THE CAPITAL QUANDARY

Speed-Bumps on the Road to Modernization

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Tom Phelps has asked me to talk about the business decisions you, as senior executives of some of the nation's most innovative banks, must make now that Congress has realigned the nation's laws to comport more closely — if far from perfectly — with the market realities you confront every day. You have already heard many distinguished speakers describe the new law. They have made amply clear that you have many new options from which to choose. They have also emphasized a point I think essential: The new law does not necessarily mean your bank must do new things — only that you must think about the business in new ways.

To some degree, the impact of Gramm-Leach-Bliley has been

over-hyped. I've seen several recent deals described as the "first use" of the new law. Sometimes, this is right — as in the Charles Schwab acquisition of U.S. Trust, for example. Often, though, it's wrong, indicating ignorance of just how far prior law went, especially under the aggressive interpretations of it advanced by the OCC. The recent acquisition by a foreign bank of a U.S. financial guarantor was described as just such a "first use," even though national banks have been allowed into the financial guarantee insurance business since 1985.

There may be even less to GLBA than boosters have thought once questions related to capital adequacy are considered. Nothing in the capital provisions in GLBA should be shocking. In fact, the sections of the law dealing with capital didn't change much over the six years it took Congress to consider the legislation. What is shocking, though, is how the Board is interpreting aspects of

the Act, especially with regard to merchant banking.

In essence, the Fed is setting up capital rules that make financial modernization a one-way street. For bank holding companies, transformation into an FHC will be relatively straightforward. For non-banks, the capital consequences of FHC status can be profound. However, banks should not rest too easy. As I speak, the deadline for comments on a massive rewrite of the Basle rules is only two days away. Capital will, I think, quickly become a key variable in the strategic equation for each of your banks.

FHC Capital Issues

For banks, meeting the new capital requirements — putting merchant banking aside for the moment — is not too difficult. To qualify as an FHC, all insured depository affiliates must be well-capitalized, as well as get a top grade for management and at least a satisfactory CRA rating. At

least 144 BHCs can meet this grade and have become FHCs, but an interesting cross-section of some of the world's largest banks have not. Some may decide to become FHCs later, but more than a few haven't applied for FHC status because their management ratings are too low.

By setting the standard for FHC status at the well-capitalized level, the Act has moved the bar for capital adequacy. A 10% risk-based rating — not 8% — is the minimum banks can have to get new powers. To keep them without restrictions, all insured depository affiliates must hold to this high standard and, as it changes, meet any increases.

Some may not think these capital standards much of a stretch, looking at the generally robust capital levels around the industry. Think back just a few years, though, and it is clear that capital was, and may again become, a significant constraint. Set as high as it now has been set, senior management must keep a

constant focus on capital, restricting stock buy-backs or other activities that could become problematic from a capital perspective, even if earnings are unaffected or even improved.

The Non-Bank Dilemma

For banks and bank holding companies, the new capital standards are, if you will, a "more so," not a sea-change. Banks are used to the current capital standards and most meet or exceed them.

Non-banks operate under a completely different capital regime. Many assets — corporate bonds, for example, that count as assets that must be capitalized under bank rules — count as capital under other GAAP or insurance regulation. Most non-banks keep on hand only as much capital as the market demands or specific lines of business are required to hold by their functional regulators. Coming up with the capital to comply with the bank rules, especially at the

holding company level, will be tough for many.

Congress anticipated this problem to some extent by imposing a "fed-lite" capital and regulatory structure at the FHC level. Those of us who have dealt with Fed-*heavy* for years, though, strongly suspected that the Fed would use all of the authority it was given.

And so it has chosen to do. The new rules would impose a 50% capital charge — that's fifty cents for every dollar — on merchant banking operations. This standard is so high that even many BHCs thinking about merchant banking will bow out of this activity. They may also have to exit some existing operations, since the Board proposes to prevent "arbitrage" by applying the 50% charge not only to new merchant banking operations, but also to existing portfolio investments.

This has come as a shock, but perhaps not an entirely unexpected one. A real bolt-out-of- the-blue was buried in a footnote in

the merchant-banking rule. Also to prevent "arbitrage," the Board plans to impose this same 50% charge on investments in insurance companies owned by FHCs. This would dramatically ratchet up the cost of becoming an FHC, making a bank acquisition prohibitive for many companies.

Congress did leave the unitary thrift holding company escape hatch open for any financial services firm wishing to acquire an insured depository. If the Fed sticks to its 50% rule for insurance companies, many will find the unitary thrift their only viable charter, since no parent- company capital standards are imposed on them. This will limit their ability to buy banks — arguably a goal of GLBA — but that's how the capital cookie could well crumble.

Capital Confusion

The Fed's moves are taking place at a time of growing confusion over what the overall capital rules governing financial services firms will look like. In addition to

the Fed's move against merchant banking, the FDIC is considering doubling the risk-based capital required against "subprime" loans. Both the Fed's and the FDIC's proposals are based on the view that these activities are inherently risky, although neither agency has yet mustered any data to prove it. If these initiatives continue, banks and FHCs could find themselves subject to capital on a line-of-business — not risk — basis. This will create incentives — some might say *mandates* — to get into or out of businesses favored or opposed by the regulators.

This broadside is in sharp contrast to the more refined approach to capital being crafted by the Basle Committee on Bank Supervision. Last year, it issued a proposal to base risk-based capital on external ratings, not arbitrary regulatory judgments. While the ratings-based approach has problems — not the least of them its complexity — it would at least eliminate an element of

arbitrariness that encourages precisely the type of arbitrage the Fed and FDIC are aiming at. Indeed, absent the Basle proposal, the proposed increases in capital could well encourage risk-taking, not eliminate it. How, after all, to earn a reasonable return with a 50% capital charge except to take a whole lot more risk?

The U.S. regulators are considering a form of ratings-based capital that could be implemented more quickly than the Basle rules. Last month, the regulators asked for comment on an inter-agency proposal addressing so-called recourse risk. It would significantly change the capital required against rated asset securitizations. It could also significantly increase the capital charged against second mortgages, which would be viewed as subordinated interests under the rule.

The Bottom Line?

There is no question that GLBA is a significant event for

financial services firms, although in many ways it only ratifies options that previously existed. It also defines what earlier had been an ambiguous regulatory and capital regime for non-traditional activities. As I've outlined, this "clarification" is not always for the better. As we watch the Act coming into action, it is becoming increasingly clear that the capital rules will be a major criterion by which companies can engage in which activities at what kind of profit. As the capital rules change — and change they will in the next few months — this criterion becomes even more critical. ❑

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