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Statement by

Susan M. Phillips

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Capital Markets, Securities and

Government Sponsored Enterprises

of the

Committee on Banking and Financial Services

U.S. House of Representatives

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I am pleased to appear before this subcommittee on behalf of the Federal Reserve Board to provide comments on the "Entrepreneurial Investment Act of 1996," a bill proposed by Chairman Baker. At his request, the Board staff provided technical assistance in the drafting of the bill.

This bill would permit smaller bank holding companies to provide limited equity capital to customers of the subsidiary banks. Specifically, bank holding companies of less than $1 billion in assets, all of whose subsidiary banks were well-capitalized, could invest in the equity of those of its customers with whom it has had a "significant" debt relationship for at least a year. The individual equity investments in these firms could not exceed 25 percent of the voting shares of the firm, the holding company could not take an active part in the management of the firm in which it held equity, and the subsidiary banks or other depository institution subsidiaries could not hold any of the stock. The aggregate amount of this equity investment could not exceed half of the amount by which the subsidiary banks' capital exceeded the well-capitalized minimum.

The bill prohibits joint marketing of the products of the banking organization and the firms in which the bank holding company invests. For prudential reasons, the Board would have to provide one-time approval for a banking organization to initiate such investments, and the Board could supervise and regulate this activity, as well as require divestiture if it concluded such action was necessary to preserve the safety and soundness of the insured depository subsidiaries. Should the banks' capital decline, the Board could take action to preserve the safety and soundness of the subsidiary insured depository institutions, including requiring divestiture by the parent holding company of shares already held. The bank holding company would be required quarterly to mark the shares to market value, if possible, and if the shares are not traded, to mark them to the lower of their acquisition price by the holding company or their book value as measured by the firm's balance sheet.

Banking organizations already are involved in similar activities under provisions of existing law. For example, under existing statute and regulation, all bank holding companies have for some time been able to acquire passive equity investments in any company of up to 5 percent of the voting shares and up to 24.9 percent of the total equity in a combination of voting and nonvoting stock. There are no limits on the total amount of equity investments that can be made under these provisions. The bill before you also permits 25 percent of the equity of a company to be purchased — although all could be voting – but there are prudential limits on the total amount of equity purchases.

Under existing interpretations of law, national banks may — in addition — take so–called "equity kickers" as part of loan agreements. That is, the bank may take part or all of its interest on a loan in the form of options or warrants for voting stock, or profit sharing. There is no limit on the percentage of the borrowers' shares that may be the subject of these equity kickers. It is our understanding that such equity kickers are increasingly being used, with the options or warrants sold into the market or exercised by a nonbank affiliate. In a number of states, state banks are permitted, under state law and the FDI Act, to participate in real estate investments and various types of equity securities through subsidiaries of the bank. Moreover, a national bank itself or any bank holding company already can invest up to 5 percent of its capital in a small business investment company that in turn can own up to 49 percent of the voting shares of any small business; the banking organization can also make loans to those businesses. In addition, national banks can invest up to 10 percent of their capital in Community Development Corporations that also take equity positions in companies designed to provide jobs in, or otherwise help improve, low– and moderate–income neighborhoods.

Finally, the Financial Services Competitiveness and Regulatory Relief Act of 1995 would permit any bank holding company with a securities subsidiary to purchase *all* of the equity of any company, so-called "merchant banking" investments. This bill, sponsored by Chairman Leach, would require such investments to be passive, but there is no limit in the statute on the aggregate amount of such investments. The bill this subcommittee is considering also requires the investments to be passive, but limits the amount of both the individual and aggregate equity investments. Moreover, the bill does not require these small holding companies to have a securities subsidiary in the holding company as a prerequisite for engaging in limited equity financing activities.

Banking organizations are in the business of taking risks; that is their economic purpose. But Congress and the banking regulators have to be concerned about excessive risk. We thus support the provisions that require the Board of Governors to supervise and regulate this activity. But we should be clear that the authority to require divestitures may not provide the relief anticipated, since these shares, as I noted, may not be readily marketable. We would consider using our authority to take a close look at the desirability of limiting the sum of loans to, and equity investments in, a single firm to guard against excessive concentration of risk in the banking organization.

The provisions of the bill before you recognize the inherent riskiness of equity investments by smaller bank holding companies and call for the prudential limits I have summarized. But, in a spirit of caution, and in recognition of future business cycles, the subcommittee might want to consider additional prudential provisions:

- **require that *all* the subsidiary banks not only be well–capitalized, but also rated CAMEL 1 or 2, as a prerequisite to equity purchases by the holding company.** Capital ratios generally are acceptable screens, but asset quality, management, asset diversification, and other factors also play a role. The addition of this provision would make very little difference in the number of bank holding companies that would be eligible to purchase equity now, but it could in the future.

- **require that the parent holding company (as well as all the subsidiary banks) be well–capitalized before it could make an equity investment.** Such a provision would have a significant effect on many quite small bank holding companies. The Federal Reserve does not apply risk–based standards to parent bank holding companies with assets of less than $150 million. Many of these parents borrow heavily to finance the equity of the subsidiary bank(s). As a result of this so–called "double leverage," many of the parents do not have very much, if any, capital in excess of the well–capitalized minimum. Note that adding this provision would mean that minimum capital requirements would be applied to small bank holding companies only for purposes of investing in stocks under the bill.

- **limit the equity investments of eligible banking organizations to 50 percent of the capital in excess of the well–capitalized minimum standard of the subsidiary banks (as in the bill) or 50 percent of the capital in excess of the well–capitalized minimum standard for bank holding companies, *whichever is smaller*.** Our best estimate is that applying this and the previous suggestion would reduce the permissible maximum aggregate equity investment quite sharply at the smallest banking organizations whose parent holding company capital is not as strong as at other small banking organizations. Banking organizations with more than $150–$200 million of assets would not be affected very much.

These suggestions are designed to minimize the risk that could occur with equity investments by smaller bank holding companies. They may sound excessively prudent, but seem to us desirable because of the limited experience of equity purchases by smaller banking organizations. The Board believes that its suggestions for revisions would not be in significant conflict with the purpose of the bill.

I would be glad, Mr. Chairman, to try to answer the subcommittee's questions.