

## BANKING

## Banking's Not-So-Secret Weapon

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The smiles were frozen on the faces of everyone in the office, and an uneasy silence had set in. A visiting group of bankers from a small regional institution had just slipped up. "These guys had extended some credit to us and were expecting to get into a bond-underwriting deal, but we had changed our mind," recalls the chief financial officer of the energy company that was hosting the bankers. "They said to me, 'We don't extend credit to people we don't get capital markets business from.' I paused and said, 'Isn't that against the law?' Everyone kind of stopped. Then they quickly backtracked and said, 'No, what we're saying is, We don't call on people for capital markets business unless we're lending them money.' Everyone in the room started to laugh," says the CFO, who asked to remain anonymous. "You know-that uncomfortable sort of laugh."

Banks just keep landing in the headlines these days, and the news never seems to be good. This week's scandal? Allegations of tying, an illegal practice in which a bank agrees to lend a corporation money only if the client promises to throw the bank some lucrative fee-generating business, such as equity underwriting or advising on an acquisition. Amid growing public concern about the practice, several members of Congress, including Representative John D. Dingell of Michigan, have called for an investigation.

Though it's been illegal for over three decades, tying has become a hot topic in the past few years because of the rise of so-called universal banks. These giants were formed in the late 1990s with the erosion of the Glass-Steagall Act and its eventual repeal, which allowed lending and cash-management services-the purviews of commercial banks-to exist under the same roof as stock and bond underwriting, the realm of investment banks and brokerage houses. A host of quickie weddings anticipated the 1999 revocation of the act. Citibank paired up with brokerage firm Salomon Smith Barney to form Citigroup, the nation's largest financial institution. Chase Manhattan Bank (already a behemoth after three bank mergers) nabbed tony investment bank J.P. Morgan. Global marriages yielded UBS Warburg, Credit Suisse First Boston, and Deutsche Bank.

The commercial banks were eager to go to the altar because their bread-and-butter business-lending money-had become a lousy one. Competition from Japanese and European banks had turned loans into commodities with the slenderest of profit margins. Compounding the pain, the risks had become enormous if the economy headed south-as it eventually did; if a few big customers went bust, a bank could lose billions. Investment banks, on the other hand, earn sky-high margins and don't put nearly the same amount of capital on the line. Not surprisingly, banks eagerly looked to convert many of their lending customers into high-fee investment-banking clients. In some areas the banks were extremely successful. In a few short years a number of universal banks jumped up several spots in the league tables for underwriting investment-grade bonds, a Wall Street measure of market share (see below).

Trouble is, banks have sometimes trodden close to the line of illegal tying in their quest to win new fees from their customers. Banking has always been a relationship business. This used to mean that your banker knew the names of your kids or occasionally treated you to a round of golf. These days banking relationships mean "I'll scratch your back if you scratch mine." Corporate officers say their bankers freely talk about how the relationship can be "win-win" or "profitable" for both parties. The implication is that banks won't lend to companies that don't buy other services. "The banks say it's tough for them to give loans to people they don't have 'relationships' with or get other business from," says Steven McNeal, treasurer at energy firm Entergy. "I wouldn't say it's a direct tie. But I don't need to be slammed in the face with a brick to understand what they want."

Are they tying illegally? The banks vehemently deny they are using loans to extort other revenues from their clients. Instead, they say they are cross-selling. They're offering their lending clients an extensive range of services, including foreign exchange, cash and pension fund management, and high-yield bond underwriting. At the same time, though, the banks complain that the laws are unfair. They are the only ones that can't legally tie. Investment firms Goldman Sachs and Lehman Brothers can tie all they want.

There's no question that the banks want high-fee business too, and they're pretty explicit about their desires. At an analysts' conference in late 2000, a Bank of America executive said the bank would drop customers that weren't meeting profit goals. The bank followed through on the threat when it turned down a request by Wal-Mart last summer to arrange a \$2.25 billion credit line. Bank of America had led these deals for the retail giant since 1995, but now reportedly felt that it wasn't earning enough in fees from other business. After Representative Dingell sent a letter in August to regulators about tying, Bank of America CEO Kenneth D. Lewis explained how he approaches his customers: "Specifically, what we say is that we take the relationship profitability-wise to the CFO and say, 'We need to find some way, if you want us to continue to be one of your lead banks, to raise this level of profitability.'"

Some corporate executives are charging, however, that the banks can cross the line in trying to drum up fees. Earlier this year the CEO of a FORTUNE 500 company was infuriated when the bank providing a bridge loan for an acquisition told him that unless the bank was named as a co-advisor on the merger, it would withdraw from the financing deal. "The cost to me to pay bribery to an alleged investment banker who didn't provide any service is frankly minimal," says the CEO, who didn't want his name revealed. "But I shouldn't have to worry about this stuff. They didn't do anything on the deal, but they wanted part of the fee, and they wanted their name on the league tables." The bank was made a co-lead on the deal.

Banks argue that without more fees their customers might be left without lenders. While investment banks that underwrite a stock issue can earn fees equal to 7% of the size of the deal, commercial banks may earn as little as 0.1% for extending a line of credit. Banks say that such minuscule returns won't let them maintain a base of services that let clients transfer cash to Thailand at three in the morning, exchange euros for dollars, sell convertible bonds to mutual funds, or create complex financial structures that smooth out corporate cash flows.

In any event, say the banks, customers love the dual relationship. By acting as lender and underwriter, banks can better understand how a secondary stock offering or an acquisition will affect critical ratios and covenants in loan agreements. And because banks conduct huge amounts of due diligence before making a loan, they can jump in quickly if a corporation wants to have, say, a last-minute junk-bond offering.

Some customers, in fact, agree. "We look for speed, execution, and global capabilities from our banks," says Brian Anderson, the CFO of medical equipment maker Baxter International. "That commands and deserves a slightly higher rate of return." And in an interview just a few weeks before allegations of accounting fraud emerged at WorldCom, CFO Scott Sullivan told FORTUNE that he liked J.P. Morgan for its one-stop shopping. "I've told people here at WorldCom that J.P. Morgan is a great example of the full-service model. The coverage teams at J.P. Morgan-the way they sell and market their service-they really know how to bundle." J.P. Morgan Chase and Citigroup were two of WorldCom's biggest lenders, which some say helped them land the lead role in WorldCom's \$12 billion bond offering last year.

Other customers have even managed to turn the tables on the banks. Ford has said it will not give other fee-related services to institutions that don't lend it money. And this year International Paper began requiring any bank that wanted other fees to provide credit to the firm. "The commercial banks can do [bond underwriting] as well as Goldman Sachs, Morgan Stanley, and Lehman Brothers," says Rosemarie Loffredo, the company's assistant treasurer. "But we want those investment banks to demonstrate that they are committed to International Paper in a way that at the end of the day will keep the lights on."

The incursion by Chase and Citi into the underwriting market has terrified Wall Street's independent investment banks. In the years since deregulation, they have lost market share in several key businesses they used to own. Take investment-grade bond underwriting. In 1997 the top three underwriters were Merrill Lynch, Goldman Sachs, and Morgan Stanley. Today Citigroup and J.P. Morgan Chase are the top two. Bank of America more than quadrupled its market share and jumped from the tenth spot to No. 4.

The way investment bankers see it, the universal banks are using their oligopoly in the lending market to win bond-underwriting fees; indeed, the nation's three largest banks-Citigroup, J.P. Morgan Chase, and Bank of America-control 70% of syndicated loans. "No one takes this sort of leap in market share on 'execution' or improved 'distribution,'" remarks an investment banker. "No one."

The universal banks aren't stopping at simple bond deals either. Last year J.P. Morgan Chase nabbed one of the biggest M&A gigs when Conoco made its \$6.1 billion acquisition of Gulf Canada Resources. The loser in that deal was Morgan Stanley, which had taken Conoco public in 1998. But J.P. Morgan was Conoco's biggest lender. Other CFOs have also said that the megabanks are increasingly asking to get into higher-fee stock and M&A deals.

To stop this trend in its tracks, the banks are ramping up their own lending activities. Goldman, Lehman, and Morgan Stanley are all doling out more loans. Merrill Lynch even opened its own bank.

But the investment banks hate lending. Yes, they're legally permitted to tie. They just don't have the balance sheets for large-scale lending and fear they will be crushed if they try to compete with banks in this game. For instance, the net worth of the largest investment bank, Merrill Lynch, is \$24 billion-only one-fourth that of Citigroup. Investment banks also complain that the lending market is fixed. The big three banks can easily manipulate the price of loans, say some investment bankers, and they are artificially depressing prices so that rivals can't encroach on their territory or get close to their customers.

The universal banks also benefit from an accounting rule that lets them delay taking hits on loans that go sour. Banks of all stripes often take the loans they

have made to corporations, cut them up into parcels, and sell them to other banks and investors. Investment banks must revalue all the loans they hold every day to reflect current market value, also known as marking to market. But even if the borrower is the same, commercial banks don't have to mark down the value of a loan until it becomes clear that the borrower will default. Goldman complained to the Financial Accounting Standards Board last year that the rule allows banks to underprice a loan because even if the loan takes a swan dive in the market, losses won't appear in the bank's earnings until months later.

Indeed, in September, J.P. Morgan Chase announced that it was setting aside \$1.4 billion in costs for bad loans, largely to telecom companies. Yet investment banks had to take those lumps when telecom companies started running into trouble some 18 months ago. FASB has put off making a decision on the accounting issue for at least four or five years.

By then, there may no longer be any stand-alone investment banks. "We'll have to beat the banks at their own game," says an investment bank executive. "We'll either have to lend more, cut our margins, and increase our risk, or we'll have to merge." The likely bidders? Banks, of course.

To be sure, banks haven't squeezed all the peril out of the game. Their loss-leading loans could be priced too low for the increased risks in the market, says Meredith Coffey, director of analytics at Loan Pricing Corp. The relationship game cuts both ways too. Some corporate loan officers are turned off by their bankers' strong-arm tactics and what-have-you-done-for-me-lately attitude. "We had a long-term lender walk away from us because it didn't believe it was getting enough other business," says a former investment banker who is now the CFO of a midsized firm. "The next time there is another big opportunity for higher-fee businesses from us, I don't know that I wouldn't invite them to bid for it, but I have other banks I want to make happy first."

Other corporate customers bridle at using their lender for investment-banking services because they fear they will be vulnerable to conflicts of interest. Should your lender be the same guy advising you on a takeover? What if you promised part of an upcoming stock offering to a bank, but the bank's analyst just downgraded your stock? Some CFOs simply want to spread their business around, just as manufacturers don't want to rely on one supplier. "I have to have multiple bank relationships for a company our size," says Hank Wolf, the CFO of railway Norfolk Southern. "It's the only way to ensure our liquidity and the availability of capital."

Still, the big universal banks have crucial advantages that brokerage houses will never enjoy, and some critics say that in return they ought to do their job-making loans. Commercial banks can draw on a huge pool of insured deposits and can borrow from the Federal Reserve's discount window. Banks that lend solely to customers they believe will be more profitable are shirking their social and economic responsibilities, argues Paul McCulley, managing director and head of the short-term desk at investment firm Pimco. "Banks may not like ... a separation between commercial banking and investment banking," says McCulley. "But are they willing to give up some of the privileges they have as banks? With these privileges comes the responsibility to be countercyclical in their lending practices. I don't know why they've gotten away with this."

One reason is that it's almost impossible to stop them from tying. The primary anti-tying law, which dates back to the Bank Holding Company Act of 1970, is maddeningly vague and hard to enforce. No bank would be dumb enough to put these quid pro quo arrangements in writing, so smoking guns don't exist. And the law has ample loopholes. Banks can legally demand other purchases in exchange for a loan if they make the loan through a nonbank affiliate, such as

Citigroup's Salomon Smith Barney. "There's tying and there's tying," says Bob Tortoriello, a lawyer at Cleary Gottlieb Steen & Hamilton, who has represented Citigroup on various issues. "Is the line always crystal clear? Of course not. And that's what the problem is."

So is anything going to be done about the practice? In fact, despite the clamor from Congress, this is one subject banking regulators would just as soon stay away from. In their response to the letter from Representative Dingell, federal regulators did agree to do a new study on tying. When agencies last investigated tying in 1997, says an insider at the Office of the Comptroller of the Currency (OCC), the study found no evidence of wrongdoing-but it was conducted by "talking to the banks" and sending in examiners. No CFOs were interviewed.

Regulators don't feel a need to poll corporate executives this time either. "Banks still have to lend money, and there are lots of banks competing for business," says the OCC insider. "As for reports of arm twisting, aren't there other banks to go to?"

When that question was posed to the CEO who felt coerced into giving his bank M&A fees for a deal it didn't do, he was aghast. "I'm the CEO of a FORTUNE 500 company. Where am I supposed to go to get money? SunTrust Bank? Is GM supposed to go to Union Savings Bank?" Good question.

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