

GAO

Report to the Chairman and Ranking  
Minority Member, Committee on  
Financial Services, House of  
Representatives

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October 2003

# BANK TYING

## Additional Steps Needed to Ensure Effective Enforcement of Tying Prohibitions



G A O

Accountability \* Integrity \* Reliability

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Highlights of [GAO-04-4](#), a report to the Chairman and Ranking Minority Member of the Committee on Financial Services, House of Representatives

## Why GAO Did This Study

Investment affiliates of large commercial banks have made competitive inroads in the annual \$1.3 trillion debt-underwriting market. Some corporate borrowers and officials from unaffiliated investment banks have alleged that commercial banks helped their investment affiliates gain market share by illegally tying and underpricing corporate credit. This report discusses these allegations, the available evidence related to the allegations, and federal bank regulatory agencies' efforts to enforce the antitying provisions.

## What GAO Recommends

Because documentary evidence of an unlawful tying arrangement generally is not available in bank files, GAO recommends that the Federal Reserve and OCC consider additional steps to enforce section 106. Additional steps could include publication of specific contact points within the agencies to answer questions from banks and bank customers about the guidance in general and its application to specific transactions, as well as to accept complaints from bank customers who believe that they have been subjected to unlawful tying.

Because low-priced credit could indicate violations of law, the Federal Reserve should also assess available evidence of loan pricing behavior to provide better supervisory information, and publish the results of this assessment.

[www.gao.gov/cgi-bin/getrpt?GAO-04-4](http://www.gao.gov/cgi-bin/getrpt?GAO-04-4).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov).

## BANK TYING

# Additional Steps Needed to Ensure Effective Enforcement of Tying Prohibitions

## What GAO Found

Section 106 of the Bank Holding Company Act Amendments of 1970 prohibits commercial banks from “tying,” a practice which includes conditioning the availability or terms of loans or other credit products on the purchase of certain other products and services. The law does permit banks to tie credit and traditional banking products, such as cash management, and does not prohibit banks from considering the profitability of their full relationship with customers in managing those relationships.

Some corporate customers and officials from an investment bank not affiliated with a commercial bank have alleged that commercial banks illegally tie the availability or terms, including price, of credit to customers' purchase of other services. However, with few exceptions, formal complaints have not been brought to the attention of the regulatory agencies and little documentary evidence surrounding these allegations exists, in part, because credit negotiations are conducted orally. Further, our review found that some corporate customers' claims involved lawful ties between traditional banking products rather than unlawful ties. These findings illustrate a key challenge for banking regulators in enforcing this law: while regulators need to carefully consider the circumstances of specific transactions to determine whether the customers' acceptance of an unlawfully tied product (that is, one that is not a traditional banking product) was made a condition of obtaining credit, documentary evidence on those circumstances might not be available. Therefore, regulators may have to look for indirect evidence to assess whether banks unlawfully tie products and services. Although customer information could have an important role in helping regulators enforce section 106, regulators generally have not solicited information from corporate bank customers.

The Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency (OCC) recently reviewed antitying policies and procedures of several large commercial banks. The Federal Reserve and OCC, however, did not analyze a broadly-based selection of transactions or generally solicit additional information from corporate borrowers about their knowledge of transactions. The agencies generally found no unlawful tying arrangements and concluded that these banks generally had adequate policies and procedures intended to prevent and detect tying practices. The agencies found variation among the banks in interpretation of the tying law and its exceptions. As a result, in August 2003, the Board of Governors of the Federal Reserve, working with OCC, released for public comment new draft guidance, with a goal of better informing banks and their customers about the requirements of the antitying provision.

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**Abbreviations**

AICPA	American Institute of Certified Public Accountants
FASB	Financial Accounting Standards Board
FAS	Financial Accounting Standards
FDIC	Federal Deposit Insurance Corporation
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission

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United States General Accounting Office  
Washington, D.C. 20548

October 10, 2003

The Honorable Michael G. Oxley  
Chairman, Committee on Financial Services  
House of Representatives

The Honorable Barney Frank  
Ranking Minority Member,  
Committee on Financial Services  
House of Representatives

In the 70 years since the passage of the Glass-Steagall Act of 1933, which prohibited commercial banks from engaging in investment banking activities such as securities underwriting, changes in legislation and regulatory interpretations have relaxed some of the restrictions imposed on bank holding companies and their subsidiaries that served to distance commercial banks from investment banking. For example, one effect of the 1970 amendments to the Bank Holding Company Act of 1956 was to permit bank holding companies to own subsidiaries engaged in limited underwriting activities, but only if the subsidiary was not “principally engaged” in such activities. More recently, the Gramm-Leach-Bliley Act of 1999, among other things, substantially removed that limitation. As a result of these and other developments, commercial banks and their investment bank affiliates (investment affiliates) can provide complementary financial products and services. Despite these developments, commercial banks have remained subject to certain restrictions on their activities. Among them is the prohibition against tying arrangements. In general, section 106 of the Bank Holding Company Act Amendments of 1970 (section 106) prohibits banks from tying the availability or price of a product or service to a customer’s purchase of another product or service or the customer’s providing some additional credit, property or service.<sup>1</sup>

In recent years, investment bank affiliates of large commercial banks have gained an increasing share of the annual \$1.3 trillion debt underwriting market. A controversy has arisen over whether or not unlawful tying has contributed to this increased market share. Some unaffiliated investment banks (investment banks) and some corporate borrowers contend that

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<sup>1</sup>As explained later, not all instances of bank tying are unlawful because certain types of products and services are not subject to the tying prohibition in the Bank Holding Company Act.

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commercial banks have facilitated investment affiliates' increased market share of debt underwriting by unlawfully tying the availability of bank credit to debt underwriting by the bank's affiliate, a violation of section 106. In addition, some investment bankers assert that large commercial banks engage in unlawful tying by offering reduced rates for corporate credit only if the borrower also purchases debt underwriting services from the bank's investment affiliate. If such a reduced rate were conditioned only on the borrower's purchase of debt underwriting services from the commercial bank's investment affiliate, the arrangement would constitute unlawful tying. Should the reduced rate constitute an underpricing of credit (that is, the extension of credit below market rates), the underpricing could also violate section 23B of the Federal Reserve Act of 1913 (section 23B).

Section 23B generally requires that certain transactions between a bank and its affiliates occur on market terms; that is, on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies. Section 23B applies to any transaction by a bank with a third party if an affiliate has a financial interest in the third party or if an affiliate is a participant in the transaction. The banking regulators suggest that the increase in debt underwriting market share by the investment affiliates of large commercial banks can be explained by a number of market and competitive factors not associated with tying, such as industry consolidation and acquisition of investment banking firms by bank holding companies. In addition, representatives from large commercial banks with investment affiliates contend that they sell a range of products and services to corporate customers, including credit, but do not unlawfully tie bank credit or credit pricing to underwriting services. Furthermore, officials from large commercial banks, federal banking and securities regulators, and investment bankers observe that ties between credit and other banking products are often customer-initiated, and thus exempt from the laws governing tying.

To more fully examine the issues raised by the allegations about unlawful tying and underpricing of corporate credit, you asked us to determine (1) what evidence, if any, suggests that commercial banks with investment affiliates engage in unlawful tying; (2) what steps the federal banking regulators have taken to examine for unlawful tying and the results of these efforts; (3) what evidence, if any, suggests that commercial banks with investment affiliates unlawfully discount the price of corporate credit to obtain underwriting business for their investment affiliates; and (4) what, if any, competitive advantages accounting rules, capital standards, and

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access to the federal safety net create for commercial banks over investment banks.

In our review of possible unlawful tying practices by large commercial banks, we focused on wholesale corporate lending and did not address retail banking. We conducted a legal review of section 106 of the Bank Holding Company Act Amendments of 1970, section 23B of the Federal Reserve Act, and relevant federal regulations, and interviewed legal experts and academics. To describe the recent concerns about possible unlawful tying practices, we reviewed the results of a 2003 survey on corporate borrowers' views about credit access conducted by the Association for Financial Professionals and reviewed recent media coverage of tying. We also interviewed several large corporate borrowers, and officials at several investment banks and commercial banks with investment affiliates. We also met with officials from NASD to discuss that organization's Special Notice to its members and its ongoing investigation related to tying. NASD is a self-regulatory organization that sets and enforces market conduct rules governing its members, which are securities firms, including those affiliated with commercial banks.

To determine what steps the federal banking regulators have taken to examine for unlawful tying, we reviewed the results of the Board of Governors of the Federal Reserve System (Federal Reserve) and the Office of Comptroller of the Currency (OCC) joint review on tying and interviewed commercial bankers to describe the measures that large commercial banks take to comply with the tying law. We also reviewed federal guidance on sections 106 and 23B and Federal Reserve and OCC examination procedures related to tying. In addition, we interviewed officials from the Federal Reserve, OCC, and the Federal Deposit Insurance Corporation (FDIC).

To identify possible credit pricing abuses and factors that affect overall prices in wholesale credit markets, we interviewed commercial bankers, credit market experts, academics experts, industry observers, and officials at the Federal Reserve and OCC. We also reviewed economic literature on wholesale credit markets.

To determine the accounting practices and requirements for commercial banks and investment banks, we performed a comparative analysis of applicable accounting standards and verified our understanding through interviews with officials from the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA),

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and the Securities and Exchange Commission (SEC). We also solicited feedback from FASB and AICPA officials on appendix I of our draft report and incorporated their technical comments in this report as appropriate. To determine the respective capital standards for commercial banks, we reviewed relevant documentation and interviewed Federal Reserve, OCC, and SEC officials and officials from commercial banks. We also spoke with Federal Reserve and OCC officials about the access of commercial banks and investment banks to the federal safety net.

We recognized certain limitations on the information collected during this review. In particular, we recognized that much of the information provided to us on selected transactions and market behavior could not be independently verified. In addition, we did not independently verify the results of the 2003 survey conducted by the Association for Financial Professionals, which we believe are subject to methodological limitations that prevent us from reporting them in detail. Nor did we verify the results of the Federal Reserve and OCC's special review targeted on tying.

We conducted our work in Charlotte, N.C.; Chicago, Ill.; New York, N.Y.; Orlando, Fla.; and Washington, D.C., between October 2002 and October 2003, in accordance with generally accepted government auditing standards.

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## Results in Brief

Although some corporate borrowers have alleged that commercial banks tie the availability or price of credit to the purchase of debt underwriting services—a violation of section 106—the available evidence did not substantiate these claims. Corporate borrowers could not provide documentary evidence to substantiate their claims. The lack of documentary evidence might be due to the fact that negotiations over credit terms and conditions (during which a tying arrangement could be imposed) were generally conducted orally. Borrowers also were reluctant to file formal complaints with banking regulators. Reasons given for their reluctance included a lack of documentary evidence of unlawful tying, uncertainty about whether certain tying arrangements were illegal, and fear of adverse consequences for their companies' access to credit and for their individual careers. Determining whether a tying arrangement is unlawful requires close examination of the specific facts and circumstances of the transactions involved, and lawful practices can easily be mistaken for unlawful tying. For example, although borrowers we interviewed described arrangements that could represent unlawful tying by banks, other arrangements that they described involved lawful practices. Because



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documentary evidence of unlawful tying is generally not available, banking regulators may have to look for other forms of indirect evidence to effectively enforce section 106.<sup>2</sup>

Regular bank examinations in recent years have not identified any instances of unlawful tying that led to enforcement actions.<sup>3</sup> In response to recent allegations of unlawful tying at large commercial banks, the Federal Reserve and OCC conducted a joint review focused on antitying policies and practices at several large commercial banks and their holding companies. The review teams found that the banks generally had adequate procedures in place to comply with section 106, and that over the past year, some banks had made additional efforts to ensure compliance. Although customer information could have an important role in helping the regulators enforce section 106, regulators did not analyze a broadly based selection of transactions or contact a broad selection of customers as part of their review. The regulators said that they met with officials and members from a trade group representing corporate financial executives. The review teams questioned some transactions but generally did not find unlawful tying arrangements. The targeted review found some variation among banks' interpretations of section 106, generally in areas where the regulators have not provided authoritative guidance. As a result, the Federal Reserve recently issued, for public comment, proposed guidance that is intended to help banks and their customers better understand what activities are lawful and unlawful under section 106.<sup>4</sup> Federal Reserve officials said that they hope this guidance also encourages customers to come forward if they believe that they have grounds to make a complaint.

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<sup>2</sup>For purposes of this report, the term "indirect evidence" refers to information that is not contained in transaction documents maintained by the bank. Section 106 is codified at 12 U.S.C. § 1972 (2000).

<sup>3</sup>After the Federal Reserve and OCC completed the targeted review, the Federal Reserve announced on August 27, 2003, that it had entered into a consent agreement and civil money penalty against WestLB AG, a German bank, and its New York branch, based on allegations that in 2001 it conditioned the availability of credit on the borrower's obtaining underwriting business from a WestLB affiliate.

<sup>4</sup>68 Fed. Reg. 52024 (Aug. 29, 2003). OCC released a white paper, "*Today's Credit Markets, Relationship Banking, and Tying*," on September 25, 2003, which discussed banks' market power and economic performance for evidence of tying, the market competitiveness of diversified banking organizations, and relationship banking. The paper concluded that the relationship banking practices, as described in the white paper, are consistent with the relevant legal framework.

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Although officials from one investment bank alleged that the pricing of some corporate credit by large commercial banks was a factor in violations of section 106 and possibly section 23B, we found that the available evidence on pricing was subject to multiple interpretations and did not necessarily demonstrate violations of either section 106 or section 23B. Some investment banks contended that large commercial banks deliberately underpriced corporate credit to attract underwriting business to their investment affiliates. Section 106 prohibits a bank from setting or varying the terms of credit on the condition that the customer purchase certain other products and services from the bank or an affiliate, unless those products and services (such as traditional banking services) are exempted from the prohibition. If the price of the credit is less than the market price and the bank's investment affiliate is a participant in the transaction, then the transaction would reduce the bank's income for the benefit of its affiliate, and thus be in violation of section 23B.<sup>5</sup> However, our review of specific transactions cited by an investment bank found the available evidence of underpricing to be ambiguous and subject to different interpretations. During the course of our review, Federal Reserve staff said that they were considering whether to conduct a research study of pricing issues in the corporate loan market. Such a study could improve the regulators' ability to determine if transactions are conducted at prices that were not determined by market forces.

Although officials at one investment bank also contended that differences in accounting conventions, regulatory capital requirements, and access to the federal safety net provide a competitive advantage that enables commercial banks with investment affiliates to underprice loan commitments, we found that these differences did not appear to provide a clear and consistent competitive advantage for commercial banks.

- Because commercial banks are not permitted by the accounting standards to recognize changes in the value of loans and loan commitments compared with current market prices while investment banks recognize these changes in their net income, officials at some investment banks have contended that accounting standards give commercial banks a competitive advantage. However, FASB, which sets private-sector financial accounting and reporting standards, noted that commercial banks and investment banks follow different accounting models for these transactions. Based on our analysis, banks' adherence

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<sup>5</sup>See 12 U.S.C. § 371c-1 (2000).

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to different accounting rules caused a temporary difference in the recognition of the service fees from short-term loan commitments—a difference that appeared to be relatively small compared with revenue from other bank activity and would be resolved by the end of the loan commitment period. Moreover, both commercial banks and investment banks must report the fair value of loan commitments in the footnotes of their financial statements. Further, we found that if the loan commitment were exercised and both firms either had the intent and ability to hold the loan for the foreseeable future or until maturity, or made the loan available for sale, the accounting would be similar and would not provide an advantage to either firm.

- Additionally, while commercial and investment banks were subject to different regulatory capital requirements, practices of both commercial and investment banks led to avoidance of regulatory charges on loan commitments with a maturity of 1 year or less. Officials from one investment bank also contended that bank regulatory capital requirements gave commercial banks a competitive advantage in lending because they are not required to hold regulatory capital against short-term unfunded loan commitments. In comparison, investment banks could face a 100-percent regulatory capital charge if they carried loan commitments in their broker-dealer affiliates. However, in practice, investment bankers told us that they generally carry loan commitments outside of their broker-dealer affiliates and thus also avoid regulatory capital charges.
- Some officials from investment banks also contended that commercial banks' access to the federal safety net, including access to federal deposit insurance and Federal Reserve discount window lending, gives the banks a further cost advantage. However, industry observers and OCC officials said that this subsidy is likely offset by regulatory costs.

This report includes a recommendation that the Federal Reserve and the OCC consider taking additional steps to ensure effective enforcement of section 106 and section 23B, including enhancing the information that they receive from corporate borrowers. For example, the agencies could develop a communication strategy that is directed at a broad audience of corporate bank customers to enhance their understanding of section 106. Because low priced credit could indicate a potential violation of section 23B, we also recommend that the Federal Reserve assess available evidence regarding loan pricing behavior, and if appropriate, conduct additional research to better enable examiners to determine whether

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transactions are conducted on market terms, and that the Federal Reserve publish the results of this assessment.

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## Background

Large banking organizations typically establish ongoing relationships with their corporate customers and evaluate the overall profitability of these relationships. They use company-specific information gained from providing certain products and services—such as credit or cash management—to identify additional products and services that customers might purchase. This practice, known as “relationship banking,” has been common in the financial services industry for well over a century.

In recent years, as the legal and regulatory obstacles that limited banking organizations’ abilities to compete in securities and insurance activities have been eased, some large banking organizations have sought to expand the range of products and services they offer customers. In particular, some commercial banks have sought to decrease their reliance on the income earned from credit products, such as corporate loans, and to increase their reliance on fee-based income by providing a range of priced services to their customers.

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## Federal Banking Regulators

The Federal Reserve and OCC are the federal banking regulators charged with supervising and regulating large commercial banks. The Federal Reserve has primary supervisory and regulatory responsibilities for bank holding companies and their nonbank and foreign subsidiaries and for state-chartered banks that are members of the Federal Reserve System and their foreign branches and subsidiaries. The Federal Reserve also has regulatory responsibilities for transactions between member banks and their affiliates. OCC has primary supervisory and regulatory responsibilities for the domestic and foreign activities of national banks and their subsidiaries. OCC also has responsibility for administering and enforcing standards governing transactions between national banks and their affiliates. Among other activities, the Federal Reserve and OCC conduct off-site reviews and on-site examinations of large banks to provide periodic analysis of financial and other information, provide ongoing supervision of their operations, and determine compliance with banking laws and regulations. Federal Reserve and OCC examinations are intended to assess the safety and soundness of large banks and identify conditions that might require corrective action.

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## Section 106 of the Bank Holding Company Act Amendments of 1970

Congress added section 106 to the Bank Holding Company Act in 1970 to address concerns that an expansion in the range of activities permissible for bank holding companies might give them an unfair competitive advantage because of the unique role their bank subsidiaries served as credit providers.<sup>6</sup> Section 106 makes it unlawful, with certain exceptions, for a bank to extend credit or furnish any product or service, or vary the price of any product or service (the “tying product”) on the “condition or requirement” that the customer obtains some additional product or service from the bank or its affiliate (the “tied product”).<sup>7</sup> Under section 106, it would be unlawful for a bank to provide credit (or to vary the terms for credit) on the condition or requirement that the customer obtain some other product from the bank or an affiliate, unless that other product was a traditional bank product.<sup>8</sup> Thus, it would be unlawful for a bank to condition the availability or pricing of new or renewal credit on the condition that the borrower purchase a nontraditional bank product from the bank or an affiliate.

In contrast, section 106 does not require a bank to extend credit or provide any other product to a customer, as long as the bank’s decision was not based on the customer’s failure to satisfy a condition or requirement prohibited by section 106. For example, it would be lawful for a bank to deny credit to a customer on the basis of the customer’s financial condition, financial resources, or credit history, but it would be unlawful for a bank to deny credit because the customer failed to purchase underwriting services from the bank’s affiliate.

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<sup>6</sup>See, e.g., H.R. Conf. Rep. No. 91-1747, reprinted in 1970 U.S.C.A.N. 5561, 5569.

<sup>7</sup>Section 106 also prohibits reciprocity and exclusive dealing arrangements. Reciprocity arrangements are arrangements that require a customer to provide some credit, property, or service to the bank or one of its affiliates as a condition of the bank providing another product to the customer. Exclusive dealing arrangements are arrangements that require a customer not to obtain some other credit, property, or service from a competitor of the bank or its affiliate as a condition of the bank providing another product to the customer. The allegations we encountered during our work did not involve such arrangements.

<sup>8</sup>A key exception to section 106 is that banks may condition the price or availability of a service or product on the basis of a customer obtaining a “traditional bank product,” which the section defines as “a loan, discount, deposit, or trust service.” Section 106 provides this exception only with respect to traditional bank products offered by the bank, but the Board has extended the exception to include traditional bank products offered by an affiliate of the bank. 12 C.F.C. § 225.7(b)(1) (2003)).

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Section 106 does not prohibit a bank from cross-marketing products that are not covered by the “traditional banking product” exemption or from granting credit or providing any other product or service to a customer based solely on the hope that the customer obtain additional products from the bank or its affiliates in the future, provided that the bank does not require the customer to purchase an additional product. Also, section 106 generally does not prohibit a bank from conditioning its relationship with a customer on the total profitability of its relationship with the customer.

Section 106 authorizes the Federal Reserve to make exceptions that are not contrary to the purposes of the tying prohibitions. The Federal Reserve has used this authority to allow banks to offer broader categories of packaging arrangements, where it has determined that, these arrangements benefit customers and do not impair competition. In 1971, the Federal Reserve adopted a regulation that extended antitying rules to bank holding companies and their nonbank affiliates and approved a number of nonbanking activities that these entities could engage in under the Bank Holding Company Act. Citing the competitive vitality of the markets in which nonbanking companies generally operate, in February 1997, the Federal Reserve rescinded this regulatory extension.<sup>9</sup> At the same time, the Federal Reserve expanded the traditional bank products exception to include traditional bank products offered by nonbank affiliates.

In the mid-1990s, the Board also added two regulatory safe harbors. First, the Board granted a regulatory safe harbor for combined-balance discount packages, which allowed a bank to vary the consideration for a product or package of products—based on a customer’s maintaining a combined minimum balance in certain products—as long as the bank offers deposits, the deposits are counted toward the combined-balance, and the deposits count at least as much as nondeposit products toward the minimum balance.<sup>10</sup> Furthermore, according to the Board, under the combined-balance safe harbor, the products included in the combined balance program may be offered by either the bank or an affiliate, provided that the bank specifies the products and the package is structured in a way that does not, as a practical matter, obligate a customer to purchase nontraditional bank products to obtain the discount. Second, the Board granted a regulatory safe harbor for foreign transactions. This safe harbor

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<sup>9</sup>See 83 Fed. Res. Bulletin 275 (April 1997).

<sup>10</sup>Id.

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provides that the antitying prohibitions of section 106 do not apply to transactions between a bank and a customer if the customer is a company that is incorporated, chartered, or otherwise organized outside of the United States, and has its principal place of business outside of the United States, or if the customer is an individual who is a citizen of a country other than the United States and is not resident in the United States.<sup>11</sup>

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## Violations of Section 106

On August 29, 2003, the Board published for public comment its proposed interpretation and supervisory guidance concerning section 106.<sup>12</sup> In this proposed interpretation, the Federal Reserve noted that determining whether a violation of section 106 occurred requires a detailed understanding of the facts underlying the transaction in question. In this proposed interpretation, the Federal Reserve also noted what it considers to be the two key elements of a violation of section 106:

(1) The arrangement must involve two or more separate products: the customer's desired product(s) and one or more separate tied products; and

(2) The bank must force the customer to obtain (or provide) the tied product(s) from (or to) the bank or an affiliate in order to obtain the customer's desired product(s) from the bank.<sup>13</sup>

A transaction does not violate section 106 unless it involves two separate products or services. For example, a bank does not violate section 106 by requiring a prospective borrower to provide the bank specified collateral to obtain a loan or by requiring an existing borrower to post additional collateral as a condition for renewing a loan. Assuming two products or services are involved, the legality of the arrangement depends on, among

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<sup>11</sup>Id.

<sup>12</sup>68 Fed. Reg. 52024 (August 29, 2003).

<sup>13</sup>68 Fed. Reg. at 52027. A tie exists under section 106 if the bank furnishes the tying product "on the condition or requirement" that the customer obtain the tied product or provide some additional credit, property or service. In its guidance, the Board stated that even if a condition or requirement exists, further inquiry might be necessary because the condition or requirement violates section 106 only if it resulted from coercion by the bank. Id. at 52028. As the Board recognized, however, some courts have held that a tying arrangement may violate section 106 without a showing that the arrangement resulted from any type of coercion by the bank. Id. at 52029, n. 36.

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other things, which products and services are involved and in what combinations. It would be unlawful for a bank to condition the availability of corporate credit on a borrower's purchase of debt underwriting services from its affiliate, because a bank cannot condition the availability of a bank product on a customer's purchase of a nontraditional product or service. According to the Board's proposed interpretation, a bank can legally condition the availability of a bank product, such as credit, on the customer's selection from a mix of traditional and nontraditional products or services—a mixed-product arrangement—only if the bank offered the customer a “meaningful choice” of products that includes one or more traditional bank products and did not require the customer to purchase any specific product or service. For example, according to the Federal Reserve, a bank could legally condition the availability of credit on a customer's purchase of products from a list of products and services that includes debt underwriting and cash management services, provided that this mixed-product arrangement contained a meaningful option to satisfy the bank's condition solely through the purchase of the traditional bank products included in the arrangement. However, it would be a violation of section 106 for a bank to condition the availability of credit on a mixed-product arrangement that did not contain a meaningful option for the customer to satisfy the bank's condition solely through the purchase of a traditional bank product.

When a bank offers a customer a low price on credit, it might or might not be a violation of law. If a bank reduced the cost of credit on the condition that the customer purchase nontraditional bank products or services offered by its investment affiliate, this arrangement would violate section 106. However, if a bank offered a low price on credit to attract additional business but did not condition the availability of the price on the purchase of a prohibited product, it would not violate section 106. Additionally, if a reduced interest rate were to constitute underpricing of a loan, such a transaction, depending on the circumstances, could violate section 23B of the Federal Reserve Act of 1913, which we discuss later in this section.

Whether the arrangement constitutes an unlawful tie under section 106 also depends upon whether a condition or requirement actually exists and which party imposes the condition or requirement. Determining the existence of either element can be difficult. The question of whether a condition or requirement exists is particularly difficult because of uncertainties about how to interpret that aspect of the prohibition. According to the Board's proposal, section 106 applies if two requirements are met: “(1) a condition or requirement exists that ties the customer's



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desired product to another product; and (2) this condition or requirement was imposed or forced on the customer by the bank.”<sup>14</sup> Thus, according to the Board’s proposal, if a condition or requirement exists, further inquiry may be necessary to determine whether the condition or requirement was imposed or forced on the customer by the bank: “If the condition or requirement resulted from coercion by the bank, then the condition or requirement violates section 106, unless an exemption is available for the transaction.”<sup>15</sup> This interpretation is not universally accepted, however. As the Board’s proposal has noted, some courts have held that a tying arrangement violates section 106 without a showing that the arrangement resulted from any type of coercion by the bank.<sup>16</sup> Uncertainties about the proper interpretation of the “condition or require” provision of section 106 have lead to disagreement over the circumstances that violate section 106.

It has been suggested that changes in financial markets that have occurred since the enactment of section 106, particularly a decreased corporate reliance on commercial bank loans, also are relevant in considering whether banks currently can base credit decisions on a “condition or requirement” that corporate customers buy other services. At the end of 1970, according to the Federal Reserve’s Flow of Funds data, bank loans accounted for about 24 percent of the total liabilities of U.S. nonfarm, nonfinancial corporations. At the end of 2002, bank loans accounted for about 14 percent of these liabilities.

Because section 106 applies only to commercial and savings banks, investment banks and insurance companies, which compete in credit markets with banks, are not subject to these tying restrictions.<sup>17</sup> Thus, under section 106, a bank’s nonbank affiliate legally could condition the availability of credit from that nonbank affiliate on a customer’s purchase of debt underwriting services. Where a transaction involves a bank as well as one or more affiliates, uncertainties could exist over whether the

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<sup>14</sup>68 Fed. Reg. at 52028.

<sup>15</sup>*Id.* at 52029.

<sup>16</sup>*Id.*, n. 36.

<sup>17</sup>Thriffs are subject to a similar antitying prohibition. Section 5(q) of the Home Owners Loan Act, 12 U.S.C. § 1464(q) (2000) places restrictions on savings associations that are almost identical to those placed on banks by section 106, although the Office of Thrift Supervision may only grant exceptions to section 5(q) that conform to exceptions to section 106 granted by the Board.

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affiliate or the bank imposed a condition or requirement. It should be noted, however, that all of these financial institutions are subject to the more broadly applicable antitrust laws, such as the Sherman Act, that prohibit anticompetitive practices, including tying arrangements.<sup>18</sup> In addition, under section 106 it is lawful for bank customers to initiate ties. For example, a customer could use its business leverage to obtain favorable credit terms or require a bank to extend a corporate loan as a condition for purchasing debt underwriting services.

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### Section 23B of the Federal Reserve Act of 1913 Prohibits Transactions That Benefit Bank Affiliates at the Expense of the Bank

Section 23B requires that transactions involving a bank and its affiliates, including those providing investment-banking services, be on market terms.<sup>19</sup> Although section 106 generally prohibits changing the price for credit on the condition that the customer obtain some other services from the bank or its affiliates, section 23B prohibits setting the price for credit at a below-market rate that would reduce the bank's income for the benefit of its affiliate. Banking regulators have noted that pricing credit at below-market rates could also be an unsafe and unsound banking practice independent of whether the practice violates section 23B specifically.

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<sup>18</sup>As the Board observed in its proposed interpretation and guidance, as a general matter a tying arrangement violates the Sherman Act (15 U.S.C. §§ 1-7 (2000)) and the Clayton Act (15 U.S.C. §§ 12-27 (2000)) if (1) the arrangement involves two or more products, (2) the seller forces a customer to purchase the tied product, (3) the seller has economic power in the market for the tying product sufficient to enable the seller to restrain trade in the market for the tied product, (4) the arrangement has anticompetitive effects in the market for the tied product, and (5) the arrangement affects a "not insubstantial" amount of interstate commerce. See 68 Fed. Reg. at 52027, n. 20.

<sup>19</sup>In October 2002, the Federal Reserve Board approved Regulation W, which comprehensively implements and unifies the Board's interpretations of sections 23A and 23B of the Federal Reserve Act. Regulation W became effective in April 2003, and restricts loans by a depository institution to its affiliates, asset purchases by a depository institution from its affiliates, and other transactions between a depository institution and its affiliates.

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## Some Corporate Borrowers Alleged That Unlawful Tying Occurs, but Available Evidence Did Not Substantiate These Allegations

Some corporate borrowers alleged that commercial banks unlawfully tie the availability of credit to the borrower's purchase of other financial services, including debt underwriting services from their banks' investment affiliates. Because banks, in certain circumstances, may legally condition the availability of credit on the borrower's purchase of other products, some of these allegations of unlawful tying could be invalid. Substantiating charges of unlawful tying, if it occurs, can be difficult because, in most cases, credit negotiations are conducted orally and thus generate no documentary evidence to support borrowers' allegations. Thus, banking regulators may have to obtain other forms of indirect evidence to assess whether banks unlawfully tie products and services. Although customer information could have an important role in helping regulators enforce section 106, regulators do not have a specific mechanism to solicit information from corporate bank customers on an ongoing basis.

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## Some Corporate Borrowers Contended That Banks Unlawfully Forced Them to Purchase Additional Services to Preserve Access to Credit

The results of a 2003 survey of financial executives, interviews that we conducted with corporate borrowers, and several newspaper articles, suggest that commercial banks frequently tie access to credit to the purchase of other financial services, including bond underwriting, equity underwriting, and cash management.<sup>20</sup> The Association for Financial Professionals reported that some respondents to their survey of financial executives at large companies (those with revenues greater than \$1 billion) claimed to have experienced the denial of credit or a change in terms after they did not award a commercial bank their bond underwriting business. In our interviews with corporate borrowers, one borrower said that a commercial bank reduced the borrower's amount of credit by \$70 million when the borrower declined to purchase debt underwriting services from the bank's investment affiliate. In addition, several newspapers and other publications have also reported instances where corporate borrowers have felt pressured by commercial banks to purchase products prohibited under section 106 for the customers to maintain their access to credit. In these

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<sup>20</sup>We did not report the specific results of the Association for Financial Professionals' "Credit Access Survey: Linking Corporate Credit to the Awarding of Other Financial Services," March 2003, because of several methodological limitations. In particular, we could not determine the degree to which these survey results represent the broad population of large companies, due to potential biases resulting from sample design and the low level of participation of sampled companies. Nevertheless, although this survey may not precisely estimate the extent of tying complaints among this population, the results suggest that at least some companies claimed to have experienced forms of tying.

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reports, corporate borrowers have described negotiations where, in their views, bankers strongly implied that future lending might be jeopardized unless they agreed to purchase additional services, such as underwriting, from the banks' investment affiliates. However, none of these situations resulted in the corporate borrower complaining to one of the banking regulators.

In its Special Notice to its members, NASD also noted the Association for Financial Professional survey. The notice cautioned that NASD regulations require members to conduct business in accordance with just and equitable principles of trade and that it could be a violation of these rules for any member to aid and abet a violation of section 106 by an affiliated commercial bank. NASD is conducting its own investigation into these matters. At the time of our renewal, NASD had not publicly announced any results of its ongoing investigation.

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## Lawful Practices Can Easily Be Mistaken for Unlawful Tying Practices

Corporate borrowers might be unaware of the subtle distinctions that make some tying arrangements lawful and others unlawful. Borrowers, officials at commercial banks, and banking regulators said that some financial executives might not be familiar with the details of section 106. For example, some borrowers we interviewed thought that banks violated the tying law when they tied the provision of loan commitments to borrowers' purchases of cash management services. However, such arrangements are not unlawful, because, as noted earlier, section 106 permits banks to tie credit to these and other traditional bank services. The legality of tying arrangements might also hinge on the combinations of products that the borrowers are offered. For example, recently proposed Federal Reserve guidance suggested that a bank could legally condition the availability of credit on the purchase of other products services, including debt underwriting, if the customer has the meaningful choice of satisfying the condition solely through the purchase of one or more additional traditional bank products.<sup>21</sup>

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<sup>21</sup>The proposed guidance noted that such an arrangement would not force a customer to purchase a nontraditional product in violation of section 106.

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## Corporate Borrowers Could Not Provide Documentary Evidence to Substantiate Allegations of Unlawful Tying

Corporate borrowers said that because the credit arrangements are made orally, they lack the documentary evidence to demonstrate unlawful tying arrangements in those situations where they believe it has occurred. Without such documentation, borrowers might find it difficult to substantiate such claims to banking regulators or seek legal remedies. Moreover, with few exceptions, complaints have not been brought to the attention of the banking regulators. Some borrowers noted that they are reluctant to report their banks' alleged unlawful tying practices because they lack documentary evidence of such arrangements and uncertainty about which arrangements are lawful or unlawful under section 106. Borrowers also noted that a fear of adverse consequences on their companies' future access to credit or on their individual careers contributed to some borrowers' reluctance to file formal complaints. Because documentary evidence demonstrating unlawful tying might not be available in bank records, regulators might have to look for other forms of indirect evidence, such as testimonial evidence, to assess whether banks unlawfully tie products and services.

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## Federal Reserve and OCC Targeted Review Identified Interpretive Issues

The guidance that the federal banking regulators have established for their regular examinations of banks calls for examiners to be alert to possible violations of law, including section 106. These examinations generally focus on specific topics based on the agencies' assessments of the banks' risk profiles, and tying is one of many possible topics. In response to recent allegations of unlawful tying at large commercial banks, the Federal Reserve and OCC conducted a special targeted review of antitying policies and procedures at several large commercial banks and their holding companies. The banking regulators focused on antitying policies and procedures; interviewed bank managers responsible for compliance, training, credit pricing, and internal audits; and also reviewed credit pricing policies, relationship banking policies, and the treatment of customer complaints regarding tying. The review did not include broadly based testing of transactions that included interviews with corporate borrowers. The regulators said that they met with officials and members of a trade group representing corporate financial executives. The banking regulators found that banks covered in the review generally had adequate controls in place. With limited exceptions, they did not detect any unlawful combinations or questionable transactions. The examiners did, however, identify variation among the banks in interpreting section 106, some of which was not addressed in the regulatory guidance then available. As a result of the findings of the special targeted review, on August 29, 2003, the

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Federal Reserve released for public comment proposed guidance to clarify the interpretation of section 106 for examiners, bankers, and corporate borrowers. Federal Reserve officials said that they hope that the guidance encourages customers to come forward if they have complaints.

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## Tying Is a Component of Guidelines for Regular Bank Examinations

As part of their routine examination procedures, the Federal Reserve and OCC provide instructions for determining compliance with section 106.<sup>22</sup> During the course of these examinations, examiners review banks' policies, procedures, controls, and internal audits. Exam teams assigned to the largest commercial banks continually review banks throughout the year, and in several cases, the teams are physically located at the bank throughout the year. The Federal Reserve and OCC expect examiners to be alert to possible violations of section 106 of the Bank Holding Company Act Amendments of 1970 and section 23B of the Federal Reserve Act and to report any evidence of possible unlawful tying for further review. Regular bank examinations in recent years have not identified any instances of unlawful tying that led to enforcement actions. Federal Reserve officials told us, however, that if an examiner had tying-related concerns about a transaction that the bank's internal or external legal counsel had reviewed, examiners deferred to the bank's legal analysis and verified that the bank took any appropriate corrective actions. Federal Reserve officials also said that legal staffs at the Board and the District Reserve Banks regularly receive and answer questions from examiners regarding the permissibility of transactions.

In a 1995 bulletin, OCC reminded national banks of their obligations under section 106 and advised them to implement appropriate systems and controls that would promote compliance with section 106.<sup>23</sup> Along with examples of lawful tying arrangements, the guidance also incorporated suggested measures for banks' systems and controls, and audit and compliance programs. Among the suggested measures were training bank employees about the tying provisions, providing relevant examples of prohibited practices, and reviewing customer files to determine whether

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<sup>22</sup>For example, Federal Reserve Board Supervision Manuals governing bank holding company and state member bank examinations and OCC Bulletin 95-20 all address section 106.

<sup>23</sup>OCC Bulletin 95-20 (April 14, 1995).

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any extension of credit was conditioned unlawfully on obtaining another nontraditional product or service from the bank or its affiliates.

In addition to reviewing banks' policies, procedures, and internal controls, examiners also review aggregate data on a bank's pricing of credit products. OCC officials noted that instances of unlawfully priced loans or credit extended to borrowers who were not creditworthy could alert examiners to potential unlawful tying arrangements. However, Federal Reserve officials pointed out that examiners typically do not focus on a banks' pricing of individual transactions because factors that are unique to the bank and its relationship with the customer affect individual pricing decisions. They said that examiners only conduct additional analyses if there was an indication of a potential problem within the aggregated data.

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### Examiners Generally Found Adequate Bank Controls and No Unlawful Tying during a Special Review

In recent years, banking regulators' examination strategies have moved toward a risk-based assessment of a bank's policies, procedures, and internal controls, and away from the former process of transaction testing. The activities judged by the regulatory agencies to pose the greatest risk to a bank are to receive the most scrutiny by examiners under the risk-based approach, and transaction testing is generally intended to validate the use and effectiveness of risk-management systems. The effectiveness of this examination approach, however, depends on the regulators' awareness of risk. In the case of tying, the regulators are confronted with the disparity between frequent allegations about tying practices and few, if any, formal complaints. Further, the examiners generally would not contact customers as part of the examinations and thus would have only limited access to information about transactions or the practices that banks employ in managing their relationships with customers.

In response to the controversy about allegations of unlawful tying, in 2002 the Federal Reserve and OCC conducted joint reviews targeted to assessing antitying policies and procedures at large commercial banks that, collectively, are the dominant syndicators of large corporate credits. The Federal Reserve and OCC exam teams found limited evidence of potentially unlawful tying in the course of the special targeted review.<sup>24</sup> For

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<sup>24</sup>After the Federal Reserve and OCC completed the targeted review, the Federal Reserve announced on August 27, 2003, that it had entered into a consent agreement and civil money penalty against WestLB AG, a German bank, and its New York branch, based on allegations that it had conditioned credit on the award of underwriting business in 2001.

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example, one bank's legal department uncovered one instance where an account officer proposed an unlawful conditional discount. The officer brought this to the attention of the legal department after the officer attended antitying training. The customer did not accept the offer, and no transaction occurred.

In addition, the teams noted that the commercial bank's interpretation of section 106 permitted some activities that the teams questioned; one of the banks reversed a transaction in response to Federal Reserve or OCC questions. Attorneys on the exam teams reviewed documents regarding lawsuits alleging unlawful tying, but they found that none of the suits contained allegations that warranted any follow-up. For example, they found that some of the suits involved customers who were asserting violations of section 106 as a defense to the bank's efforts to collect on loans and that some of the ties alleged in the suits involved ties to traditional bank products, which are exempted from section 106.

Federal Reserve and OCC officials noted that it would be unusual to find a provision in a loan contract or other loan documentation containing an unlawful tie. Some corporate borrowers said that there is no documentary evidence because banks only communicate such conditions on loans orally. According to members of the review team, they did not sample transactions during the review because past reviews suggested that this would probably not produce any instances of unlawful tying practices. The targeted review did include contacting some bank customers to obtain information on specific transactions. The Federal Reserve noted that without examiners being present during credit negotiations, there is no way for examiners to know what the customer was told. Given the complex nature of these transactions, the facts and circumstances could vary considerably among individual transactions. Federal Reserve officials, however, noted that customer information could play an important role in enforcing the law, because so much depends on whether the customer voluntarily agreed with the transaction or was compelled to agree with the conditions imposed by the bank. As the officials noted, this determination cannot be made based solely on the loan documentation.

During the targeted review, Federal Reserve and OCC officials found that all of the banks they reviewed generally had adequate procedures in place to comply with section 106. All banks had specific antitying policies, procedures, and training programs in place. The policies we reviewed from two banks encouraged employees to consult legal staff for assistance with arrangements that could raise a tying-related issue. According to the



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Federal Reserve and OCC, at other banks, lawyers reviewed all transactions for tying-related issues before they were completed. The training materials we reviewed from two banks included examples that distinguished lawful from unlawful tying arrangements. Banking regulators noted that some banking organizations had newly enhanced policies, procedures, and training programs as a result of recent media and regulatory attention.

However, examiners also found that the oversight by internal audit functions at several banks needed improvement. In one case, they found that bank internal auditors were trained to look for the obvious indications of tying, but that banks' audit procedures would not necessarily provide a basis to detect all cases of tying. For example, recent antitying training programs at two banks helped employees identify possible tying violations. Officials at one large banking organization also said that banks' compliance efforts generally are constrained by the inability to anticipate every situation that could raise tying concerns. They also noted that banks could not monitor every conversation that bank employees had with customers, and thus guarantee that mistakes would never occur.

In addition, examiners were concerned that certain arrangements might cause customer confusion when dealing with employees who work for both the bank and its investment affiliate. In those cases, it could be difficult to determine whether the "dual" employee was representing the bank or its affiliate for specific parts of a transaction. However, the examiners noted that in the legal analysis of one banking organization, the use of such dual employees was not necessarily problematic, given that the tie was created by the investment affiliate, rather than the bank, and that section 106 addresses the legal entity involved in a transaction and not the employment status of the individuals involved. Proposed Federal Reserve guidance did not add clarification to this matter beyond emphasizing the importance of training programs for bank employees as an important internal control.

The targeted review concluded that the policies and procedures of the selected banks generally provided an adequate basis to enforce compliance with section 106, and identified only a limited number of instances where the bank's interpretation of the law permitted actions that were questioned during the review. However, this targeted review was limited to an assessment of the banks' controls environment; and as noted above, the review did not test a broad range of transactions for analysis or review and did not include any questions addressed to a broad selection of bank

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customers. As the Federal Reserve’s proposed interpretation of section 106 notes, however,

“the determination of whether a violation of section 106 has occurred often requires a careful review of the specific facts and circumstances associated with the relevant transaction (or proposed transaction) between the bank and the customer.”<sup>25</sup>

Customers could provide information on the facts and circumstances associated with specific transactions and provide a basis for testing whether the bank actions were in compliance with its policies and procedures. If the banks’ actions are not consistent with their policies and procedures, there could be violations of section 106. A review of the transactions would provide direct evidence of compliance or noncompliance with section 106. Further, information from analysis of transactions and information obtained from customers could provide the bank regulatory agencies with more information on the circumstances where there could be a greater risk of tying, contributing to their risk-based examination strategies.

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## Federal Reserve and OCC Identified Several Interpretive Issues

The examiners and attorneys participating in the targeted review found variations in banks’ interpretation of section 106 in areas where authoritative guidance was absent or incomplete at the time of the review.

One interpretative issue was the extent to which a bank could consider the profitability of the overall customer relationship in making credit decisions, particularly whether a bank could consider a customer’s use of nontraditional banking services in deciding to terminate the customer relationship without violating section 106. This issue also encompassed the appropriateness of the language that a bank might use when entering into or discontinuing credit relationships—including whether a bank could appropriately use language implying the acceptance of a tied product in a letter formalizing a commitment for a loan and communication protocols that a bank might use to disengage clients who did not meet internal profitability targets.

Examiners found that all banks in the joint targeted review had undergone a “balance sheet reduction,” disengaging from lending relationships with their least desirable customers. An official at one commercial bank

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<sup>25</sup>38 Fed. Reg. at 52026.

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acknowledged that, when banks discontinue relationships, their decision might appear to be unlawful tying from the perspective of the customer. However, it would not be unlawful for a bank to decline to provide credit to a customer as long as the bank's decision was not based on the customer's failure to satisfy a condition or requirement prohibited by section 106.

Examiners questioned whether it would be appropriate for a banking organization to provide both a bridge loan and securities underwriting to vary the amount of fees it charged for services that would normally be done independently for each service.<sup>26</sup> For example, a bank conducting a credit analysis for both commercial and investment banking services and reducing the overall fees to only include one credit analysis might raise tying considerations. Banks and their outside counsels believed that this price reduction would be appropriate. However, the Federal Reserve staff said that whether or not a price reduction would be appropriate would depend on the facts and condition of the transaction, including whether or not the bank offered the customer the opportunity to obtain the discount from the bank separately from the tied product.

Examiners were also concerned that some bank transactions might appear to circumvent section 106. For example, the examiners found one instance in which a nonbank affiliate had tied bridge loans to the purchase of securities underwriting and syndicated some or all of the loans to its commercial bank. The examiners noted that although this issue had not been addressed in the guidance available at the time, this arrangement created the appearance of an attempt to circumvent the application of section 106. The bank thereupon discontinued the practice. As mentioned previously, because section 106 applies only to banks, it is not a violation of the section for most nonbank affiliates of commercial banks to tie together any two products or services. The banks thereupon discontinued the practice. The proposed interpretation of section 106 recently issued by the Federal Reserve addresses this issue.

Finally, the examiners found that one bank might be overstating the relief gained from the foreign transactions safe harbor. The Federal Reserve adopted a safe harbor from the antitying rules for transactions with corporate customers that are incorporated or otherwise organized and that

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<sup>26</sup>A bridge loan is an interim financing arrangement provided by a bank, investment bank, or special purpose investment fund to allow a corporation to make an acquisition before arranging permanent financing to carry the acquisition.

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have their principal place of business outside the United States.<sup>27</sup> This safe harbor also applies to individuals who are citizens of a foreign country and are not resident in the United States. However, the new guidance developed by the banking regulators does not address the examiners' specific concerns. Federal Reserve officials said that a general rule on these issues would not be feasible and that any determinations would depend on the facts and circumstances of the specific transactions.

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### The Federal Reserve's Proposed Interpretation and Guidance Released for Public Comment

Based on the interpretive issues examiners found during the special targeted review and its analysis, and after significant consultation with OCC, the Federal Reserve recently released for public comment a proposed interpretation of section 106. The proposed interpretation noted that the application of section 106 is complicated and heavily dependent on the particular circumstances and facts of specific transactions. The proposed guidance outlines, among other things, some of the information that would be considered in determining whether a transaction or proposed transaction would be lawful or unlawful under section 106. Federal Reserve officials also have noted that another desired effect of additional guidance could be providing bank customers a better understanding of section 106 and what bank actions are lawful. The officials also said that they hoped that the new guidance would encourage customers to come forward with any complaints. The deadline for public comments on the proposed guidance was September 30, 2003. At the time of our review, the Federal Reserve was reviewing comments that had been received.

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<sup>27</sup>See also, 83 Fed. Res. Bulletin 275 (April 1997). Federal Reserve Board Bank Holding Company Supervision Manual, Section 3500.0.2.3, Safe Harbor for Foreign Transactions.

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## Evidence That We Reviewed on the Pricing of Corporate Credit Did Not Demonstrate That Commercial Banks Unlawfully Discount Credit

Although officials at one investment bank contended that large commercial banks deliberately “underpriced”—or priced credit at below market rates—corporate credit to attract underwriting business to their investment affiliates, the evidence of “underpricing” is ambiguous and subject to different interpretations. They claimed that these commercial banks underprice credit in an effort to promote business at the banks’ investment affiliates, which would increase the bank holding companies’ fee-based income. Such behavior, they contended, could indicate violations of section 106, with credit terms depending on the customer buying the tied product. The banking regulators also noted that pricing credit below market interest rates, if it did occur, could violate section 23B, with the bank’s income being reduced for the benefit of its investment affiliate. Commercial bankers counter that the syndication of these loans and loan commitments—the sharing of them among several lenders—makes it impossible to underprice credit, since the other members of the syndicate would not participate at below market prices. Federal Reserve staff is considering further research into the issue of loan pricing, which could clarify the issue.

Investment bankers and commercial bankers also disagreed whether differences between the prices for loans and loan commitments and those for other credit products indicated that nonmarket forces were involved in setting credit prices. Both investment bankers and commercial bankers cited specific transactions to support their contentions; in some cases, they pointed to the prices for the same loan products at different times. Commercial bankers also noted that their business strategies called for them to ensure the profitability of their relationship with customers; if market-driven credit prices alone did not provide adequate profitability, the strategies commonly called for marketing an array of other products to make the entire relationship a profitable one. The banking regulators noted that such strategies would be within the bounds of the law as long as the bank customers had a “meaningful choice” that includes traditional bank products.

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## Investment Affiliates of Commercial Banks Have Gained Market Share in Underwriting

In recent years, the market share of the fees earned from debt and equity underwriting has declined at investment banks and grown at investment affiliates of commercial banks. In 2002, the three largest investment banks had a combined market share of 31.9 percent, a decline from a 38.1 percent market share that these investment banks held in 1995. In comparison, the market share of the three largest investment affiliates of commercial banks

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was 30.4 percent in 2002, compared with their 17.8 percent market share that these investment banks held in 1995. Some of this growth might be the result of the ability of commercial banks and their investment affiliates to offer a wide array of financial services. However, banking regulators noted that industry consolidation and the acquisition of investment banking firms by bank holding companies also has been a significant factor contributing to this growth. For example, regulators noted that Citigroup Inc. is the result of the 1998 merger of Citicorp and Travelers Group Inc., which combined Citicorp's investment business with that of Salomon Smith Barney, Inc., a Travelers subsidiary that was already a prominent investment bank. J.P. Morgan & Co. Incorporated and The Chase Manhattan Corporation also combined in 2000 to form J.P. Morgan Chase & Co.

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### Pricing Evidence from the Secondary Market Is Inconclusive

Some investment bankers contended that commercial banks offer loans and loan commitments to corporate borrowers at below-market rates if borrowers agree to engage the services of their investment affiliates. Large loans and loan commitments to corporations—including the lines of credit that borrowers use in conjunction with issuing commercial paper—are frequently syndicated.<sup>28</sup> A syndicated loan is financing provided by a group of commercial banks and investment banks whereby each bank agrees to advance a portion of the funding. Commercial bankers contended that these prices of the loans and loan commitments reflected a competitive market, where individual lenders have no control over prices.

Officials from one investment bank who contended that banking organizations have underpriced credits to win investment banking business drew comparisons between the original pricing terms of specific syndicated loans and the pricing of the same loans in the secondary market. Specifically, they pointed to several transactions, including one in which they questioned the pricing but participated because the borrower insisted that underwriters provide loan commitments. The investment bank officials said that when they subsequently attempted to sell part of their

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<sup>28</sup>Commercial paper is an unsecured obligation issued by a corporation or bank to finance its short-term credit needs, such as accounts receivable and inventory. Commercial paper is usually issued by companies with high credit ratings. Commercial paper is available in a wide range of denominations and can be either discounted or interest bearing. Maturities for commercial paper typically range from 2 to 270 days. Commonly, companies issuing commercial paper will also obtain a backup loan commitment that would provide funds if the company is unable to payoff or roll over the commercial paper as it matures.

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share of the credits, the pricing was unattractive to the market and that they could not get full value. In one case, they noted that the credit facility was sold in the secondary market at about 93 cents on the dollar shortly after origination. They said that, in their opinion, this immediate decline in value was evidence that the credit facility had been underpriced at origination.

Commercial bankers said that competition in the corporate loan market determines loan pricing. One banker said that if a loan officer overpriced a loan by even a basis point or two the customer would turn to another bank.<sup>29</sup> Bankers also noted that if loans were underpriced, the syndicators would not be able to syndicate the loan to investors who are not engaged in debt underwriting and insist on earning a competitive return. An official from one commercial bank provided data on its syndicated loans, showing that a number of the participants in the loans and loan commitments did not participate in the associated securities underwriting for the borrower and—in spite of having no investment banking business to win—found the terms of the loans and loan commitments attractive. However, we do not know the extent, if any, to which these other participants might have had other revenue-generating business with the borrowers.

Officials from a commercial bank and loan market experts also said that the secondary market for loans was illiquid, compared with that for most securities. The bank officials said that therefore prices could swing in response to a single large sale as a result of this illiquidity. Officials from one commercial bank said that the price of the loan to which investment bank officials referred, which had sold for about 93 cents on the dollar shortly after origination, had risen to about 98 cents on the dollar in secondary trades a few months later. These officials said that, in their opinion, this return in pricing toward the loan's origination value is proof that the syndicated loan was never underpriced and that the movement in price was the result of a large portion of the facility being sold soon after the origination. Independent loan market experts also observed that trading in loan commitments is illiquid, and thus subsequent price fluctuations might not reflect fair value.

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<sup>29</sup>A basis point is a measure of a bond's yield, equal to 1/100th of 1 percent of yield.

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## Pricing Evidence from Credit Default Swap Markets Is Subject to Multiple Interpretations

Commercial bankers and investment bankers disagreed on whether a comparison of the prices of loans and other credit products demonstrated underpricing. In particular, one key disagreement involved the use of credit default swaps.<sup>30</sup> Banks and other financial institutions can use credit default swaps, among other instruments, to reduce or diversify credit risk exposures. With a credit default swap, the lender keeps the loan or loan commitment on its books and essentially purchases insurance against borrower default.

Officials at one investment bank compared the prices of syndicated loans with the prices of credit default swaps used to hedge the credit risk of the loan. In their view, the differences in the two prices demonstrated that commercial banks underpriced corporate credit. They provided us with several examples of syndicated loans, wherein the difference between the interest rate on the loan or loan commitment and the corresponding credit default swap was so great that the investment bankers believed that the bank would have earned more from insuring the credit than extending it.

On the other hand, Federal Reserve officials, commercial bankers, and loan market experts disputed the extent to which the pricing of corporate credit could be compared with their corresponding credit default swaps, because of important differences between the two products and between the institutions that dealt in them. Officials from the Federal Reserve noted that the triggering mechanisms for the two products differed. Although the trigger for the exercise of a credit default swap is a clearly defined indication of the borrower's credit impairment, the exercise of a commercial paper back-up line is triggered by the issuer's inability to access the commercial paper market—an event that could occur without there necessarily being any credit impairment of the issuer. For example, in 1998, Russia's declaration of a debt moratorium and the near-failure of a large hedge fund created financial market turmoil; since this severely disrupted corporations' issuance of bonds and commercial paper, they drew on their loan commitments from banks. In addition, loan market

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<sup>30</sup>Credit default swaps are financial contracts that allow the transfer of credit risk from one market participant to another, potentially facilitating greater efficiency in the pricing and distribution of credit risk among financial market participants. In a "plain vanilla" credit default swap, the protection buyer agrees to make periodic payments (the swap "spread" or premium) over a predetermined number of years (the maturity of the credit default swap) to the protection seller in exchange for a payment in the event of default by a third party. Typically, credit default swaps premiums are paid quarterly, and the most common maturities are 3, 5, and 10 years.



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experts and officials from a commercial bank also said that the loan market and the credit default swap market involve different participants with different motivations. Loan market experts noted that lead originators of loans and loan commitments have an advantage gained from knowledge of the borrower through direct business relationships. On the other hand, those who provide credit protection by selling credit swap might be entities with no direct knowledge of the customer's creditworthiness, but use these instruments for diversifying risks.

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**Evidence from the Pricing of Undrawn Fees Did Not Resolve Whether Commercial Banks Unlawfully Price Credit Risk**

To present their differing positions on whether or not credit is underpriced, investment bankers, loan market experts, and commercial bankers discussed the pricing of selected syndicated loan commitments. In syndicated loan commitments, participants receive commitment fees on the undrawn amount and a specified interest rate if the loan is drawn. In addition, participants in syndicated loan commitments are protected from certain risks by various conditions. Also, the lead participant might receive an up-front fee from the borrower. Each of these factors can influence the price of the loan commitment.

Officials at one investment bank noted that the pricing for undrawn loan commitments provided as back-up lines for commercial paper issuers have been low for several years and had been relatively stable, even when other credit market prices fluctuated. Available data showed that this was the case for the fees for undrawn commitments provided for investment-grade borrowers, with undrawn fees averaging under 0.10 percent per year of the undrawn amount. The investment bankers further noted that the loan commitment would be drawn in the event of adverse conditions for the borrower in the commercial paper market. Thus, commercial paper back-up lines exposed the provider to the risk that they might have to book loans to borrowers when they were no longer creditworthy. In the opinion of these investment bankers, the low undrawn loan fees do not reflect this risk.

In contrast, officials from commercial banks and loan market experts said that the level of undrawn fees for loan commitments did not represent all the ways that commercial banks might adjust credit terms to address rising credit risk. These officials said that in response to perceived weakening in credit quality, lenders had shortened the maturity of credit lines. Lenders also tightened contract covenants to protect themselves against a borrowers' potential future weakening. In addition, commercial bank officials told us that other factors were involved in the pricing of loan

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commitments. For example, they said that a comprehensive analysis should include the upfront fees to measure the total return on undrawn loan commitments. However, loan market experts said that published loan pricing data do not include the up-front fees that many banks collect when they extend credit. Thus, publicly available information was insufficient to indicate the total return commercial banks received on such lending.

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### Investment Banks and Commercial Banks Have Different Views on the Profitability of Corporate Lending

Officials at one investment bank claimed that because the fees that commercial banks receive for corporate credits barely exceed their cost of funds, commercial banks are not covering all of their costs and are in essence subsidizing corporate credits. Conversely, several bankers said that the rates they can charge on corporate credits do exceed their cost of funds but are not always high enough to allow them to meet their institution's profitability targets. Officials at one commercial bank noted that their internal controls included separation of powers, where any extensions of credit over \$10 million would have to be approved by a credit committee rather than those responsible for managing the bank's customer relationships. However, these same officials said that they often base lending decisions on the profitability of customer relationships, not individual products. Thus, a loan that might not reach profitability targets on a stand-alone basis could still be attractive as part of an overall customer relationship.

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### Federal Reserve Staff Is Considering a Study about Loan Pricing

During our review, members of the Federal Reserve's staff said that they were considering conducting research into pricing issues in the corporate loan market. Such research could shed some additional light on the charges of the investment bankers and the responses of the commercial bankers.<sup>31</sup> It also could provide useful supervisory information. If the study finds indications that pricing of credit to customers who also use underwriting services is lower than other comparable credit, this could lend support to the investment banker's allegations of violations of section 23B. However, if the charges are not valid and credit pricing does reflect market conditions,

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<sup>31</sup>Preliminary results from an academic study of loan pricing and securities underwriting suggest that the rates charged on loans to corporate borrowers who subsequently purchase underwriting services from an investment affiliate of the lender were not lower than rates charged on loans not followed by the purchase of underwriting services. See Charles W. Calomiris and Thanavult Pornrojngkool, "Tying, Relationship Banking, and the Repeal of Glass Stegall," Unpublished paper presented at the American Enterprise Institute, Sept. 24, 2003.

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this information would serve as useful confirmation of the findings of the Federal Reserve-OCC targeted review, which found that the policies and procedures of the largest commercial banks served as effective deterrents against unlawful tying.

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## Differences between Commercial Banks and Investment Banks Did Not Necessarily Affect Competition

Based on our analysis, the different accounting methods, capital requirements, and levels of access to the federal safety net did not appear to give commercial banks a consistent competitive advantage over investment banks. Officials at some investment banks asserted that these differences gave commercial banks an unfair advantage that they could use in lending to customers who also purchase debt-underwriting services from their investment affiliates. Under current accounting rules, commercial banks and investment banks are required to use different accounting methods to record the value of loan commitments and loans. Although these different methods could cause temporary differences in the financial statements for commercial banks and financial banks. While these different methods could cause temporary differences in financial statements, these differences would be reconciled at the end of the credit contract periods. Further, if the loan commitment were exercised and both firms either held the loan until maturity or made the loan available for sale, the accounting would be similar and would not provide an advantage to either firm. Additionally, while commercial and investment banks were subject to different regulatory capital requirements, practices of both commercial and investment banks led to avoidance of regulatory charges on loan commitments with a maturity of 1 year or less. Moreover, while the banks had different levels of access to the federal safety net, some industry observers argued that greater access could be offset by corresponding greater regulatory costs.

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## Commercial Banks and Investment Banks Follow Different Accounting Models for Loan Commitments

According to FASB, which sets the private sector accounting and reporting standards, commercial banks and investment banks follow different accounting models for similar transactions involving loans and loan commitments. Most commercial banks follow a mixed model, where some financial assets and liabilities are measured at historical cost, some at the lower of cost or market value and some at fair value. In contrast, some investment banks follow a fair-value accounting model, in which they report changes in the fair value of inventory, which may include loans or loan commitments, in the periods in which the changes occur.

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Where FASB guidance is nonexistent, as is currently the case for fair-value accounting for loan commitments, firms are required to follow guidance from the AICPA, which provides industry specific accounting and auditing guidance that is cleared by FASB prior to publication. FASB officials said that it is currently appropriate for commercial banks and investment banks to follow different accounting models because of their different business models.

When commercial banks make loan commitments, they must follow FASB's Statement of Financial Accounting Standards (FAS) No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which directs them to book the historic carrying value of the fees received for loan commitments as deferred revenue.<sup>32</sup> In the historic carrying value model, commercial banks are not allowed to reflect changes in the fair value of loan commitments in their earnings. However, commercial banks are required to disclose the fair value of all loan commitments in the footnotes to their financial statements, along with the method used to determine fair value.<sup>33</sup>

Some investment banks follow the AICPA *Audit and Accounting Guide, Brokers and Dealers in Securities*, which directs them to record the fair value of loan commitments.<sup>34</sup> The AICPA guidance is directed at broker-dealers within a commercial bank or investment bank holding company structure. However, some investment banks whose broker-dealer subsidiaries comprised a majority of the firms' financial activity would also be required to follow the fair-value accounting model outlined in the AICPA guidance for instruments held in all subsidiaries.<sup>35</sup> When using the fair-value model, investment banks must recognize in income gains or losses resulting from changes in the fair value of a financial instrument, such as a

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<sup>32</sup>The historic carrying value of a loan commitment is the value of the loan commitment service fees at the time a firm extends the commitment. The fees received are recognized either over the life of the loan commitment when the likelihood of the borrower exercising the commitment is remote or over the life of the loan if the commitment is exercised.

<sup>33</sup>This is required by FAS No. 107, *Disclosures about Fair Value of Financial Instruments*.

<sup>34</sup>The fair value of a loan commitment is generally based on quoted market prices of similar transactions or modeling with market data.

<sup>35</sup>It is important to note that, in practice, investment banks often do not hold loan commitments in their broker-dealer subsidiaries because of the high capital requirements of broker-dealers. (We discuss the regulatory capital requirements of broker-dealers in greater detail in the next section.)

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loan commitment. Investment banks said that they determine the current fair value of loan commitments based on the quoted market price for an identical or similar transaction or by modeling with market data if market prices are not available.

According to FASB, although measurement of financial instruments at fair value has conceptual advantages, not all issues have been resolved, and FASB has not yet decided when, if ever, it will require essentially all financial instruments held in its inventory to be reported at fair value. A loan market expert said that, although the discipline of using market-based measures works well for some companies, fair-value accounting might not be the appropriate model for the entire wholesale loan industry. FASB said that one reason is that in the absence of a liquid market for loan commitments, there is potential for management manipulation of fair value because of the management discretion involved in choosing the data used to estimate fair value.

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### Some Investment Banks Contended That Different Accounting Methods Give Commercial Banks a Competitive Advantage

Officials from some investment banks contended that adherence to different accounting models gave commercial banks a competitive advantage relative to investment banks in lending to customers who also purchased investment banking services. They alleged that commercial banks extended underpriced 364-day loan commitments to attract customers' other, more profitable business—such as underwriting—but they were not required to report on their financial statements the difference in value, if any, between the original price of the loan commitment and the current market price.<sup>36</sup> The investment bank officials contended that the current accounting standards facilitate this alleged underpricing of credit because commercial banks record loan commitments at their historic value rather than their current value, which might be higher or lower, and do not have to report the losses incurred in extending an allegedly underpriced loan commitment.

Officials from some investment banks also claimed that the historic carrying value model allowed commercial banks to hide the risk of these allegedly underpriced loan commitments from stockholders and market analysts, because the model did not require them to report changes in the value of loan commitments. Officials said that differences in accounting for

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<sup>36</sup>The historic carrying value model does not permit commercial banks to record these changes in value.

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identical transactions might put investment banks at a disadvantage; compared with commercial banks when analysts reviewed their quarterly filings. Yet, as discussed in an earlier section, it is not clear that commercial banks underprice loan commitments.

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### Commercial Banks Do Not Enjoy a Consistent Competitive Advantage over Investment Banks in Accounting for Loan Commitments

Although commercial and investment banks might have different values on their financial statements for similar loan commitments, both are subject to the same fair-value footnote disclosure requirements in which they report the fair value of all loan commitments in their financial statement footnotes, along with the method used to determine fair value. As a result, financial analysts and investors are presented with the same information about the commercial and investment banks' loan commitments in the financial statement footnotes. According to FAS 107: *Disclosures about Fair Value of Financial Instruments*, in the absence of a quoted market price, firms estimate fair value based on (1) the market prices of similar traded financial instruments with similar credit ratings, interest rates, and maturity dates; (2) current prices (interest rates) offered for similar financial instruments in the entity's own lending activities; or (3) valuations obtained from loan pricing services offered by various specialist firms or from other sources. FASB said that they have found no conclusive evidence that an active market for loan commitments exists; thus, the fair value recorded might frequently be estimated through modeling with market data. When a quoted market price for an identical transaction is not available, management judgment and the assumptions used in the model valuations could significantly affect the estimated fair value of a particular financial instrument.

SEC and the banking regulators said the footnote disclosures included with financial statements, which are the same for both commercial banks and investment banks, were an integral part of communicating risk. They considered the statement of position and statement of operations alone to be incomplete instruments through which to convey the risk of loan commitments. They emphasized that to fully ascertain a firm's financial standing, financial footnotes must be read along with the financial statements.

Although different accounting models would likely introduce differences in the amount of revenue or loss recognized in any period, all differences in accounting for loan commitments that were not exercised would be resolved by the end of the commitment period. Any interim accounting differences between a commercial bank and investment bank would be

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relatively short-lived because most of these loan commitment periods are less than 1 year. Further, if a loan commitment were underpriced, an investment bank using the fair-value accounting model would recognize the difference between the fair value and the contractual price as a loss, while a commercial bank using the historical cost model would not be permitted to do so. This difference in the recognition of gains or losses would be evident in commercial and investment banks' quarterly filings over the length of the commitment period. However, there is no clear advantage to one method over the other in accounting for loan commitments when the commitments are priced consistently between the two firms at origination.

According to investment bankers we spoke with and staff from the AICPA, loan commitments generally decline in value after they are made. Under fair-value accounting, these declines in fair value are actually recognized by the investment bank as revenue because the reduction is recognized in a liability account known as deferred revenue. Therefore, if an investment bank participated with commercial banks in a loan commitment that was deemed underpriced, any initial loss recognized by the investment bank would be offset by each subsequent decline in the loan commitment's fair value. Further, as discussed in an earlier section, it is not clear that commercial banks underprice loan commitments. Whether a commercial bank using the historic carrying value model or an investment bank using the fair-value model would recognize more revenue or loss on a given loan commitment earlier or later would depend on changes in the borrower's credit pricing which reflects overall market trends and customer-specific events, as well as on the accounting model that the firm follows.

In addition, when similar loan commitments held by a commercial bank and an investment bank are exercised and become loans, both firms would be subject to the same accounting standards if they had the intent and ability to hold the loan for the foreseeable future or to maturity.<sup>37</sup> In this situation, both commercial banks and investment banks would be required to establish an allowance for probable or possible losses, based on the

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<sup>37</sup>Although investment banks generally classify financial instruments as inventory and account for them at fair value, AICPA Task Force members and some investment bankers noted that, in some instances, the firms might decide to hold a loan for the foreseeable future or until maturity. In this case, the loan would not be classified as held-for-sale and would not be accounted for at fair value.

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estimated degree of impairment of the loan commitment or historic experience with similar borrowers.<sup>38</sup>

If both an investment bank and a commercial bank decided to sell a loan that it previously had the intent and ability to hold for the foreseeable future or until maturity, the firms would follow different guidance that would produce similar results. A commercial bank would follow the AICPA's Statement of Position 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others* that was issued in December, 2001. According to this guidance, once bank management decides to sell a loan that had not been previously classified as held-for-sale, the loan's value should be adjusted to the lower of historical cost or fair value, and any amount by which historical cost exceeds fair value should be accounted for as a valuation allowance. Further, as long as the loan's fair value remained less than historical cost, any subsequent changes in the loan's fair value would be recognized in income. The investment bank would follow the guidance in the AICPA's *Audit and Accounting Guide, Brokers and Dealers in Securities*, and account for inventory, the loan in this instance, at fair value and recognize changes in the fair value in earnings.

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### Capital Requirements Do Not Give Commercial Banks a Competitive Advantage

Regulatory capital is the minimum long-term funding level that financial institutions are required to maintain to cushion themselves against unexpected losses, and differing requirements for commercial banks and broker-dealers reflect distinct regulatory purposes.<sup>39</sup> The primary purposes of commercial bank regulatory capital requirements are to maintain the safety and soundness of the banking and payment systems and to protect the deposit insurance funds. Under the bank risk-based capital guidelines, off-balance sheet transactions, such as loan commitments, are converted

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<sup>38</sup>According to FAS 114: *Accounting by Creditors for Impairment of a Loan*, a loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. To comply with FAS 114, creditors must create a valuation allowance that reduces the value of the loan with a corresponding charge to a bad-debt expense. When a loan is not impaired, creditors must follow FAS 5: *Accounting for Contingencies* and establish an allowance for loss when there is at least a reasonable possibility that a loss or an additional loss might be incurred.

<sup>39</sup>U.S. General Accounting Office, *Risk Based Capital: Regulatory and Industry Approaches to Capital and Risk*, [GAO/GGD-98-153](#) (Washington, D.C.: July 1998).



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into one of four categories of asset equivalents.<sup>40</sup> Unfunded loan commitments of one year or less are assigned to the zero percent conversion category, which means that banks are not required to hold regulatory capital for these commitments. In contrast, the primary purposes of broker-dealers' capital requirements are to protect customers and other market participants from losses caused by broker-dealer failures and to protect the integrity of the financial markets. The SEC net capital rule requires broker-dealer affiliates of investment banks to hold 100-percent capital against loan commitments of any length.<sup>41</sup> However, nonbroker-dealer affiliates of investment banks are not subject to any regulatory capital requirements, and are therefore not required to hold regulatory capital against loan commitments of any length.

It is costly for banks or other institutions to hold capital; thus, to the extent that the level of regulatory capital requirements determines the amount of capital actually held, lower capital requirements can translate into lower costs. Officials from an investment bank contended that bank capital requirements gave commercial banks with investment affiliates a cost advantage they could use when lending to customers who also purchased underwriting business. They said that because banks' regulatory capital requirements for unfunded credits of 1 year or less were zero, commercial banks had the opportunity to adjust the length of credit commitments to avoid capital charges. Furthermore, officials said that the ability to avoid capital charges allowed commercial banks to underprice these loan commitments, because they could extend the commitments without the cost of assigning additional regulatory capital. They pointed to the high percentage of credit commercial banks structured in 364-day facilities as evidence that banks structure underpriced credit in short-term arrangements to avoid capital charges.

We found no evidence that bank regulatory capital requirements provided commercial banks with a competitive advantage. Although investment banks could face a 100-percent regulatory capital charge if they carried loan commitments in their broker-dealer affiliates, investment bank officials and officials from the SEC said that, in practice, investment banks carried loan commitments outside of their broker-dealer affiliates, and thus

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<sup>40</sup>Effective 1990, U.S. banking regulators added regulatory capital requirements for loan commitments with maturities greater than 1 year. Previously, there had been no regulatory capital requirements for unfunded loan commitments of any length.

<sup>41</sup>SEC Rule 15c3-1(c)(2)(viii).

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avoided all regulatory capital charges. Furthermore, banking regulators did not think that the current regulatory capital requirements adversely affected the overall amount of capital banks held, because commercial banks generally carried internal risk-based capital on instruments—including loan commitments—that were in excess of the amount of regulatory capital required. In addition, the banking regulators said that bank regulatory capital requirements had not affected banks' use of loan commitments of 1 year or less. Although loan market data indicated that the percentage of investment-grade loans structured on 364-day terms has increased, commercial bank officials and banking regulators said that this shift was, in part, the banks' response to the increased amount of risk in lending.

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### Industry Observers and Some Banking Regulators Doubt That the Federal Safety Net Provides Commercial Banks with a Competitive Advantage

Commercial banks have access to a range of services sometimes described as the federal safety net, which includes access to the Federal Reserve discount window and deposit insurance.<sup>42</sup> The Federal Reserve discount window allows banks and other organizations to borrow funds from the Federal Reserve.<sup>43</sup> Commercial banks' ability to hold deposits backed by federal deposit insurance provides them with a low-cost source of funds available for lending.

Industry observers and banking regulators agreed that commercial banks receive a subsidy from the federal safety net; however, they differed on the extent to which the subsidy was offset by regulatory costs. Although officials at the Federal Reserve and at an investment bank contended that access to the federal safety net gave commercial banks a net subsidy, officials from OCC and an industry observer said that the costs associated with access to the safety net might offset these advantages. We could not measure the extent to which regulatory costs offset the subsidy provided by the access to the federal safety net because reliable measures of the regulatory costs borne by banks were not available.

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<sup>42</sup>The federal safety net also includes access to the Federal Reserve payments system. Because the investment bankers with whom we spoke did not mention the payments system as a competitive advantage, we omitted this aspect from our discussion of the federal safety net.

<sup>43</sup>In unusual and exigent circumstances, and after consulting with the Board of Governors of the Federal Reserve System, a Federal Reserve Bank can extend credit to an individual, partnership, or corporation that is not a depository institution if, in the judgment of the Federal Reserve Bank, credit is not available from other sources and failure to obtain such credit would adversely affect the economy.

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## Conclusions

Although the Gramm-Leach-Bliley Act of 1999, among other things, expanded the ability of financial services providers, including commercial banks and their affiliates, to offer their customers a wide range of products and services, it did not repeal the tying prohibitions of section 106, which remains a complex provision to enforce. Regulatory guidance has noted that some tying arrangements involving corporate credit are clearly lawful, particularly those involving ties between credit and traditional bank products. The targeted review conducted by the Federal Reserve and OCC, however, identified other arrangements that raise interpretive issues that were not addressed in prevailing guidance. The Federal Reserve recently issued for public comment a proposed interpretation of section 106 that is intended to provide banks and their customers a guide to the section. As the proposed interpretation notes, however, the complexity of section 106 requires a careful review of the facts and circumstances of each specific transaction. The challenge for the Federal Reserve and OCC remains that of enforcing a law where determining whether a violation exists or not depends on considering the precise circumstances of specific transactions; however, information on such circumstances is inherently limited. Customers have a key role in providing information that is needed to enforce section 106. However, the Federal Reserve and OCC have little information on customers' understanding of lawful and unlawful tying under section 106 or on customers' knowledge of the circumstances of specific transactions.

The available evidence did not clearly support contentions that banks violated section 106 and unlawfully tied credit availability or underpriced credit to gain investment banking revenues. Corporate borrowers generally have not filed complaints with the banking regulators and attribute the lack of complaints, in part, to a lack of documentary evidence and uncertainty about which tying arrangements section 106 prohibits. The Federal Reserve and OCC report that they found only limited evidence of even potentially unlawful tying practices involving corporate credit during a targeted review that began in 2002, and they found that the banks surveyed generally had adequate policies and procedures in place to deter violations of section 106. However, while the teams conducting this review analyzed some specific transactions, they did not test a broad range of transactions, or outreach widely to bank customers. Information from customers could be an important step in assessing both implementation of and compliance with a bank's policies and procedures. While regulators could take further steps to encourage customers to provide information, in addition to the

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recent Federal Reserve proposal, bank customers themselves are crucial to enforcement of section 106.

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## Recommendations for Executive Action

Distinguishing lawful and unlawful tying depends on the specific facts and circumstances of individual transactions. Because the facts, if any, that would suggest a tying violation generally would not be found in the loan documentation that banks maintain and because bank customers have been unwilling to file formal complaints, effective enforcement of section 106 requires an assessment of other indirect forms of evidence. We therefore recommend that the Federal Reserve and the OCC consider taking additional steps to ensure effective enforcement of section 106 and section 23B, by enhancing the information that they receive from corporate borrowers. For example, the agencies could develop a communication strategy targeted at a broad audience of corporate bank customers to help ensure that they understand which activities are permitted under section 106 as well as those that are prohibited. This strategy could include publication of specific contact points within the agencies to answer questions from banks and bank customers about the guidance in general and its application to specific transactions, as well as to accept complaints from bank customers who believe that they have been subjected to unlawful tying. Because low priced credit could indicate a potential violation of section 23B, we also recommend that the Federal Reserve assess available evidence regarding loan pricing behavior, and if appropriate, conduct additional research to better enable examiners to determine whether transactions are conducted on market terms and that the Federal Reserve publish the results of this assessment.

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## Agency Comments

We requested comments on a draft of this report from the Federal Reserve and OCC. We received written comments from the Federal Reserve and OCC that are summarized below and reprinted in appendixes II and III respectively. The Comptroller of the Currency and the General Counsel of the Board of Governors of the Federal Reserve System replied that they generally agreed with the findings of the report and concurred in our recommendation. Federal Reserve and OCC staff also provided technical suggestions and corrections that we have incorporated where appropriate.

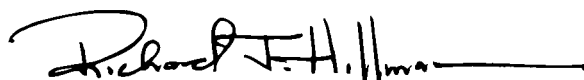
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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its

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issuance date. At that time, we will send copies to the Chairman and Ranking Minority Member, Senate Committee on Banking, Housing, and Urban Affairs; the Chairman, House Committee on Energy and Commerce; the Chairman of the Board of Governors of the Federal Reserve System; and the Comptroller of the Currency. We will make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact James McDermott or me at (202) 512-8678. Key contacts and major contributors to this report are listed in appendix IV.

A handwritten signature in black ink that reads "Richard J. Hillman" followed by a horizontal line.

Richard Hillman, Director  
Financial Markets and Community Investment

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# Differences in Accounting between Commercial and Investment Banks for Loan Commitments

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Because commercial and investment banks follow different accounting models, there are differences in the financial statement presentation of some similar transactions. This appendix summarizes the differences, under generally accepted accounting principles in how commercial banks and investment banks account for loan commitments—specifically commercial paper back-up credit facilities—using hypothetical scenarios to illustrate how these differences could affect the financial statements of a commercial and investment bank.<sup>1</sup> We use three hypothetical scenarios to illustrate the accounting differences that would occur between the commercial and investment banks for similar transactions if (1) a loan commitment were made, (2) the loan commitment was exercised by the borrower and the loan was actually made, and (3) the loan was subsequently sold. This appendix does not assess the differences in accounting that would occur if a loan was made by both a commercial bank and an investment bank when one entity decided to hold the loan to maturity and the other opted to hold the loan as available for sale, because the basis for these actions and the resulting accounting treatment are not similar.

The examples in this appendix demonstrate that, as of a given financial statement reporting date, differences would likely exist between commercial and investment banks in the reported value of a loan commitment and a loan resulting from an exercised commitment, as well as the recognition of the related deferred revenue. In addition, the volatility of the fair value of loan commitments and the related loan, if the commitment were exercised, would be reflected more transparently in an investment bank's financial statements, because an investment bank must recognize these changes in value in earnings as they occur in net income.<sup>2</sup> In contrast, commercial banks are not allowed to recognize changes in the fair value of the loan commitment, its related deferred revenue, or the related loan (if drawn). The differences in accounting between commercial banks and investment banks are temporary; and, as the examples in the following sections show, whether a commercial bank or an investment

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<sup>1</sup>Commercial paper is generally a short-term, unsecured, money-market obligation issued by prime rated commercial firms and financial companies. A commercial paper back-up facility is generally a short-term bank line of credit that serves as an alternate source of liquidity for an issuer of commercial paper lasting less than 1 year.

<sup>2</sup>FASB has defined fair value in FAS 107, *Disclosures about Fair Value of Financial Instruments*, as the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than a forced liquidation sale.

bank recognizes more fee revenue first would depend on various market conditions, including interest rates and spreads. Similarly, any differences between the fair value of a loan or loan commitment on an investment bank's book and the net book value of a similar loan or loan commitment on a commercial bank's books would be eliminated by the end of the loan term or commitment period.<sup>3</sup> Given that loan commitment terms are usually for less than 1 year, any accounting differences between the commercial and investment banks would be for a relatively short period of time. Further, both commercial and investment banks are required to make similar footnote disclosures about the fair value of their financial instruments.<sup>4</sup> Thus, neither accounting model provides a clear advantage over the life of the loan commitment or the loan if the commitment were exercised.

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## Background

Since 1973, the Financial Accounting Standards Board (FASB) has been establishing private-sector financial accounting and reporting standards. In addition, the American Institute of Certified Public Accountants (AICPA) Accounting Standards Executive Committee also provides industry-specific authoritative guidance that is cleared with FASB prior to publication. Where FASB guidance is nonexistent, as is currently the case in fair-value accounting for loan commitments, firms are required to follow AICPA guidance.

Most commercial banks generally follow a mixed-attribute accounting model, where some financial assets and liabilities are measured at historical cost, some at the lower of cost or market value and some at fair value. In accounting for loan commitments, banks follow the guidance in Statement of Financial Accounting Standards (FAS) Number 91

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<sup>3</sup>The net book value of a loan is generally its unpaid principal balance less any allowance for credit losses.

<sup>4</sup>FASB has defined a financial instrument as cash, evidence of an ownership interest in an entity, or a contract that both imposes on one entity a contractual obligation to (1) deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity and conveys to that second entity a contractual right to (1) receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

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**Appendix I**  
**Differences in Accounting between**  
**Commercial and Investment Banks for Loan**  
**Commitments**

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*Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*<sup>5</sup>

Broker-dealer affiliates and investment banks whose primary business is to act as a broker-dealer follow the AICPA's *Audit and Accounting Guide, Brokers and Dealers in Securities*, where the inventory (that may include loan commitments) are recorded at the current fair value and the change in value from the prior period is recognized in net income.<sup>6</sup> Further, FASB currently has a project on revenue recognition that includes the accounting for loan commitment fees by investment banks and others. The purpose of that project includes addressing the inconsistent recognition of commitment fee income and may eliminate some of the accounting differences that exist between commercial banks and investment banks described in this appendix.

FASB has stated that it is committed to work diligently toward resolving, in a timely manner, the conceptual and practical issues related to determining the fair values of financial instruments and portfolios of financial instruments. Further, FASB has stated that while measurement at fair value has conceptual advantages, all implementation issues have not yet been resolved; and the Board has not yet decided when, if ever, it will be feasible to require essentially all financial instruments to be reported at fair value in the basic financial statements. Although FASB has not yet issued comprehensive guidance on fair-value accounting, recent literature has stated that the fair-value accounting model provides more relevant information about financial assets and liabilities and can keep up with

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<sup>5</sup>FAS 91 *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* applies to loan commitments held by lending institutions. If a commercial bank held a loan commitment in a broker-dealer affiliate registered with the Securities and Exchange Commission, the affiliate would follow the AICPA guidance for broker-dealers.

<sup>6</sup>For simplicity, in this appendix the term investment bank will be used to mean an investment bank in which the broker-dealer comprises a majority of the financial activity. In practice, investment banks do not often hold loan commitments in their broker-dealer affiliates because of the high capital requirements of broker-dealers; rather, the investment bank would generally hold these financial instruments in a nonbroker-dealer affiliate. However, according to AICPA staff, at the consolidated level, the entity would retain the specialized accounting model used for the broker-dealer subsidiary. The commercial bank would continue to use FAS 91 to account for its loan commitments. A nonbroker-dealer that is a subsidiary of a broker-dealer holding company (not a bank holding company) may also follow the accounting used by its broker-dealer subsidiary, if the broker-dealer comprises the majority of the financial activity of the consolidated entity; that is, the fair-value model would also be used for the consolidated broker-dealer holding company financial statements.



today's complex financial instruments better than the historical cost accounting model. The effect of the fair-value accounting model is to recognize in net income during the current accounting period amounts that, under the historical cost model, would have been referred to as unrealized gains or losses because the bank did not sell or otherwise dispose of the financial instrument. Further, proponents of the fair-value accounting model contend that unrealized gains and losses on financial instruments are actually lost opportunities as of a specific date to realize a gain or loss by selling or settling a financial instrument at a current price. However, a disadvantage of fair-value accounting exists when there is not an active market for the financial instrument being valued. In this case, the fair value is more subjective and is often determined by various modeling techniques or based on the discounted value of expected future cash flows.

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## Hypothetical Scenario for Unexercised Loan Commitments

On the first day of an accounting period, Commercial Bank A and Investment Bank B each made a \$100 million loan commitment to a highly rated company to back up a commercial paper issuance. This loan commitment was irrevocable and would expire at the end of three quarterly accounting periods. Because the loan commitment was issued to a highly rated company, both banks determined that the chance of the company drawing on the facility was remote. Both banks received \$10,000 in fees for these loan commitments. Commercial Bank A followed the guidance in FAS No. 91 and recorded this transaction on a historical cost basis while Investment Bank B, subject to specialized accounting principles that require fair-value accounting, reported changes in fair value included the effect of these changes in earnings.

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## Revenue Recognition for the Commercial Bank

Upon receipt of the loan commitment fee, Commercial Bank A would record the \$10,000 as a liability, called deferred revenue, because the bank would be obligated to perform services in the future in order to "earn" this revenue. In practice, because of the relatively small or immaterial amounts of deferred revenue compared with other liabilities on a bank's statement of position (balance sheet), this amount would not be reported separately and would likely be included in a line item called "other liabilities."<sup>7</sup> Commercial Bank A would follow the accounting requirements of FAS No.

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<sup>7</sup>The concept of materiality is discussed at length in FASB's Concept Statement 2, *Qualitative Characteristics of Accounting Information*, paragraphs 123 – 132.

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**Appendix I**  
**Differences in Accounting between**  
**Commercial and Investment Banks for Loan**  
**Commitments**

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91 and recognize the revenue as service-fee income in equal portions over the commitment period, regardless of market conditions—a practice often referred to as revenue recognition on a straight-line basis. Thus, at the end of the first accounting period, Commercial Bank A would reduce the \$10,000 deferred revenue on its statement of position (balance sheet) by one-third or \$3,333 and record the same amount of service-fee revenue on the statement of operations (income statement). The same accounting would occur at the end of the second and third accounting periods, so that an equal portion of service revenue would have been recognized during each period that the bank was obligated to loan the highly rated company \$100 million.<sup>8</sup> Regarding disclosure of the \$100 million commitment, Commercial Bank A would not report the value of the loan commitment on its balance sheet. However, the bank would disclose in the footnotes to its financial statements the fair value of this commercial paper back-up facility as well as the method used to estimate the fair value.<sup>9</sup>

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**Revenue Recognition for the**  
**Investment Bank**

Although AICPA's *Audit and Accounting Guide, Brokers and Dealers in Securities* does not provide explicit guidance for how Investment Bank B would account for this specific transaction, the guide provides relevant guidance on accounting for loan commitments in general. This guide states that Investment Bank B would account for inventory, including financial instruments such as a commercial paper back-up facility, at fair value and report changes in the fair value of the loan commitment in earnings. When changes occurred in the fair value of the loan commitment, Investment Bank B would need to recognize these differences by adjusting the balance of the deferred revenue account to equal the new fair value of the loan commitment. Generally, quoted market prices of identical or similar instruments, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, as is often the case with loan commitments, management's best estimate of fair value may be based on the quoted market price of an instrument with similar characteristics; or it may be developed by using certain valuation techniques such as estimated future cash flows using a discount rate

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<sup>8</sup>If the likelihood of exercising this commitment had not been remote, Commercial Bank A would have followed the requirements of FAS 91, and not amortized the deferred revenue until the commitment was exercised. Once exercised, the bank would recognize the fee income over the life of the loan. If the commitment remained unexercised, income would be recognized upon expiration of the commitment.

<sup>9</sup>This is required by FAS No. 107, *Disclosures about Fair Value of Financial Instruments*.

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commensurate with the risk involved, option pricing models, or matrix pricing models. A corresponding entry of identical value would be made to revenue during the period in which the change in fair value occurred. Once the commitment period ended, as described in the previous paragraph, the deferred revenue account would be eliminated and the remaining balance recorded as income.

If market conditions changed shortly after Investment Bank B issued this credit facility and its fair value declined by 20 percent to \$8,000, Investment Bank B would reduce the deferred revenue account on its statement of position (balance sheet) to \$8,000, the new fair value. Investment Bank B would recognize \$2,000 of service-fee income, the amount of the change in value from the last reporting period, in its statement of operations (income statement). Investment Bank B would also disclose in its footnotes the fair value of this credit facility, as well as the method used to estimate the fair value.

If during the second accounting period there was another change in market conditions and the value of this credit facility declined another 5 percent of the original amount to \$7,500, Investment Bank B would decrease the balance in the deferred revenue account to \$7,500 and recognize \$500 in service-fee revenue. Further, Investment Bank B would disclose in its footnotes the fair value of this credit facility.

During the accounting period in which the commitment to lend \$100 million was due to expire, accounting period 3 in this example, the balance of the deferred revenue account would be recognized because the commitment period had expired and the fair value would be zero. Thus, \$7,500 would be recognized in revenue and the balance of deferred revenue account eliminated. In this accounting period, there would be no disclosure about the fair value of the credit facility.

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**Differences in Revenue**  
**Recognition Are Temporary**

The following table summarizes the amount of revenue Commercial Bank A and Investment Bank B would recognize and the balance of the deferred revenue account for each of the three accounting periods when there were changes in the value of the loan commitments. Commercial Bank A would recognize more service-fee income in accounting periods 1 and 2 than Investment Bank B. However, this situation would be reversed in period 3, when Investment Bank B would recognize more revenue. Thus, differences in the value of the loan commitment and the amount of revenue recognized would likely exist between specific accounting periods, reflecting the

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volatility of the financial markets more transparently in Investment B's financial statements. The magnitude of the difference is determined by the market conditions at the time and could be significant or minor. However, these differences would be resolved by the end of the commitment period, when both entities would have recognized the same amount of total revenue for the loan commitment.

**Table 1: Accounting Differences for a Loan Commitment**

Accounting period	Commercial Bank A		Investment Bank B	
	Service-fee revenue recognized	Balance of deferred revenue	Service-fee revenue recognized	Balance of deferred revenue
Initial recording of the credit facility	\$0	\$10,000	\$0	\$10,000
1	3,333	6,667	2,000	8,000
2	3,333	3,334	500	7,500
3	3,334	0	7,500	0
<b>Total service-fee revenue recognized</b>	<b>\$10,000</b>		<b>\$10,000</b>	

Source: GAO.

**Hypothetical Scenario for Exercised Loan Commitments**

Commercial Bank A and Investment Bank B issued the same loan commitment described previously. However, at the end of the second accounting period, the highly rated company exercised its right to borrow the \$100 million from each provider because its financial condition had deteriorated and it could no longer access the commercial paper market. The accounting treatment for this loan would depend upon whether bank management had the intent and ability to hold the loan for the foreseeable future or until maturity. AICPA Task Force members and some investment bankers told us that in practice, this loan could be either held or sold, and as a result, the accounting for both is summarized in the following sections.

**Loans Intended to Be Held to Maturity**

At the time the loan was made, Commercial Bank A would record the \$100 million dollar loan as an asset on its statement of position (balance sheet). Investment Bank B would initially record this loan at its historical cost basis, less the loan commitment's fair value at the time the loan was drawn

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(\$100 million - \$7,500). Further, based on an analysis by the banks' loan review teams, a determination of "impairment" would be made. According to FAS 114, *Accounting by Creditors for Impairment of a Loan*, "a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." If the loan were determined to be impaired, FAS 114 states that, the bank would measure the amount of impairment as either the (1) present value of expected future cash flows discounted at the loan's effective interest rate, (2) loan's observable market price, or (3) fair value of the collateral if the loan were collateral dependent.

FAS 114 directs both banks to establish an allowance for losses when the measure of the impaired loan is less than the recorded investment in the loan (including accrued interest, net of deferred loan fees or costs and unamortized premium or discount) by creating a valuation allowance that reduces the recorded value of the loan with a corresponding charge to bad-debt expense. When there are significant changes in the amount or timing of the expected future cash flows from this loan, the banks would need to adjust, up or down, the loan-loss allowance as appropriate so that the net balance of the loan reflects management's best estimate of the loan's cash flows. However, the net value of the loan cannot exceed the recorded investment in the loan.

If the loan were not impaired, both banks would still record an allowance for credit losses in accordance with FAS 5, *Accounting for Contingencies*, when it was probable that a future event would likely occur that would cause a loss and the amount of the loss was estimable.<sup>10</sup> Thus, both banks would establish an allowance for loss in line with historical performance for borrowers of this type.<sup>11</sup> Because the loan was performing, both banks would receive identical monthly payments of principal and interest. Generally, these cash receipts would be applied in accordance with the

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<sup>10</sup>On June 19, 2003, AICPA issued an exposure draft of a proposed statement of position for allowance for credit losses. This exposure draft proposes various revisions to how banks would estimate credit losses and report them on their financial statements and is proposed to be implemented after December 15, 2003.

<sup>11</sup>FAS 5 states that receivables by their nature usually involve some degree of uncertainty about their collectibility, in which case a loss contingency exists. If a loss were not probable and estimable, both banks would disclose in their financial statement footnotes, the loss contingency when there was at least a reasonable possibility that a loss or additional loss might be incurred.

loan terms, and a portion would be recorded as interest income; and the balance applied would reduce the banks' investment in the loan. At the end of the loan term, the balance and the related allowance for this loan would be eliminated.

FAS 91 also directs both banks to recognize the remaining unamortized commitment fee over the life of the loan as an adjustment to interest income. Because the borrower's financial condition had deteriorated, both banks would likely have charged a higher interest rate than the rate stated in the loan commitment. As a result, at the time it becomes evident that the loan is to be drawn, Investment Bank B would record a liability on its balance sheet to recognize the difference between the actual interest rate of the loan and the interest rate at which a loan to a borrower with this level of risk would have been made—in essence the fair value interest rate. This liability would also be amortized by Investment Bank B over the life of the loan as an adjustment to interest income.

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## Loans Made Available for Sale

If Commercial Bank A and Investment Bank B's policies both permitted the firms to only hold loans for the foreseeable future or until maturity when the borrowers were highly rated, it is unlikely that the banks would keep the loan in the previous hypothetical scenario and would sell the loan soon after it was made.<sup>12</sup> Although the banks would follow different guidance there would be similar results. Commercial Bank A would follow the guidance in the AICPA Statement of Position 01-6.<sup>13</sup> According to this guidance, once bank management decides to sell a loan that had not been previously classified as held-for-sale, the loan's value should be adjusted to the lower of historical cost or fair value, and any amount by which historical cost exceeds fair value should be accounted for as a valuation allowance. Further, as long as the loan's fair value remained less than historical cost, any subsequent changes in the loan's fair value would be

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<sup>12</sup>In order to keep this exception scenario example simple, it is also assumed that there are not conditions that would constrain Commercial Bank A and Investment Bank B from selling the loan, that both banks will not retain any interest in the loans sold, and the loans are sold without recourse.

<sup>13</sup>*Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*, December, 2001.

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recognized in other comprehensive income.<sup>14</sup> Investment Bank B would follow the guidance in the AICPA's *Audit and Accounting Guide, Brokers and Dealers in Securities*, as it did with loan commitments, and account for inventory at fair value and report changes in the fair value of the loan in net income.

For example, if bank management decided to sell the loan soon after it was drawn when some payments had been made to reduce the principal balance and the net book value of this loan was \$88,200,000 (unpaid principal balance of \$90,000,000 less the related allowance of \$1,800,000) and the fair value was 97 percent of the unpaid principal balance or \$87,300,000, both banks would recognize the decline in value of \$900,000 in earnings. While the loan remained available-for-sale, any changes in its fair value would be recorded in net income. For example, if the loan's fair value declined further to \$85,500,000, both banks would recognize the additional decline in value of \$1,800,000 in earnings.

Table 2 below summarizes the accounting similarities between Commercial Bank A and Investment Bank B for the loan sale. Although the two banks followed different guidance, the effect of the loan sale is the same for both banks.

**Table 2: Accounting Differences for a Loan Sale**

<b>Transaction</b>	<b>Commercial Bank A loss amount</b>	<b>Investment Bank B loss amount</b>
Transfer the loan to the trading portfolio	<\$900,000>	<\$900,000>
Change in fair value	<\$1,800,000>	<\$1,800,000>
<b>Total loss on loan sale</b>	<b>&lt;\$2,700,000&gt;</b>	<b>&lt;\$2,700,000&gt;</b>

Source: GAO.

<sup>14</sup>Comprehensive income is defined in FAS 130, *Reporting Comprehensive Income*, as the change in equity [net assets] of a business during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

# Comments from the Federal Reserve System



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

J. VIRGIL MATTINGLY, JR.  
GENERAL COUNSEL

October 2, 2003

Mr. Richard Hillman  
Director  
Financial Markets and Community Investment  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. Hillman:

We appreciate the opportunity to review and comment on the draft report concerning the special anti-tying prohibitions that apply to banks under section 106 of the Bank Holding Company Act Amendments of 1970 (GAO-04-3).

The report describes some of the steps that the Federal Reserve has taken to ensure that banks comply with section 106, other banking statutes and safe and sound banking practices. For example, Federal Reserve examiners review the anti-tying programs of bank holding companies and state member banks as part of the regular compliance reviews of these organizations. In addition, examiners from the Federal Reserve and the Office of the Comptroller of the Currency recently conducted targeted anti-tying examinations at several large banking organizations. The targeted exams indicated that the banking organizations reviewed generally have adequate policies and procedures to ensure compliance with the anti-tying restrictions of section 106, and the agencies generally did not uncover unlawful tying arrangements in these examinations. We note that the GAO also found that the available evidence does not substantiate claims that banks are tying the availability or price of credit to the purchase of debt underwriting services from a securities affiliate of the bank.

The special anti-tying rules that apply to banks under section 106, however, are quite complex. We concur with your finding that this complexity has led to some uncertainty and confusion, both among banks and their customers, as to what actions by a bank are prohibited and permissible under the statute. It was, in part, to address this uncertainty and confusion that the Federal Reserve recently requested public comment on a formal interpretation of section 106.<sup>1</sup> The interpretation is intended to provide banks and their customers a comprehensive guide to section 106 and includes examples of both the types of bank actions that are prohibited and those that are permissible under the statute.

<sup>1</sup> See 68 *Federal Register* 52024 (Aug. 29, 2003).



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**Appendix II**  
**Comments from the Federal Reserve System**

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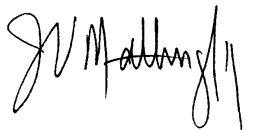
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We agree with your finding that the facts and circumstances surrounding a particular transaction, including information from the bank's customer, often are crucial in determining whether a violation of section 106 has occurred. Accordingly, the Federal Reserve has informally solicited information from corporate customers concerning bank compliance with section 106. Moreover, the Federal Reserve's proposed interpretation of section 106 expressly encourages customers that believe they have been the object of an illegal tying arrangement to contact the appropriate Federal banking agency for the bank involved.<sup>2</sup> When information provided by a customer or other source indicates that a banking organization within the Federal Reserve's supervisory jurisdiction has violated section 106, the Federal Reserve will investigate the matter and, if the allegations are established, take appropriate supervisory or enforcement action against the organization.<sup>3</sup>

Your report recommends that the Federal Reserve consider taking additional steps to ensure the effective enforcement of section 106 by, for example, developing a communication strategy designed to help corporate customers of banks better understand section 106 and publishing specific contact points at the Federal Reserve for responding to questions and accepting customer complaints concerning section 106. We concur with this recommendation and will consider taking additional educational, outreach and administrative steps in order to further improve the understanding among banks and their customers of the prohibitions of section 106 and the ability of bank customers to submit complaints concerning potential violations of section 106.

The report also recommends that the Board consider whether it would be appropriate to conduct a study of loan pricing behavior. Board staff currently is engaged in an effort to study recent developments in the market for syndicated loans using publicly available data. We hope that this study will enhance the understanding of the nature of competition among participants in this market and shed light on the factors that influence loan pricing.

Sincerely,



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<sup>2</sup> Id. at 52027.

<sup>3</sup> See, e.g. Order to Cease and Desist and Order of Assessment of a Civil Monetary Penalty entered into with WestLB AG, Dusseldorf, Germany, and its New York branch, dated Aug. 27, 2003.

# Comments from the Office of the Comptroller of the Currency



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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

October 1, 2003

Mr. Richard J. Hillman  
Director, Financial Markets and Community Investment  
United States General Accounting Office  
Washington, DC 20548

Dear Mr. Hillman:

The Office of the Comptroller of the Currency received and reviewed a draft report titled Bank Tying: Additional Steps Needed to Ensure Effective Enforcement of Tying Prohibitions. The report was prepared at Congressional request to examine allegations that commercial banks helped their investment affiliates gain market share by illegally tying and underpricing corporate credit. Your objectives were to determine: (1) what evidence, if any, suggests that commercial banks with investment affiliates engage in unlawful tying; (2) what steps the federal banking regulators have taken to examine for unlawful tying and the results of these efforts; (3) what evidence, if any, suggests that commercial banks with investment affiliates unlawfully discount the price of corporate credit to obtain underwriting business for their investment affiliates; and (4) what, if any, competitive advantages accounting rules, capital standards, and access to the federal safety net create for commercial banks over investment banks.

You concluded and are reporting that available evidence did not substantiate allegations the unlawful tying occurs; that the Board of Governors of the Federal Reserve System's (Federal Reserve) and the Office of the Comptroller of the Currency's (OCC) targeted reviews identified interpretive issues; that evidence you reviewed did not demonstrate that commercial banks unlawfully discount credit; and that differences between commercial banks and investment banks did not necessarily affect competition.

You recommend that the Federal Reserve and the OCC consider taking additional steps to ensure effective enforcement of the antitying provisions by increasing the amount of information available on which to make an assessment.

We concur with your conclusions and agree to implement your recommendation. We provided technical comments on the draft report to the analysts separately.

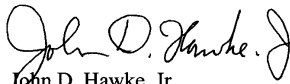
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**Appendix III**  
**Comments from the Office of the Comptroller**  
**of the Currency**

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Thank you for the opportunity to comment on the draft report.

Sincerely,



John D. Hawke, Jr.  
Comptroller of the Currency

# GAO Contacts and Staff Acknowledgments

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## GAO Contacts

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## Acknowledgments

In addition to those individuals named above, Daniel Blair, Tonita W. Gillich, Gretchen Pattison, Robert Pollard, Paul Thompson, and John Treanor made key contributions to this report.

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