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SVP Commentary on…

Liquidity Management

by Michael E. Collins

Due in part to the long economic expansion and in part to the rapid evolution of the capital markets, core deposit growth has slowed and competition for retail funds has intensified. Many financial institutions have not fully integrated changes in balance sheet funding into their enterprise wide risk management profile. After all, there are so many new funding sources that the banking industry should have no problem maintaining asset growth rates approaching 10 percent, right? Perhaps not…

Since 1993, both loan and asset growth at insured commercial banks has significantly outpaced growth in domestic deposits (excluding time deposits greater than $100,000). What fueled this growth? Time deposits greater than $100,000 and foreign deposits provided only modest contributions, since total loan growth exceeded deposit growth in all years but 1997, and asset growth exceeded deposit growth in all years but 2000. Rather, the industry looked toward other borrowings—purchased fed funds, FHLB borrowings, and subordinated debt—to fund strong loan demand. Not surprisingly, the loan to deposit ratio, one measure of liquidity, increased from the decade low of 75.3 percent on December 31, 1992 to a new high of 91.4 percent on December 31, 2000. The expanded use of wholesale funding sources has been

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Primer on Equity Investment and Merchant Banking Activities

by Joseph J. Willcox, Examiner and Randolph D. Brown, Senior Examiner

With the passage of the Gramm-Leach-Bliley Act ("GLB Act") in November 1999, the landscape of banking in the United States was significantly changed. Among the major changes in the landmark legislation was the blurring of the separation between banking and commerce, specifically the lowering of the barriers for commercial banks to conduct merchant banking operations that make equity investments in nonfinancial companies and lend to private equity-financed companies. As a result, financial holding companies established under the GLB Act are ripe to enter the private equity industry. The purpose of this article is to provide an introduction to the private equity market, explain the authorities under which merchant banking activities may be conducted, provide an overview of permissible investments, and discuss sound investment and risk management practices for these transactions.

Financial holding companies are ripe to enter the private equity industry.

What is "Private Equity"?

Private equity is the generic term for the industry of finance professionals that make direct investments in companies. These investors generally receive an ownership interest in the form of common or preferred stock, and typically target privately held companies offering a unique product or service that has significant growth potential. This activity is primarily conducted through private equity funds, the manager or general partner of which locate and evaluate investment opportunities while the limited partners provide the necessary capitalization. It is not uncommon that, after making an investment, the general partner will become actively involved in the management of the company, usually by taking a seat on the board. This board seat allows the general partner to influence the company's strategy without having to manage the operation on a daily basis. The typical private investment firm might manage numerous targeted private equity funds, participate in the funds of other investment firms, or directly invest in a company.

What is "Merchant Banking"?

The term merchant banking refers to a segment of the private equity industry. A merchant bank makes its own direct investments, may manage its own private equity funds, and can provide debt financing to companies. When a merchant banker provides the seed money or start up capital, it is involved in the venture capital phase of the business enterprise. By their nature, venture capital investments carry the greatest risk but also offer potentially great rewards, as the eventual sale of the company could occur at a substantial profit. A merchant bank may also be involved in later stages of development financing by providing capital to fund growth or mezzanine financing to facilitate management buy-ins, buyouts, and ownership changes. Mezzanine financing has both debt and equity characteristics, through which an investor will take a convertible and/or subordinated debt position or preferred stock and receive a current interest return with equity participation. Additional funding may be provided for middle-market business expansion and mergers or acquisitions.

Private Equity: Pre-GLB Act

Banking organizations have participated in the private equity industry since the late 1950s through direct investments in Small Business Investment Corporations (SBICs). Both banks and bank holding companies (BHCs) are eligible to own SBICs, although the aggregate investment is limited to five percent of the bank's capital and surplus.

A second investment authority is contained in sections 4(c)6 and 4(c)7 of the Bank Holding Company Act. These sections permit a holding company to make investments in up to five percent of the outstanding voting shares of any one company and up to 25 percent of the total equity of a company, with no aggregate limits on the total dollar amount of equity investments held by the BHC.[1]

A third authority exists under Regulation K, which implements sections 25 and 25A of the Federal Reserve Act and section 4(c)(13) of the Bank Holding Company Act. Under this authority, banking organizations subject to Regulation K may make, with Board of Governors' approval, portfolio investments that in aggregate do not exceed 25 percent of the Tier 1 capital of the BHC. In addition, individual investments must be less than 20 percent of a portfolio company's voting shares and not exceed 40 percent of the portfolio company's total equity.

Private Equity: Post -GLB Act

The GLB Act dramatically expanded these authorities. A BHC that elects to become a financial holding company (FHC) may engage in a broad range of merchant banking activities. An FHC may invest in shares or ownership interests of any type of nonfinancial company, whether or not constituting control of the company. However, there are several restrictions placed on the FHC, as enumerated in more detail in Subpart J of Regulation Y (12 CFR 225.170 *et seq.*). For example, the portfolio company's shares or ownership interests must be acquired and held by a securities affiliate or an affiliate of an insurance company that provides investment advice to an insurance company, and cannot be acquired or held by a depository institution. During the holding period, the FHC may not routinely manage or operate the portfolio company except as necessary or required to obtain a reasonable return on its investment. The FHC may hold the shares or ownership interests for a period of time to enable the disposition thereof on a reasonable basis consistent with financial viability; this generally will not exceed ten years. In addition, pending the issuance of final capital rules covering merchant banking activities, FHC merchant banking activities must remain within certain thresholds.

Industry Growth

At a number of banking organizations, merchant banking investments in non-financial companies and lending to private equity-financed companies has emerged as a significant source of earnings. Merchant banks are able to use far more creative forms of financing than are available to a traditional bank. Over the past three years, the growth in venture capital and corporate finance activities has been dramatic, particularly between 1999 and 2000 when venture capital investment grew 220 percent. However, a sharp slowdown in funding attributable to the shakeout of internet-specific and communications-related companies did occur in the second half of 2000 and into the first quarter of 2001.

Due to the volatility of the earnings in merchant banking activities, the extent of the reward must be commensurate with the associated risk. Historically, equity investment activity has contributed between 5 and 27 percent of consolidated income based upon two percent or less of consolidated assets. Moreover, given the right circumstances, realized gains in the short term can be astonishing. Every successful merchant banking investment contains an exit strategy, the most common being either an initial public offering or the sale of the company. The time horizon for exit strategies in the last decade has shortened considerably and it is not unusual to see a company go from inception to public ownership in a two-year time span. Private equity investors mitigate investment risk by developing a portfolio of companies, usually in a single fund. In addition, partnerships managing the investment will manage multiple funds simultaneously and may focus on a specific industry sector in which they have a particular expertise.

SR 00-9 Supervisory Guidance

Although equity investments in nonfinancial companies can contribute substantially to a bank's profitability, the associated risks of these investments, such as market sensitivity and liquidity risks, require commensurate risk management practices. In the Federal Reserve Board's SR Letter 00-9, *Supervisory Guidance on Equity Investment and Merchant Banking Activities*[2], guidance is provided that reflects actual industry practices compiled from a number of industry and supervisory reviews of banking orga

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[1] For additional detail on the legal and regulatory authority for these investments, see SR Letter 00-9, *Supervisory Guidance on Equity Investment and Merchant Banking Activities*, at <www.federalreserve.gov/boarddocs/SRLETTERS/2000/SR0009.HTM>.

[2] See SR 00-9, *Supervisory Guidance on Equity Investment and Merchant Banking Activities*, at <www.federalreserve.gov/boarddocs/SRLETTERS/2000/SR0009.HTM>.

Subprime Lending: New Definition, New Guidelines

by Thomas H. McManus, Examiner, and Stephen J. Pipito, Analyst

What does "subprime lending" have in common with "predatory lending"? Are they the same? Are they different? What are their definitions? What are the regulatory implications of subprime lending?

This article will attempt to answer these and other questions related to subprime lending as well as give the current regulatory perspective and financial institution industry reaction to recently published regulatory guidance. This article will also expand upon articles in prior editions of *SRC Insights.*[1]

Subprime Lending Defined

Subprime lenders offer loans to lower-income borrowers with high credit risk. Because the risk is higher, the interest rate and fees are generally higher than those paid by customers with better credit records. However, the use of terms such as "lower-income" and "high credit risk" is not very objective, and has lead to differing opinions of what is really subprime lending. Fortunately, recent regulatory guidance provides an objective, updated definition of subprime lending. On January 31, 2001, the federal bank supervisory agencies issued *Interagency Guidelines on Subprime Lending*. These guidelines, issued by the Board of Governors in SR Letter 01-4, update, but do not replace, the *Interagency Guidance on Subprime Lending* originally issued in March 1999 (SR 99-06).[2]

As defined in SR 01-4, the term "subprime loan" refers to a loan to an individual borrower who displays one or more credit risk characteristics at the time of origination or purchase. Due primarily to these borrower characteristics, subprime loans have a higher risk of default than loans to prime borrowers.

The expanded guidance in SR 01-4 applies specifically to institutions that have subprime lending programs with an aggregate credit exposure greater than or equal to 25 percent of tier 1 capital. The guidelines do not apply to institutions that originate or manage subprime loans in the ordinary course of business as exceptions to prime risk selection standards.

Predatory Lending Defined

How does subprime lending differ from "predatory lending"? The term "subprime" is often misused to refer to certain predatory or abusive lending practices. Aristotelian logic dictates that all horses are animals, but not all animals are horses. Similarly, while all predatory lending is subprime lending, not all subprime lending is predatory lending. Federal Reserve Governor Edward M. Gramlich has emphasized that it is important that the distinction between the generally beneficial

Subprime Borrower Credit Risk Characteristics

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months.
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months.
- Bankruptcy in the last 5 years.
- Relatively high default probability as evidenced by a credit bureau risk score (FICO) of 660 or below (depending on the product or collateral), or other bureau or proprietary score with an equivalent default probability likelihood.
- Debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

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[1] See *SRC Insights* "SVP Commentary on Predatory Lending," by Michael E. Collins, Third Quarter 2000, and *SRC Insights* "Dispelling Misconceptions About Consumer Subprime Lending," by Randolph D. Brown, Fourth Quarter 1998.

[2] See SR 01-4, *Subprime Lending,* at <www.federalreserve.gov/boarddocs/SRLETTERS/2001/sr0104.htm> and SR 99-06, *Subprime Lending,* at <www.federalreserve.gov/boarddocs/SRLETTERS/1999/sr9906.htm>.

subprime market and destructive predatory lending be kept clear.

As noted in Michael Collins's article in the Third Quarter 2000 edition of *SRC Insights,* predatory lenders take advantage of uninformed consumers, preying on their lack of knowledge and withholding information necessary to make informed borrowing decisions. Typically, predatory lending practices involve fraud, harmful sales practices, and/or abusive or deceptive terms and conditions. Predatory lending practices appear to be designed to transfer wealth from the borrower to the lender or loan originator without a commensurate exchange of value.

The Size of the Subprime Market
The subprime market includes most consumer loan products—such as automobile, mortgage, and credit card loans—and has attracted some of the biggest names in American finance. Financial institutions are flocking to the market because they can charge higher interest rates and reap higher profit margins than what is possible with conventional loans. These lenders recognize that by using modern screening software, pricing according to risk, and laying off exposure through securitization, they can use their vast marketing and distribution channels to enlarge the subprime market even further.

Financial institutions are flocking to the subprime market because they can charge higher interest rates and reap higher profit margins.

Despite 1.2 million consumer bankruptcies in 2000 and a tempestuous secondary market for subprime loans, the subprime lending sector has been in a long-term growth phase. In a March 23, 2001 speech, Governor Gramlich noted that much of the increase in subprime lending could be attributed to the development of the subprime mortgage market. According to Home Mortgage Disclosure Act (HMDA) data, the number of subprime home equity loans grew from 66,000 in 1993 to 856,000 in 1999, while the number of subprime purchase money mortgages increased from 16,000 to 263,000. Some refer to this rapid growth of the subprime sector as the democratization of credit, as it provided credit access to consumers who had difficulty in meeting the underwriting criteria of prime lenders due to blemished credit histories or other factors.

The future of subprime lending will be determined by a multitude of factors, including the slowing economy, industry consolidation, and automation. However, while growth in the subprime market is expected to level off in 2001 and 2002, it is unlikely that this business is going away, particularly with relatively new secondary market entrants such as Fannie Mae and Freddie Mac.

Important Guidance in SR 01-4
Capital. One of the most significant elements in SR 01-4 relates to the holding of additional capital against subprime portfolios. Examiners will evaluate the capital adequacy of subprime lenders on a case-by-case basis and will consider, among other factors, the institution's documented analysis of the capital needed to support its subprime lending activities. This analysis should be comprehensive and commensurate with the size, concentration level, and relative risk of subprime lending activities. Given the higher inherent risk of subprime lending, institutions engaged in this activity should hold capital against these portfolios well above that for prime portfolios. As a starting point, examiners will expect capital held against subprime loan portfolios to be one and one-half to three times greater than what is appropriate for non-subprime assets of a similar type. However, institutions might support a lower capital level by reasoned and documented analysis of factors such as trends in the level and volatility of loss rates and the amount, quality, and liquidity of collateral securing the loans.

Risk Management. SR 01-4 makes it clear that the March 1999 *Interagency Guidelines on Subprime Lending* related to expectations for risk management standards necessary to manage and control subprime lending activities remain in effect. If examiners determine that subprime lending risk management practices are deficient, they may initiate formal or informal enforcement actions or, if the risk management practices are materially deficient, they may instruct the institution to discontinue its subprime lending program.

Loan Classification. Examiners will classify subprime loans and portfolios in accordance with the evaluation of consumer loans as governed by the

Uniform Retail Credit Classification and Account Management Policy issued by FFIEC on June 12, 2000.[3] However, as noted in SR 01-4, banks should internally classify delinquent subprime loans well before the timeframes outlined in the *Retail Credit Classification Policy* due to the heightened loss characteristics of these portfolios.

Allowance for Loan and Lease Losses (ALLL). Examiners will specifically evaluate the adequacy of the ALLL allocated to subprime lending activities, consistent with the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* issued in December 1993.[4] As noted in SR 01-4, the ALLL required for subprime loans should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, which is typically 12 months. The analysis of the ALLL for the subprime loan portfolio should be comprehensive, addressing significant factors including historical loss experience, ratio analysis, and peer group analysis among other quantitative factors, and should be well documented.

Financial Industry Comments and Reaction

The subprime lending guidelines were released to mixed reviews from the banking industry and have been rapidly attracting more critics. Many in the banking industry argue that the regulators defined subprime lending too broadly, instituted excessive capital requirements, and disguised a burdensome new regulation as nonbinding recommendations.

Some analysts believe that the regulatory guidelines for subprime lending will be burdensome, as new capital charges expose subprime lenders to significantly higher capital requirements. In addition, many believe that the credit score threshold of 660, which is higher than the threshold of 620 typically used by the industry, will cause more lenders to fall within the scope of the guidance. Others have expressed concern that two or more delinquencies is a low threshold that might be breached even by prime borrowers.

Regulatory Response

Bank regulators believe that the explosion of subprime lending requires a regulatory response, and that the capital guidelines should affect a relatively small number of high-volume subprime lenders. For example, the FDIC has estimated recently that only 150 institutions would automatically fall under the guidelines. In addition, the regulators note that the traditional capital standards were developed with traditional bank assets in mind. Subprime assets are generally substantially higher-risk assets, and higher-risk assets require higher amounts of capital.

Final Thoughts

Although subprime lending is generally associated with higher inherent risk levels, a properly managed subprime lending program can be a sound and profitable business. Because of the elevated risk levels, the quality of subprime loan pools may be prone to rapid deterioration, especially in the early stages of an economic downturn. Sound underwriting practices and effective control systems can provide the lead time necessary to react to deteriorating conditions, while sufficient capital levels and allowances for loss can mitigate the potential financial impact of subprime lending. ■

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[3] See SR 00-8, *Revised Uniform Retail Credit Classification and Account Management Policy,* at <www.federalreserve.gov/boarddocs/SRLETTERS/2000/SR0008.HTM>.

[4] See SR 93-70, *Interagency Policy Statement on the Allowance for Loan and Lease Losses,* at <www.federalreserve.gov/boarddocs/SRLETTERS/1993/SR9370.HTM>.

DID YOU HEAR?

- The Board of Governors has asked for comment on its new Regulation W, which would implement sections 23A and 23B of the Federal Reserve Act. The comment period is open until August 15, 2001. Find out more at <www.federalreserve.gov/BoardDocs/Press/BoardActs/2001/20010504/default.htm>.

- The Basel Committee has issued a paper titled *Risk Management Principles for Electronic Banking*. Find out more at <www.bis.org/publ/bcbs82.htm>.

Liquidity Management

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accompanied by downgrades in the liquidity component of the CAMELS rating at some banks. In 2000, examiners downgraded the liquidity rating of 25 of the 141 Third District commercial banks examined during the year and upgraded the liquidity rating of only six banks.

Unarguably, the increased reliance on borrowed funds to fuel loan and asset growth can increase liquidity risk at insured commercial banks as a whole, prompting the need for stronger risk management techniques. However, the profile is somewhat different for community banks, regional banks, and large banks. Changes in funding composition are most prominent at Large Banks, with assets greater than $10 billion, and Regional Banks, with assets between $1 billion and $10 billion. At these banks, nontraditional sources of funding, including FHLB advances and other borrowings, represented approximately 10 percent of assets at year-end 2000. In contrast, nontraditional funding represented less than 4 percent of assets at Community Banks (assets less than $1 billion). Of interest, however, is the fact that the ratio of nontraditional funding to assets at Large Community Banks ($100 million to $1 billion in assets) exceeds the level at Regional Banks less than a decade ago.

Our conversations with bankers over the past few years support these statistical findings. Community banks in the Third District are being challenged to attract and retain core deposits, as the lure of the bull market of the 1990s pulled consumer deposits from banks into mutual funds and brokerage accounts. Also, the continued prohibition on the payment of interest on business checking accounts pushed many business deposits to the industry's competitors or to larger institutions that could offer sweep and other cash management accounts.

In response to these pressures, many community banks turned to the Federal Home Loan Bank (FHLB) System for funding. Allan I. Mendelowitz, Chairman of the Federal Housing Finance Board, recently noted that the vast majority of FHLB members— more than 6,400 of the system's 7,777 members— are banks with less than $500 million in assets. In the Third District, as of December 31, 2000, 116 banks had aggregate outstandings of $5.9 billion with the FHLB, and an additional 39 were members with no balances. An expanding FHLB product line, the recent GLBA changes to FHLB programs allowing additional forms of collateral to secure borrowings, and other trends in retail funding suggest continuing expansion of the use of this wholesale funding source.

Many banks have continued their pressure on Congress to repeal the prohibitions on the payment of interest on business checking accounts in section 19(i) of the Federal Reserve Act (12 U.S.C. 371a) and section 18(g) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)). There have been several bills recently introduced in the House and Senate that would do just that. For example, House Bill HR 974, the *Small Business Interest Checking Act of 2001*, was referred to the Senate on April 4, 2001. HR 974 would, among other provisions, repeal the prohibition on the payment of interest on demand deposits and increase the number of permissible interaccount transfers per month.

Alternatives such FHLB borrowings and business checking accounts are considered "liability liquidity." Additional sources of liability liquidity used by some banks include purchases of fed funds, discount window borrowing, and subordinated debt issuance. The industry's use of liabilities to manage liquidity increased in the 1990s with increased access to FHLB and other capital markets.

"Asset liquidity" alternatives can also

As *SRC Insights* went to press, the federal banking regulatory agencies issued an advisory on the risks of brokered and other rate-sensitive deposits. See the May 11, 2001 press release and attached advisory at <www.federalreserve.gov/BoardDocs/Press/General/2001/20010511/default.htm>.

fund continued loan growth, but by definition rarely fund total asset growth. Maintaining a liquid investment portfolio, and reducing it as needed, is one asset liquidity alternative used by many banks in the early stages of loan growth. The securitization and sale of loans, even by community banks, has become increasingly commonplace as secondary markets for these products continue to evolve.

Liquidity management through both liability and asset transactions changes a bank's liquidity risk profile. As defined by banking regulators, liquidity risk represents the potential that a bank will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding. This is referred to as "funding-liquidity risk." Liquidity risk also encompasses the potential that the bank cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions. This is referred to as "market-liquidity risk."

Liquidity management through asset transactions generally does not increase the size of the balance sheet, but it could significantly change its structure. As a bank shifts its assets from lower risk, less rate sensitive investments to higher risk and possibly more rate sensitive loans, it assumes not only additional liquidity risk, but might also assume additional credit risk and interest rate risk. Under the proposed revisions to the Basel Capital Accord, these transactions might also place additional pressure on a bank's risk-based capital.

Liquidity management through liability transactions has its own risks. When a bank takes on nontraditional liabilities to fund asset growth, it may face higher funding costs. In response, the bank might accept lower interest margins or it might assume additional credit risk or market risk in its attempts to minimize pressure on the net interest margin by acquiring higher yielding and/or longer maturity assets.

A bank also must remain vigilant to ensure that it appropriately manages its funding and investing maturities. For example, a one-year wholesale CD and a one-year renewable loan both arguably reprice in one year, and might be considered matched funding. However, changes in the bank's risk profile might significantly affect the likelihood that the wholesale CD will remain after maturity, while the bank might find it more difficult to deny renewal of the loan. The use of the Internet to solicit deposits might exacerbate liability volatility, as the availability of nationwide competitive pricing at maturity increases the probability that the deposit might not be renewed.

Nontraditional liabilities might also be more complex than traditional funding sources, and might include embedded options or prepayment penalties. If not prudently managed, complex liabilities might significantly increase a bank's sensitivity to market and liquidity risks. In addition, an ill-conceived liability liquidity strategy and its accompanying balance sheet growth might place pressure on a bank's capital ratios.

Because of the risks of imprudent liquidity strategies, the federal banking regulators are concerned with the trend toward higher reliance on nontraditional funding sources. In a December 5, 2000 speech at the America's Community Bankers Conference in New York, Federal Reserve Chairman Greenspan remarked on the growing dependence on wholesale funding at both large and small financial institutions. He noted:

"Although day-to-day decisions about wholesale versus retail funding may appear immaterial at the time, the effect of such decisions may gradually transform the overall liquidity and risk profile of an institution. It is crucial, therefore, that bank managers take stock of how their balance sheets have evolved—including the widening menu of choices available to customers on both sides of that balance sheet—and understand the accompanying implications."

The Board of Governors recently issued SR 01-8, *Supervisory Guidance on Complex Wholesale Borrowings.** This SR letter provides guidance on how examiners will assess banks with material amounts of wholesale borrowings. Additional examination procedures at these institutions might include:

- A review of borrowing contracts for embedded options or other features that may affect the bank's liquidity and sensitivity to market risks.

* See SR 01-8, *Supervisory Guidance on Complex Wholesale Borrowings*, at <www.federalreserve.gov/boarddocs/SRLETTERS/2001/sr0108.htm>.

- An assessment of the bank's management processes for identifying and monitoring the risks of the various terms of each borrowing contract, including penalties and option features over the expected life of the contract.

- An evaluation of management processes for controlling risks, including interest rate risks arising from the borrowings, as well as liquidity risks.

- A determination as to whether the asset/liability management committee or board of directors is fully informed of the risks and ramifications of complex wholesale borrowing agreements before engaging in the transactions as well as on an ongoing basis.

- A determination as to whether funding strategies regarding wholesale borrowings, especially those with optionality, are consistent with both the portfolio objectives of the bank and the level of sophistication of the bank's risk management.

New products, advances in technology and financial management, embedded options, changing customer value propositions, increased reliance on market discipline and disclosure, and expanding international markets will all play a role in effective liquidity management. Bankers should continually assess the cumulative affect of these trends on their ability to manage risk in the banking and financial services sector through all economic cycles. ■

Primer on Equity Investment and Merchant Banking Activities

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nizations engaged in equity investment activities.

Broadly, the supervisory guidance in SR 00-9 espouses a risk management framework for these activities that requires active oversight by the board of directors and senior management, appropriate management of the investment process, and adequate internal controls.

Management of Investment Process
The board of directors must approve portfolio objectives, investment strategies, and policies and limits that are consistent with their risk tolerance level. Portfolio objectives and investment strategies need to clearly articulate the types and amounts of investments, expected business returns, desired holding periods (i.e., guidelines for divestiture of an under-performing investment), and diversification parameters available to senior management. All objectives, strategies, and policies should be documented so that the board can actively monitor the performance of equity investments against these requirements.

Investment Analysis and Appropriateness. In order to maintain an appropriate investment management process, an institution must develop

Sound Investment and Risk Management Practices for Equity Investment and Merchant Banking Activities

Active Oversight by the Board of Directors and Senior Management

Appropriate Management of the Investment Process
- Policies and Limits
- Investment Procedures
  - Investment analysis and approvals
  - Investment risk ratings
  - Periodic reviews
  - Valuation and accounting guidance
  - Exit strategies and investment disposition
  - Capital adequacy

Adequate Internal Controls
- Documentation
- Legal Compliance
- Compensation

specific procedures requiring a thorough assessment of the appropriateness of all investment opportunities in the portfolio. Through a formal approval process for equity investments, a detailed explanation of an investment's suitability should include information on management fees, capital commitments by general partners, wind-down provisions, and performance benchmark/return calculation methodologies, to name a few.

Investment Risk Ratings and Periodic Reviews. As institutions begin to acquire equity investments, management must develop an internal risk rating system and assign each investment a rating. These ratings should be based on many factors, including the nature of the company, management strengths and weaknesses, industry dynamics, financial condition, and expected exit strategies. When assigning a risk rating to an investment, other factors such as the history of the investment, commitment amounts, current actual percentage of ownership in the company on both a diluted and undiluted basis, and rating change triggers need to be reviewed for appropriateness.

Once investment decisions have been made, management should conduct periodic portfolio investment reviews to identify problems in a timely manner. Typical issues requiring management's prompt attention might include poorly performing investments or illiquid investments held in portfolio for a considerable length of time. At a minimum, institutions' periodic reviews must consider the best case, worst case, and probable case assessments of investment performance due to the uncertainties in private equity investing.

Valuation and Accounting Guidance. Valuation and accounting methods used for equity investments can significantly affect a merchant bank's bottom line. It is imperative that management clearly articulates methods for valuing investments. For example, two commonly used valuation methods in the venture capital industry are comparable companies and multiple scenarios. The simplest valuation method requires taking the market valuation of a similar company and transposing its value to another company. However, this method is often not available to investors because target companies are privately held and do not have independent price quotes or meaningful liquidity to arrive at an accurate market valuation. Because of these shortcomings, industry multiples based on revenue and earnings are typically used in the valuation process.

Valuations of companies in an early stage of development are more likely to be based on revenue, and valuations for companies in later stages of development are more likely to be based on earnings and cash flow. These multiples are influenced by the attractiveness of the market in which the company operates, competition among other investors to be part of this financing, the stage of the company's development, and how other relevant or comparable public companies are valued.[3]

Accounting methods for equity investments must adhere to generally accepted accounting principles (GAAP). Under GAAP, equity investments held by investment companies or broker/dealers or maintained in the trading account are reported at fair value, with any unrealized appreciation or depreciation included in earnings and flowing to Tier 1 capital. For some holdings, fair value may reflect adjustments for liquidity and other factors. Equity investments not held by investment companies or broker/dealers or in the trading account that have a readily determinable fair value (quoted market price) are generally reported as available for sale (AFS). These investments are marked-to-market, with unrealized appreciation or depreciation recognized in GAAP-defined "comprehensive income" but not in earnings. Appreciation or depreciation then flows to equity and, for regulatory capital purposes, depreciation is included in Tier 1 capital. Equity investments without readily determinable fair values gen

Institutions' periodic reviews of private equity investments must consider the best case, worst case, and probable case assessments.

[3] "Selecting and Structuring Investments: The Venture Capitalist's Perspective," *Readings in Venture Capital,* Association for Investment Management and Research, 1996.

erally are held at cost, subject to write-downs for value impairments.

Exit Strategies and Investment Disposition. An institution's assumptions regarding exit strategies and potential investment disposition alternatives can significantly affect the valuation of the investment. Management should periodically review investment exit strategies with particular focus on larger or less liquid investments. The disposition of investments should be outlined in policies and procedures that govern the sale, exchange, transfer, or other disposition of the institution's investments.

Capital Treatment for Equity Investment Activities. Management in banking organizations that conduct material equity investment activities must develop an internal methodology for allocating economic capital based on the risk inherent in the activities. The amount and percentage of capital that is dedicated to this business line should be appropriate to the size and complexity of the activities, and the financial condition of the banking organization.

Under current rules, merchant banking investments cannot exceed 30 percent of FHC tier 1 capital without prior approval. However, in January 2001, the federal banking agencies released proposed capital rules that would impose a sliding capital charge based on the percentage of FHC assets in merchant banking investments.[4] The comment period for the proposed capital rules closed in mid-April 2001. Institutions conducting merchant banking activities should monitor their federal banking agency's web site for the issuance of final rules.

Internal Controls

As with any risk management process, internal controls play an important role. Appropriate internal controls ensure adherence to policies and procedures, with an emphasis placed on the integrity and adequacy of investment valuations. Documented risk identification, regulatory compliance, and management reporting also strengthen the process.

Documented risk identification is the cornerstone of a prudent private equity investment internal control system.

Documented risk identification—including documented initial due diligence, approval reviews, valuations, and dispositions—is the cornerstone of a prudent private equity investment internal control system. Periodic independent reviews of investment process and valuation methodologies by internal auditors or independent outside parties also validate risk identification controls. In addition, the ability to ensure compliance with all federal laws and regulations applicable to equity investment activities further supports the control environment. Finally, compensation agreements, such as co-investment arrangements, can provide a strong incentive to management for controlling risk in a private equity investment business line.

Final Thoughts

Before a financial holding company decides to engage in private equity and merchant banking activities, management must evaluate whether or not it has appropriate expertise to engage in these activities. After critically evaluating its capabilities, management must ensure that appropriate risk management infrastructure and capital allocations are in place. Even after taking all these precautions, management should be able to accept that a significant amount of unprofitable investments might occur before they obtain investments that yield significant returns.

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[4] A copy of the press release and attachment announcing the request for comment on the proposed new rules governing the regulatory capital treatment for equity investments in nonfinancial companies held by banks, bank holding companies and financial holding companies can be found on the Board of Governor's web site at <www.federalreserve.gov/boarddocs/press/boardacts/2001/20010118/default.htm>.

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