLB Act would have had a direct negative impact on these types of markets.

[26] Board staff and others also have specifically researched the relationship between bank consolidation and credit flows to small business in the Group of Ten's *Report on Consolidation in the Financial Sector*, published by the Bank for International Settlements in January 2001.

[27] *FRB 2002 Report* at p. 4.

[28] *FRB 2002 Report* at p. 4.

Reviewing the various academic studies in this area, the *FRB 2002 Report* found[29] --

- "Although mergers and acquisitions sever existing bank-firm relationships and may introduce some short-term uncertainty,[30] the results of the research generally suggest that overall they have not reduced credit availability."

- "One issue that has been addressed is the effect of mergers on the small business lending activities of the banks directly involved in those mergers. The results of these studies generally indicate that deals involving at least one large bank tend to reduce small business loans as a share of assets, whereas deals between two small banks tend to increase small business loans as a share of assets."[31]

- "Evidence suggests that banks competing with recent merger participants tend to increase their lending [to small businesses]."[32]

- "Two other empirical findings suggest that a growing amount of credit may be supplied by banks that compete with recently merged banks. First, consolidation increases the likelihood of new entry into a market.[33] Second, younger banks tend to make more small business loans than similar, but more mature, institutions.[34] These two empirical findings suggest that a common response to merger activity is greater entry of new banks, which tend to be active lenders to small businesses."

- "From the perspective of small firms, the effect of banking consolidation on credit availability may not be especially substantial for the size of the banks operating in a market appears not to affect the availability of credit. Small businesses in areas with few small banks are no more credit-constrained than small firms in areas with many small banks.[35] In addition, the likelihood that a small business will borrow from a bank of a given size is

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[29] *FRB 2002 Report* at pp. 41-42.
[30] Allen N. Berger and Gregory F. Udell, "Relationship Lending and Lines of Credit in Small Firm Finance," *Journal of Business*, vol. 68 (1995), pp. 351-82.
[31] For example, Katherine Samolyk and Christopher A. Richardson, "Bank Consolidation and Small Business Lending within Local Markets," Working Paper 2003-02, Federal Deposit Insurance Corporation. The *FRB 2002 Report (p. 41)* pointed out that a fairly large number of deals between 1990 and 2001 had occurred with small- or medium-sized acquirers, and therefore, after merger activity, many banks had an overall increase in the share of their asset portfolios dedicated to small business lending.
[32] Allen N. Berger, Anthony Saunders, Joseph M. Scalise, and Gregory F. Udell, "The Effects of Bank Mergers and Acquisitions on Small Business Lending," *Journal of Financial Economics, vol. 50 (1998), pp. 187-22;* Allen N. Berger, Lawrence G. Goldberg, and Lawrence J. White, "The Effects of Dynamic Changes in Bank Competition on the Supply of Small Business Credit," *European Finance Review*, vol. 5 (2001), pp. 115-39.
[33] For example, Allen N. Berger, Seth D. Bonime, Lawrence G. Goldberg, and Lawrence J. White, "The Dynamics of Market Entry: The Effects of Mergers and Acquisitions on Entry in the Banking Industry," *Journal of Business* (forthcoming).
[34] Robert DeYoung, Lawrence G. Goldberg, and Lawrence J. White, "Youth, Adolescence, and Maturity of Banks: Credit Availability to Small Business in an Era of Banking Consolidation," *Journal of Banking and Finance*, vol. 23 (Feb. 1999), pp. 463-92.
[35] Jith Jayaratne and John Wolken, "How Important Are Small Banks to Small Business Lending? New Evidence from a Survey of Small Firms," *Journal of Banking and Finance*, vol. 23 (Feb. 1999), pp. 427-58.

roughly proportional to the local presence of banks of that size, although some evidence shows that small banks are more likely to make very small loans."[36]

While the research findings described above were focused on the general impact on small business lending from merger activity, other research suggests similar results for farm lending.[37]

Section D. Impact of Federal Home Loan Bank Provisions

In 2003, the Treasury Department initiated a review of the FHLBank System as part of the Department's overall responsibility for monitoring financial institutions and the financial system. As part of that review we have evaluated the implementation and impact of key FHLBank provisions in the GLB Act. The GLB Act made fundamental changes to the capital structure of the FHLBanks, and perhaps more importantly for the purposes of this report, the GLB Act also contained provisions that were designed to expand access to the System for smaller depository institutions. In particular, for smaller depository institutions, the GLB Act expanded the types of collateral that are eligible for advances and relaxed membership requirements. These two provisions are discussed in detail below.

Expanded Collateral for Advances

The FHLBank Act requires that members post eligible collateral for the full amount of the advances that they borrow from an FHLBank. Typically, FHLBank advances are collateralized with a blanket lien, meaning that the FHLBanks can take control of any eligible collateral among the member's assets if the member fails to repay the advance. Alternatively (and less frequently), a member will directly pledge specific eligible collateral to secure an advance.

Prior to the enactment of the GLB Act, members of an FHLBank could pledge four types of collateral: 1) fully disbursed, whole single-family or multifamily first mortgages that are no more than ninety days delinquent, or securities representing a whole interest in these mortgages; 2) securities issued, insured, or guaranteed by the United States or a U.S. agency, as well as mortgage-backed securities issued by Fannie Mae or Freddie Mac; 3) deposits at an FHLBank; or 4) other real estate-related collateral, such as home equity loans or commercial real estate loans, acceptable to the FHLBank and subject to certain conditions[38] (e.g., member institutions were limited in the amount of non-housing real estate collateral that they could pledge to no more than 30 percent of the member's capital). The FHLBanks could further restrict the types of eligible collateral based on the quality of the collateral, the creditworthiness of the borrower, or other reasonable criteria.

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[36] Allen N. Berger, Richard J. Rosen, and Gregory F. Udell, "The Effect of Market Size Structure on Competition: The Case of Small Business Lending," Working Paper 2001-63, Finance and Economics Discussion Series, Board of Governors of the Federal Reserve System, 2001.

[37] See Sharon Bard, Peter Barry and Paul Ellinger, "Effects of Commercial Bank Structure and Other Characteristics on Agricultural Lending," *Agricultural Finance Review*, vol. 60 (2000), pp. 17-31.

[38] 12 U.S.C. § 1430.

The GLB Act made two changes to the FHLBanks' collateral requirements. First, the Act allowed the FHLBanks to accept new categories of collateral from "community financial institutions" (CFIs), which are FDIC-insured institutions with assets of $500 million or less as of 2000 (and adjusted for inflation on an annual basis, for 2004 that standard was $548 million or less[39]). CFIs can post as collateral secured loans for small businesses or agriculture, or securities representing a whole interest in such secured loans (collectively referred to as CFI collateral). In addition to expanding access to the System, this provision of the Act expands the purpose of advances (for CFIs) to include loans to "small businesses, small farms, and small agri-businesses."[40] Second, the Act eliminated the 30 percent of capital limitation on non-housing real estate related collateral.

The Board of Directors of each of the FHLBanks has latitude in implementing the collateral structure allowed by the Act and promulgated by the Federal Housing Finance Board (Finance Board). Instead of directly prohibiting riskier types of small business or small farm loans, the Finance Board requires that the FHLBanks have policies and the capacity to value the assets that the FHLBank accepts as collateral. The FHLBanks may discount the value of CFI collateral as they deem appropriate and may limit the borrowing capacity of a member to account for risk. According to the Finance Board, in general, the FHLBanks limit the borrowing support of CFI collateral to 40 to 60 percent of its market value. Furthermore, at most of the FHLBanks, advances secured by CFI collateral may not exceed two times the member's capital or 15 percent of the member's assets. However, the Finance Board believes that the borrowing support of CFI collateral will increase as the FHLBanks gain confidence in CFI collateral management.

The FHLBanks have further latitude in setting collateral structures with their authority either to include CFI eligible collateral in the blanket lien or to ask for a direct pledge of specific collateral.[41] In addition, the FHLBanks may require that a CFI exhaust all other types of eligible collateral prior to the direct pledging of CFI collateral. According to the Finance Board, all of the FHLBanks that accept CFI collateral require this ordering in the posting of collateral.[42]

Information on the implementation of the expanded collateral opportunities provided by the Finance Board and direct responses collected by the Treasury from FHLBanks in late 2003 and early 2004 indicate that the FHLBanks have been cautious in accepting CFI collateral. For instance, the FHLBank of New York has not yet formally offered the acceptance of CFI collateral, due to a lack of demand from members for approval of this type of collateral, according to the Bank. While the other eleven FHLBanks have approved the acceptance of CFI collateral, three FHLBanks (Atlanta, Cincinnati, and Boston) still had not accepted any CFI collateral as of year end 2003.

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[39] See 69 *Federal Register* (Jan. 2, 2004) at p. 77.

[40] See Section 604(a)(2) of the Act. Ideally, one would track the extent to which member banks use advances for loans to these types of entities. However, due to the blanket lien on collateral and the fungibility of money, this would be very difficult to do. Thus, we examined the member banks' reliance on expanded collateral as a proxy.

[41] The FHLBank of San Francisco, for example, requires that a member must execute a blanket lien against all CFI collateral on its books in order for that member to receive borrowing capacity from CFI collateral.

[42] According to the Government Accountability Office, some FHLBanks even require that members pledge all of their single-family mortgages as collateral before they accept any other type of collateral. Government Accountability Office, "Federal Home Loan Bank System: Key Loan Pricing Terms Can Differ Significantly" (Sept. 2003), GAO-03-973, at p. 22.

The limited use of expanded collateral by CFIs could be due to FHLBank requirements that all other types of eligible collateral be used before posting expanded collateral. Information from the Finance Board shows that the FHLBanks most active in accepting CFI collateral, particularly small farm and small agri-business loans, are the FHLBanks of Dallas, Des Moines, and Topeka. Some of the responses that we received from the FHLBanks on this issue included the following:

- The FHLBank of Pittsburgh reported that it had no members whose advances exceeded the member's non-CFI collateral. Thus, due to ordered posting, no CFI collateral had supported any advance at that FHLBank.

- The FHLBank of Chicago estimated that $32 million or 0.13 percent of its advances were secured by CFI collateral. The FHLBank of San Francisco reported that $57 million or 0.07 percent of its advances could be linked to CFI collateral.

- The FHLBank of Topeka reported that $119 million or 0.5 percent of its outstanding credit obligations were secured by CFI collateral, even though the CFIs in its membership collectively held $818 million in eligible CFI collateral.

- The FHLBank of Seattle stated that it had approved 9 members for CFI collateral although only about 5 of those actually relied on CFI collateral to cover a portion of their existing advances.

- At the upper end, the FHLBank of Dallas estimated that $2 billion or 5 percent of its advances were secured by CFI collateral.

The data on advances secured by CFI collateral, however, may not be comparable across the FHLBanks. In a recent report, the Government Accountability Office (GAO) listed the total value of collateral securing advances made by each FHLBank as reported to the Finance Board. According to the GAO, some FHLBanks report all of the eligible collateral on the books of their members due to the blanket lien, which may far exceed what would otherwise be required when posting specific collateral, while others report specific collateral.[43] Only the FHLBank of Dallas explained, in responses to our inquiry, how it calculates the amount of advances secured by CFI collateral: it subtracts the amount of traditional collateral from the total amount of advances and assumes that the remaining balance of advances is secured by CFI collateral.

While there are some data issues associated with evaluating the use of CFI collateral, it appears that CFIs have not yet made widespread use of the GLB Act's expanded collateral provisions. A number of factors may explain this result.

- <u>Ample Traditional FHLBank Collateral</u> - From the data we have received, it appears that many FHLBank members have ample traditional FHLBank collateral, thus limiting the need to use new CFI collateral. It should be noted, however, that even with ample traditional

[43] Government Accountability Office, "Federal Home Loan Bank System: Key Loan Pricing Terms Can Differ Significantly" (Sept. 2003), GAO-03-973, at pp. 30-31.

collateral, the expanded CFI collateral could increase potential advance usage by CFIs, increasing the size of the liquidity cushion that FHLBank access provides to these FHLBank members.

- Strong Deposit Growth - The period since the enactment of the GLB Act might not be an ideal representative time frame to evaluate the effectiveness of the expanded collateral provisions. In the recent environment of low returns in the securities markets, deposit growth at member banks has been strong, and interest rates on deposits have been low, making deposits a more attractive funding source than FHLBank advances.

- Implementation of FHLBank Capital Plans is New or Incomplete – As of June 30, 2004, the FHLBanks were only two-thirds of the way to implementing their new capital plans, and two of the FHLBanks that have implemented their capital plans have only done so recently. Thus, some of the pre-GLB Act capital provisions that may have affected members' advance borrowing (e.g., the non-Qualified Thrift Lender capital stock purchase requirements) are either still in place or have only recently been lifted.[44]

Membership Requirements

Access to membership in the FHLBank System has changed over time. Originally, only savings associations could be members of the System. Federal savings associations were required by statute to be members in the System, and, before 1995, state savings associations were required by regulation to be members.[45]

After the passage of the Financial Institutions Reform, Recovery and Enforcement Act in 1989, commercial banks and credit unions could become members, although there were a number of restrictions. Non-thrift institutions were required to meet a residential mortgage loan (RML) test, under which RMLs or related assets must comprise at least 10 percent of the institution's assets for the institution to *become* a member of an FHLBank. Because they were not required to *maintain* this percentage, institutions could easily purchase enough RMLs to qualify for membership and then sell those assets after they became members. Banks and credit unions that became members of the System, and then withdrew from membership, could not rejoin the System until 10 years after leaving. Furthermore, prior to the GLB Act, institutions not classified as Qualified Thrift Lenders (QTLs) faced more hurdles in obtaining advances. For example, non-QTL members were required to make greater stock purchases to receive advances,

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[44] For thrifts to meet Qualified Thrift Lender (QTL) requirements they must maintain at least 65 percent of their assets in qualified thrift investments that include mortgage and mortgage-related products. Prior to the GLB Act, an FHLBank member's stock purchase requirement was determined by the greater of two components: (1) an asset-based requirement, and (2) an advance-based requirement. The asset-based stock purchase requirement equaled the greater of 0.3 percent of the member's total assets or 1 percent of its home mortgage loans. For member institutions of like size, if the asset-based requirement were the binding constraint, most members that were not QTLs would have a lower stock purchase requirement than QTL members. The advance-based stock purchase requirement equaled 5 percent of advances for QTL members, or 5 percent divided by a member's thrift investment percentage of advances for non-QTL members. If the advance-based stock purchase requirement was the binding constraint, it was more expensive for non-QTL members to borrow from the System than QTL members.

[45] A 1993 OTS regulation (effective in 1995) made membership voluntary for state savings associations: 58 *Federal Register* 14510 (March 18, 1993).

and advances to non-QTLs could not exceed 30 percent of all outstanding advances in the System.

The GLB Act eliminated the RML test for CFIs.[46] Institutions that are not CFIs but wish to join the System are still required to meet the RML test; although, as stated above, the RML requirement under the statute is a one-time screen, rather than an ongoing requirement. The GLB Act also made membership in the System voluntary for all institutions and decreased the waiting period on reacquisition of membership from 10 to 5 years.

Table 1, constructed with information provided by the Federal Housing Finance Board, shows the number of new CFIs that have joined the system in the years after the GLB Act and the number of them that would not have met the RML test. Of the 1,521 new CFIs that joined the System since 1999, 19 percent would not have met the RML requirement. Overall, about 4 percent of System members were made eligible as a result of the GLB Act's removal of the RML test for CFIs.

Table 1

Year	Total Members	New CFIs	New CFIs not meeting the RML test	New CFIs not meeting the RML test as a percent of all new CFIs	Total CFIs not meeting the RML test as a percent of total members
2000	7,777	669	125	19%	2%
2001	7,877	328	69	21%	2%
2002	8,011	281	46	16%	3%
2003	8,101	243	46	19%	4%
	Totals:	1,521	286	19%	

Other GLB Act changes have also had a seemingly minimal impact on membership. According to the Finance Board, only 7 institutions that were previously mandatory members have voluntarily withdrawn. (Two hundred ten of the 1,100 once mandatory members have left the System since the GLB Act, but all but 7 were due to mergers or liquidations.) Furthermore, there has been no significant impact on the membership of those FHLBanks that have implemented the new capital structure and the associated new stock purchase requirements. As of June 30, 2004, there were 27 voluntary withdrawals associated with the stock conversion in the FHLBanks that have implemented their plans. Two of these FHLBanks, Seattle and Cincinnati, did not have any voluntary withdrawals, while the FHLBank of Dallas reported 15 withdrawals.

[46] As noted previously, CFIs are FDIC-insured institutions with assets of $500 million or less as of 2000 (and adjusted for inflation on an annual basis, for 2004 that standard was $548 million or less). In practice, eliminating the RML test provided increased membership opportunities for commercial banks because thrift institutions would have met the test.

The key membership changes of the GLB Act, removing the 10 percent RML requirement for non-thrift CFIs and eliminating mandatory membership, have had a limited noticeable impact on overall membership. There has been some impact on some FHLBanks, particularly in rural areas, and the FHLBank of Dallas did report a fair increase in new CFI members that would not have otherwise qualified for membership. The minimal impact on membership is likely the result of two factors:

- <u>Pre-GLB Act Commercial Bank Membership Already High</u> – Prior to the Act, commercial bank membership in the FHLBanks was already significant, and there was limited range for attracting new members.

- <u>Pre-GLB Act RML Test Not Difficult to Meet</u> – The pre-GLB Act RML test was not an ongoing requirement, so if a commercial bank wanted to become an FHLBank member it was not that difficult to meet this one-time test.

Part III. Conclusion and Recommendation

This Report has analyzed the impact of the Gramm-Leach-Bliley Act on credit availability to small businesses and farms. The Report found:

- no reason to believe the GLB Act has negatively affected the efficiency of the market for credit to small businesses or farms;

- no reason to believe that financial consolidation has reduced credit availability to small businesses and farms; and

- there may have been some improvement in credit availability to small businesses and farms from the FHLBank provisions of the GLB Act, but the impact at this point is difficult to measure.

This study provides no grounds for subsequent legislative or administrative actions.

Appendix A: Section 109 of the GLB Act

Section 109. STUDY OF FINANCIAL MODERNIZATION'S EFFECT ON THE ACCESSIBLITY OF SMALL BUSINESS AND FARM LOANS.

(a) STUDY.—The Secretary of the Treasury, in consultation with the Federal banking agencies (as defined in section 3(z) of the Federal Deposit Insurance Act), shall conduct a study of the extent to which credit is being provided to and for small businesses and farms, as a result of this Act and the amendments made by this Act.

(b) REPORT.—Before the end of the 5-year period beginning on the date of the enactment of this Act, the Secretary, in consultation with the Federal banking agencies, shall submit a report to the Congress on the study conducted pursuant to subsection (a) and shall include such recommendations as the Secretary determines to be appropriate for administrative and legislative action.

Appendix B: Activities Defined To Be Financial in Nature by the GLB Act

Section 4(k)(4) of the GLB Act defines the following activities to be financial in nature:

(A) Lending, exchanging, transferring, investing for others, or safeguarding money or securities.

(B) Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State.

(C) Providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940).

(D) Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly.

(E) Underwriting, dealing in, or making a market in securities.

(F) Engaging in any activity that the Board had determined, by order or regulation that is in effect on November 12, 1999, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto (subject to the same terms and conditions contained in such order or regulation, unless modified by the Board).

(G) Engaging, in the United States, in any activity that –

(i) a bank holding company may engage in outside of the United States; and

(ii) the Board had determined, under regulations prescribed or interpretations issued pursuant to subsection (c)(13) (as in effect on November 11, 1999) to be usual in connection with the transaction of banking or other financial operations abroad.

(H) Directly, or indirectly acquiring or controlling, whether as principal, on behalf of 1 or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls), or otherwise, shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates, or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if—

(i) the shares, assets, or ownership interests are not acquired or held by a depository institution or subsidiary of a depository institution;

(ii) such shares, assets, or ownership interests are acquired and held by –

(I) a securities affiliate or an affiliate thereof; or

(II) an affiliate of an insurance company described in (I)(ii) below that provides investment advice to an insurance company and is registered pursuant to the Investment Advisers Act of 1940, or an affiliate of such investment adviser;

as part of a bona fide underwriting or merchant or investment banking activity, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment;

(iii) such shares, assets, or ownership interests are held for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the activities described in (H)(ii) above; and

(iv) during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.

(I) Directly or indirectly acquiring or controlling, whether as principal, on behalf of 1 or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls) or otherwise, shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if--

(i) the shares, assets, or ownership interests are not acquired or held by a depository institution or a subsidiary of a depository institution;

(ii) such shares, assets, or ownership interests are acquired and held by an insurance company that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities;

(ii) such shares, assets, or ownership interests represent an investment made in the ordinary course of business of such insurance company in accordance with relevant State law governing such investments; and

(iv) during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company except as may be necessary or required to obtain a reasonable return on investment.

Appendix C: Federal Reserve Staff Submission

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF RESEARCH AND STATISTICS

July 20, 2004

Mr. Mario Ugoletti
Acting Director
Office of Financial Institutions Policy
Main Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Mario,

This letter responds to your request for the views of the Board staff on how enactment of the Gramm-Leach-Bliley (GLB) Act in November 1999 may have affected the flow of credit to small businesses. Our bottom line is that, in our judgment, enactment of GLB has had no measurable effect on the flow of credit to small business, although some minor effects cannot be completely discounted. The rest of this letter summarizes our reasons for coming to this judgment. Three enclosures provide documentation of our views and may be of assistance to you as well.

As you know, in November 2003 the Treasury and the Board of Governors submitted a *Report to Congress on Financial Holding Companies under the Gramm-Leach-Bliley Act*, a copy of which is enclosed. Importantly, this Report did not identify any significant effects of GLB on flows of credit to small businesses. Overall, I would characterize the Report as indicating that the market response to GLB had been one of evolutionary, not radical change. Virtually all large bank holding companies, and a substantial number of smaller institutions, have become financial holding companies (FHCs). Thus, the vast majority of U.S. banking assets are in FHCs. Still, as of the end of 2003 only 633 out of 6,415 U.S. banking organizations were FHCs. The segment of the financial services industry that has seen the most significant changes has been securities underwriting and dealing, where banking organizations have expanded their activities. Substantial growth has also occurred in insurance agency activities. Neither of these activities is particularly important for small business finance. Equally important, the Report documents that there have been no significant changes in the U.S. market structures of the securities underwriting and dealing, the insurance underwriting, the insurance agency, and the merchant banking segments of the financial services industry. No doubt some firms have done better than others, but overall the evidence indicates that competition in these markets has remained quite robust. Indeed, one of the purposes of GLB was to stimulate competition. In short, the facts documented in this Report strongly suggest that there is no reason to believe that the efficiency of the market for credit to small businesses has been affected by GLB.

This having been said, the GLB Act may have somewhat affected the financing of small business by altering the incentive of banks to make *equity* investments in small businesses either directly or through Small Business Investment Corporations (SBICs). On the plus side, the merchant banking provisions of GLB allow for more investment in small business by providing FHCs with an alternative authority that overrides the pre-existing limitation on ownership stakes that constrained BHCs investing in SBICs. On the other hand, some decreased incentive for equity investments may have come from the capital rules that were established for merchant banking activity. These new rules, published by the Board, the FDIC and the OCC in January 2002, increased capital requirements on merchant banking investments, but provided an exemption for SBICs to the extent that a banking organization's investment in SBICs does not exceed 15 percent of Tier 1 capital. However, banking organizations with SBIC investments in excess of 15 percent of Tier 1 capital face higher capital charges. The net effects, if any, of all of these actions are very unclear. Moreover, the lack of data on merchant banking activities, the extreme difficulty of controlling for other relevant changes in the business environment, and the short period of time that has elapsed since the new capital rules went into effect would, in my judgment, severely limit the usefulness of any study of this aspect of GLB on small business finance.

The U.S. banking system has undergone substantial consolidation over the past decade.[1] If GLB has contributed to this consolidation, then it is possible that GLB may have indirectly affected the flow of credit to small business via this mechanism. However, a substantial body of research suggests that such an indirect effect is very unlikely. As noted in the first paragraph of this letter, the evidence does not suggest that GLB has changed the competitive structure of segments of the financial services industry directly affected by GLB (securities, insurance and merchant banking). Given this result, any indirect effect on bank consolidation seems unlikely, and the substantial body of research on why banks merge has not identified GLB as a causal factor. More importantly, the large body of research that has studied the possible effects of banking consolidation on credit flows to small businesses suggests that financial consolidation activity has not tended to reduce the availability of credit to small businesses. Following a merger, any decrease in small business loans by the newly consolidated bank is generally offset by an increase in small business lending by other existing banks and new banks that often are created in the wake of a major merger. These issues were examined, and these conclusions reached, most recently by Board staff in the enclosed *Report to the Congress on the Availability of Credit to Small Businesses*, submitted to Congress in September 2002.[2] It is worth noting that this Report, completed well after enactment of GLB, did not identify GLB as having affected credit flows to small businesses.

I hope this information is useful to you in the preparation of your Report to Congress.

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[1] The enclosed Staff Study by Steven J. Pilloff documents this in considerable detail.

[2] Board staff and others also specifically researched the relationship between bank consolidation and credit flows to small business in the Group of Ten's *Report on Consolidation in the Financial Sector*, published by the Bank for International Settlements in January 2001.

Sincerely yours,

Myron L. Kwast
Associate Director
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enclosures (3)

The three enclosures with the Federal Reserve staff submission can be found at the following web links:

1. Report to the Congress on Financial Holding Companies under the Gramm-Leach-Bliley Act, http://www.federalreserve.gov/boarddocs/rptcongress/glbarptcongress.pdf

2. Report to the Congress on the Availability of Credit to Small Businesses: http://www.federalreserve.gov/boarddocs/rptcongress/sbfreport2002.pdf

3. Bank Merger Activity in the United States, 1994-2003: http://www.federalreserve.gov/pubs/staffstudies/2000-present/ss176.pdf