Board of Governors of the Federal Reserve System
Office of the Comptroller of the Currency

October 16, 2002

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
House of Representatives
Washington, D.C. 20515-6115

Dear Representative Dingell:

This letter is in response to your letter of September 12, 2002, in which you pose follow-up questions to our response to your July 11, 2002, letter regarding whether banks are tying the provision of credit to their investment banking business.

As mentioned in our last letter, the agencies have in place and will continue our supervisory efforts to ensure compliance with section 106 of the Bank Holding Company Act Amendments of 1970, other banking statutes and safe and sound banking practices. The agencies are also committed to taking any corrective actions that are appropriate as a result of the targeted reviews and any other findings made through the supervisory process. We are concerned about the potential for illegal tying as both a violation of law and an unsafe and unsound banking practice.

Responses to the individual questions you asked in your September 12 letter are set forth in the enclosed Appendix. As we stated in our August 13 letter, the agencies are conducting joint targeted tying reviews at several large banking organizations. Our response to your question 8 provides some additional detail regarding the scope of the reviews.

Sincerely,

Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System

John D. Hawke, Jr.
Comptroller of the Currency

Enclosure

APPENDIX

1. **You indicate that, "to date, the agencies have not found that commercial banks are manipulating the pricing of credit to build investment banking market share" and that you "do not have evidence of significant 'mispricing' of bank credits."**

   Have you reviewed the public statements of bank senior executives which state openly that bank credit is mispriced? Do you intend to interview any of these executives?

We have reviewed the public statements of bank senior executives in Appendix B to your July 11, 2002, letter. As part of the targeted tying reviews, which are currently underway, examiners are interviewing bank executives concerning, among other things, credit pricing policies, relationship banking policies, antitying policies, compliance training, and treatment of customer complaints regarding tying. If the results of the reviews indicate that the business practices of a bank, including the pricing of credit, violate the anti-tying statute, we will take appropriate supervisory action. Whether or not specific violations are found, we will consider whether any follow-up action, such as enhanced supervisory guidance, is warranted.

2. **You cite the large number of participants in syndicated credit facilities as evidence that credit facilities are being priced at market. Specifically, you state that "in the syndicated loan market, 80 percent of the dollar amount of the commitments outstanding in 2001 or $1.6 trillion of the $2.0 trillion in commitments, involved nine or more participating banks and non-banks, a strong indicator that the loan was adequately priced on a stand-alone basis."**

   Have you inquired of any of the smaller bank participants as to whether they are pressured by lead arrangers or corporate borrowers to enter into credit facilities as a condition to obtaining other business from the corporation? Have you asked any of these participants what price would be required to transfer these positions to other financial institutions who are not "relationship lenders" such as institutional investors?

We have not received complaints from smaller banking organizations about pressure to participate in credit facilities as a condition to obtaining other business from a corporate borrower. It is important to note that all banking institutions are expected to have their own internal credit approval processes and to independently judge the merits of any transaction. They are expected to base their decisions on their independent credit judgment, regardless of any pressure exerted by a third party.

There are a variety of reasons why smaller banking organizations may participate in loan syndications of large corporate borrowers. These reasons may include the desire to acquire good quality large corporate credits to which they may not otherwise have direct access, the pursuit of access to large corporate customers in hopes of providing niche services such as localized cash management services that can generate desirable fee income, and a myriad of other business motivations.

It is also important to recognize that the pricing of a given credit may be different for different lenders. As a general matter, the pricing of a particular credit depends upon a number of lender-, borrower-, and facility-specific factors as well as general market characteristics and conditions at any given time. For example, up-front fees received by the initial lender, the ability of "relationship lenders" to more effectively monitor the credit quality of a borrower on an ongoing basis, and the different objectives, risk profiles and financial structures of "relationship and non-relationship lenders," are just a few of the factors that might result in institutional investors requiring different returns on a given credit than originating banking organizations.

3. **You mention that, "institutional bond investors have, over the past several years, increasingly looked to the syndicated and secondary loan markets for investment candidates."**

   Have you had discussions with [institutional bond] investors to determine what types of credit facilities they participate in? Available information appears to show that these investors participate entirely in funded loans for non-investment grade credits or in distressed bank loans. With rare exception, they do not participate in the mispriced unfunded credit facilities, which are almost exclusively provided by commercial or investment banks.

We regularly monitor developments in the capital and credit markets. For a variety of reasons, including the greater liquidity and certainty of timing of cash flows of funded loans, institutional bond investors tend not to participate in unfunded credit facilities. Our observations regarding the increasing role of institutional investors in the syndicated loan market were made with regard to the market in general in response to question 2 of your July 11 letter. Even in the case of unfunded facilities, available information does not indicate that these credits are "mispriced." As mentioned above, lender- and facility-specific characteristics significantly affect credit pricing given their impact on the returns required by different types of lenders.

4. **Certain institutional lenders and smaller banks purchase unfunded credit facilities at a steep discount following primary syndication.**

   Have you asked any such investors about such transactions and how they determine the price at which they make such investments?

Based on our supervisory experience and ongoing monitoring of the credit markets at issue, we believe there are numerous factors that impact the price at which different institutions may enter into a transaction. An investor's risk profile, risk tolerance, financial and cost structure, regulatory capital requirements, and importantly, bona fide customer relationship considerations, are all important components in credit-pricing decisions. In the case of unfunded facilities, factors such as the up-front fees paid to the originating lenders, the on-going relationship of primary lenders with the borrower that effects closer monitoring of credit quality, and the liquidity of the investment relative to other, more traditional fixed income investments made by institutional investors are just a few of the factors that may underlie the discounts seen in the secondary markets. Institutional investors and smaller banks purchasing such credits obviously make their transaction decisions stressing different factors than the originators of the credit. Moreover, evidence from the banking agencies' Shared National Credit Program suggests that non-bank investors in syndicated credits have focused on sub-investment grade and distressed loans that normally sell in the secondary market at discounts to par. In summary, it is unclear whether discounts in the secondary market provide evidence of "mispricing" or simply reflect differences in risk profile, risk appetite, financial structure, or other institution-specific characteristics between originating institutions and secondary market participants.

5. **You state that "the extent to which the pricing of certain credit products in the past has not fully compensated lenders for the ultimate risks undertaken may reflect a cyclical over-optimism about the fundamental credit condition of the borrowers at the time the credit extension was made," but that "any past mispricing is currently being corrected."**

   Have you reviewed historic data on loan commitment pricing (particularly the critical components of such instruments, the unfunded commitment fees)? The evidence in such data appears to clearly suggest that, far from being corrected, the mispricing has increased as credit spreads have widened in the capital markets, reflecting the difficult current economic environment, whereas pricing on revolving credit facilities has remained constant. Please explain how you could compare pricing of loan commitments to large corporations with corporate bond and credit default swap pricing of those same borrowers and conclude that these instruments are being priced at market.

As mentioned above, our August 13 letter addressed the overall trends in the syndicated loan markets. One cannot compare the pricing of loan commitments to large corporations with the pricing of corporate bond and credit default swaps of those same borrowers, as they are very different products with unique characteristics and markets. The risk-mitigating impact of standard loan commitment covenants, such as material adverse change clauses, which permit the bank to decline funding if the borrower's financial condition deteriorates, is just one characteristic that makes such comparisons difficult. Additional factors that make the pricing of the two products difficult to compare include different fee structures, terms, and recovery rates. Commitment originators receive fees from borrowers whether or not a loan facility is drawn. Loan commitments generally have a shorter term than do bonds and swaps. They also tend to have a higher recovery experience than bonds. Regulatory capital requirements may also be a factor in differential pricing. Due to a myriad of factors affecting credit pricing, it is difficult to conclude that differences in the trends of spreads in the bond and credit default markets and trends in the pricing of unfunded commitments reflect "mispricing" of bank credit.

6. **Many banks use fair value accounting for internal risk management and for management accounting. We understand that these internal accounting models reflect the fact that credit is being provided at below market prices (for example, securities affiliates are charged extra costs for providing credit to corporate clients).**

Have you made any inquiries as to the differences between internal and external financial reporting systems for corporate credit facilities?

We believe you may be referring to efforts at a few large complex banking organizations and investment banks to implement internal capital allocation methodologies or internal credit risk portfolio management capabilities for risk management purposes. Under these approaches, business lines may be charged internal capital or assessed an internal price for a specific type of risk undertaken in a transaction or activity. These internal capital allocation or risk-pricing methodologies are primarily focused on achieving, in some form, an internal hurdle rate of return. In turn, these internal hurdle rates are determined by both market driven and institution-specific characteristics. One critical component is the corporate return on equity required by shareholders, which can be very different for companies even in the same industry. We understand that in some cases individual transactions conducted by a business at market prices may be insufficient to meet these internal hurdle rates. In such cases, the business line in the banking organization or investment bank is held responsible (or charged-back depending on the methodology) for the portion of the return necessary to meet the corporate hurdle rate. Often these internal profitability goals can be achieved by the execution of other transactions or the provision of other services that generate returns in excess of the internal hurdle rate. Accordingly, many banking institutions and investment banks are increasingly taking a relationship approach in meeting the needs of their customers given the market prices they can charge for their products and services.

The use of portfolio-based internal capital allocation methodologies is an accepted practice in many industries including financial services industries such as banking, investment banking and insurance conducted either by separate legal entities or by financial conglomerates. While the industry may not have reached consensus on the best techniques to use for assessing capital adequacy internally, sophisticated institutions are making greater use of analytical techniques developed either for pricing and performance measurement across business and product lines or for making portfolio risk management decisions. These techniques incorporate one or more volatility-based measures that allow for analysis of expected and unexpected losses as well as more subjective considerations. For banking organizations, the issue is whether such portfolio-based assessments and related business practices constitute permissible cross-marketing and relationship pricing.

It is important to note that the use of such internal risk management tools in no way compromises the meaningfulness of published financial statements or other "external financial reporting for credit facilities." Published financial statements are prepared in accordance with Generally Accepted Accounting Principles (GAAP) which may or may not coincide with measures and values used for internal risk management or funds transfer pricing purposes. We are aware of the types of information used in some internal risk management systems and understand that the values and internal pricing methodologies used may often be derived employing internal, institution-specific factors including management objectives for a given business line, as well as internal hurdle rates. For example, to discourage undue credit concentrations to a particular borrower or industry, an institution may assess additional internal pricing charges to a credit that would not be permissible under GAAP. Accordingly, while values and measures used in internal risk management systems may be different than those prepared in accordance with GAAP, this may be entirely appropriate given the different objectives they are designed to achieve. Further, as you know, financial reporting and disclosure is subject to review by banks' independent auditors.

7. **You reference the requirement under GAAP for banks to disclose in financial statement footnotes the fair value of assets, liabilities, and commitments that are financial instruments (FAS 107).**

Given the significant evidence of mispricing of loan commitments referred to in the preceding questions, have you reviewed the methodologies used by banks in preparing FAS 107 disclosures and whether such disclosures properly reflect the fair value of these instruments? Are the FAS 107 disclosures consistent with the banks' internal and management accounting for these instruments?

As mentioned above, it has not been demonstrated that unfunded loan commitments are being "mispriced" and we hope that our targeted reviews will provide more information as to this contention.

As you know, FAS 107 disclosures are provided in audited financial statements submitted to the SEC. We have discussed with external auditors of banking organizations their approaches to reviewing the fair value disclosures required by FAS 107. Several auditing firms have given us overviews of the processes they undertake in order to validate disclosures and have assured us that their audits of financial statement disclosures are performed in accordance with GAAP. As previously mentioned, there are a number of reasons why internal risk management measures and published financial statements may differ.

8. **You indicate that FRB and OCC staff are conducting a special targeted review of the circumstances described in the press and referenced in my letter. You say that you will review the antitying training and compliance programs, marketing programs, training materials and adequacy of internal audit for compliance with the bank's internal policies and procedures at several of the country's largest banks.**

I note your comments on the proposed nature of the targeted reviews. Since tying, however, is understandably never done in written form, do you intend to directly question bank officials about whether they violate formal written policies in verbal communications with corporate borrowers? For example, will you ask them whether, notwithstanding any such policies or procedures, they ever request that a borrower provide investment banking business as a condition of extending or renewing a credit facility?

Will you specifically investigate any of the widely publicized reports of tying in cases such as Phillip Morris Co.'s multi-billion dollar initial public offering (IPO) spin-off of its Kraft Foods Inc. subsidiary, Lucent's IPO spin-off of Agere Systems Inc., Motorola, Corning and Vivendi? I am transmitting copies of complaints that I have received involving Bank of America and Westdeutsche Landesbank. I also note that it has been widely reported that Enron's treasury staff systematically linked fee-based business to credit extension.

Do you intend to contact corporate financial executives to inquire as to whether they feel pressure to award investment banking business or other services as a condition to obtaining commercial bank participation in loans? (See the October 2001 Greenwich Associates Survey of Corporate Executives.)

As mentioned above, as part of our targeted reviews, Board and OCC examiners will interview bank officials about their credit extension practices. This includes questions concerning the bank's pricing practices, including to what extent the bank may vary the pricing of its products and services based on the customer's entire relationship with the bank (keeping in mind that not all such variations are prohibited under section 106 of the Bank Holding Company Act Amendments of 1970). Examiners are also inquiring into any internal investigations the subject banks may have conducted into allegations of tying, including any that may have been prompted by the news reports you have cited. Additional supervisory efforts are underway at institutions that have been the subject of complaints. Bank customers would be contacted if reviews of anti-tying policies and procedures appear to warrant investigation of individual transactions.