TRENDS

IN FINANCIAL MANAGEMENT

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When Ties to Banks Cut Too Close

➤ **FINANCIAL PROFESSIONALS SAY** that since laws separating commercial and investment banks were lifted nearly five years ago, commercial banks increasingly have been forcing corporate customers to buy investment banking services in exchange for loans, a new survey shows.

The survey by the Association for Financial Professionals (AFP) of 370 corporate financial officers released in June 2004 revealed what regulators have said was missing: empirical evidence from commercial buyers of financial services that the sometimes-illegal practice of "tying" is widespread and growing. Tying refers to conditioning the availability or terms of loans or other credit products on the purchase of certain other products and services.

The survey shows 53% of respondents from "large" companies with at least $1 billion in revenue, and 42% from all companies surveyed including those in the middle market, indicate that in the last five years a commercial bank explicitly told them they were denied credit or had credit terms changed because they didn't buy investment banking or strategic advisory services from that bank.

Want a bank loan? You'll need to buy investment banking, too.

The respondents said that continuing consolidation of commercial banks will lead to decreased credit availability, higher-priced bank credit, higher prices for cash management services, and greater negotiating power for commercial banks.

The relentless banking merger wave of the past two decades has concentrated much of the nation's lending capabilities in a few huge commercial banks, including Citigroup Inc., J.P. Morgan Chase & Co., and Bank of America Corp. In underwriting stock, those three banks' market share rose to 22% in 2003, up from 12% in 2000, according to research from Thomson Financial.

What constitutes illegal tying isn't entirely clear. Explicit quid pro quo arrangements that condition loans on buying other services are considered "tying" and have been illegal since Congress passed the Bank Holding Company Act Amendments (BHCA) in 1970. Generally, section 106 of the BHCA prohibits banks from extending credit, furnishing any product or service, or varying the price of any product or service on the "condition or requirement" that the customer obtain some additional product or service from the bank or its affiliate.

But tying can take subtler forms

that aren't necessarily illegal. The BHCA does permit banks to tie credit and traditional banking products, such as cash management, and doesn't prohibit banks from telling corporate customers that the relationship can't be sustained with only marginally profitable loans. Critics say tying can be anticompetitive, allowing banks to use their dominance of lines of credit to force corporate customers to buy additional services for which they otherwise could get a better deal elsewhere.

Banks contend that corporate borrowers often initiate tying arrangements, telling banks that they won't get other business unless they make commercial credit readily available. They complain that federal banking laws and regulatory policies pull them in opposite directions. On one hand, the law doesn't prohibit banks from bundling services, and regulators have encouraged banks to diversify into related businesses for greater profitability and stability of the financial sector. On the other hand, the BHCA bars banks from lending on the condition that the borrower buy other products as well.

Banking regulators from the Federal Reserve and the Office of the Comptroller of the Currency (OCC), as well as the Government Accountability Office (GAO) (formerly the General Accounting Office)—the investigative arm of Congress—have been studying the issue of tying and are at odds.

In August 2003, the Federal Reserve issued a proposed interpretation of what would and wouldn't constitute illegal tying. The following month, the OCC concluded there was no empirical evidence of illegal tying activity. The GAO also found little evidence of widespread illegal tying, but it said that the nature of banking negotiations made "documentary evidence" very difficult to find. It reported that neither the Fed nor the OCC reviewed individual transactions or interviewed customers about possible tying activities.

The AFP study would seem to fill that gap.

The Federal Reserve's proposed interpretation said it's acceptable for banks to require corporate customers to generate a set amount of banking fees as long as the company has a "meaningful option" of spending that money only on "traditional bank products." But half of the survey respondents said they couldn't meet those spending requirements without awarding underwriting or strategic advisory services. So the bank's requirements could effectively force companies to buy both commercial and investment banking services, which could be construed as illegal tying.

Similarly, the Fed interpretation said banks can't bar their customers from using their competitors. Yet 21% of all companies and 28% of companies with revenues over $1 billion in the AFP survey said banks have threatened to terminate their credit relationship if the companies were to use a competitor's underwriting services.

The Fed has also said that making a corporate loan contingent on a company's commitment to hire the bank's investment banking unit to underwrite a bond offering, for example, would violate antitying laws. Yet 20% of those surveyed said they had been explicitly required to do just that in the last five years.

Meanwhile, the U.S. Department of Justice has weighed in on the issue, saying that tying can be good because it allows large and savvy borrowers to make banks compete more by buying only the best package deal. In a November 2003 letter to a Federal Reserve official, U.S. Assistant Attorney General R. Hewitt Pate wrote: "Borrowers in [the syndicated lending] market are large corporations with well-trained and sophisticated staff fully capable of negotiating favorable terms." He continued: "We see no evidence that large borrowers such as syndicated loan borrowers need additional assistance beyond the antitrust laws to protect themselves from anticompetitive tying."

But the AFP survey showed that it's large companies who are more likely to be subject to tying because their size and complex credit needs give them fewer options for commercial credit. ■

Answer to puzzle on p. 64.

A	R	R	O	W	S				S	A	R	S
R	E	S	U	P	P	L	Y		P	L	E	O
I	B	E	T		F	O	E		E	V	I	L
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N	E	A	S				A	D	I	D	A	S